HM Treasury

Review of enforcement decision-making at the financial services regulators:

final report

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1 Introduction

1.1 To ensure the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) continue to make fair, transparent, timely, and efficient enforcement decisions, on 6 May 2014, the Chancellor of the Exchequer announced a HM Treasury review of the relevant institutional arrangements and processes of both institutions. This report sets out the review's findings and recommendations.

Background

1.2 This review sits alongside the significant steps that the government has already taken to improve standards in banking and financial services, including by replacing the tripartite system, and creating the new regulators, the FCA and PRA.

1.3 The new regulators have already delivered strong enforcement action, and will continue to do so. In the last financial year, the FCA imposed fines totalling £425 million.[1] By October of this year, £450 million had been paid under an FCA redress scheme to consumers who were mis-sold card and identity protection policies.[2] In November, the FCA took action in response to attempted manipulation of the FX market, so far fining 5 banks £1.1 billion, with potentially criminal misconduct by individuals being investigated by the Serious Fraud Office.[3]

1.4 Payday lender Wonga has recently agreed to pay £2.6 million in redress and write off over £200 million of loans, following intervention by the FCA.[4] Most recently, the FCA and PRA have imposed combined fines of £56 million following an investigation into IT system failings at RBS, Natwest and Ulster Bank which left customers without access to their funds.[5]

1.5 The government has continued to take action to restore trust and credibility in financial markets, including by implementing the conclusions of the Parliamentary Commission on Banking Standards (PCBS), and setting up – with the Bank of England and the FCA – the fair and effective markets review,[6] to identify what further action may be required.

Conclusions of this review

1.6 The recommendations of this review will continue to strengthen accountability in the financial services industry. Effective, proportionate and robust enforcement action delivers credible deterrence, so that wrongdoers believe they will be held to account and that meaningful sanctions will follow. This helps to protect consumers, enhance the integrity of UK markets, and increase the stability of our financial system.

1.7 This review has focused on ensuring the transparency, fairness, effectiveness and speed of enforcement decision-making at the financial regulators. Consultation respondents generally focused on FCA processes, consistent with the number of concluded FCA enforcement cases, as compared to PRA cases. Respondents expressed a reasonable level of satisfaction with current decision-making processes and arrangements. Nevertheless, a range of improvements were

[1] In the financial year 2008/2009, the Financial Services Authority ('FSA') imposed what was then a record £27 million in financial penalties.

[2] http://www.fca.org.uk/news/compensation-for-card-and-identity-protection-policyholders

[3] http://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings, http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2014/forex-investigation.aspx

[4] http://www.fca.org.uk/news/wonga-major-changes-to-affordability-criteria

[5] http://www.fca.org.uk/news/fca-fines-rbs-natwest-and-ulster-bank-ltd-42m-for-it-failures, http://www.bankofengland.co.uk/publications/Pages/news/2014/152.aspx

[6] https://www.gov.uk/government/publications/fair-and-effective-markets-review-terms-of-reference/fair-and-effective-financial-markets-review-terms-of-reference

suggested, focusing primarily on the referral and settlement decision-making stages. The government's recommendations reflect many of the points made during consultation.

1.8 Recommendations are made across the full life cycle of an enforcement case. They cover decision-making around the referral of cases for investigation, the investigation period, settlement negotiations, and dealing with contested cases. Taken together, the recommendations will ensure that the regulators continue to: focus on the right enforcement cases; investigate and deal with cases more efficiently, thus enhancing their enforcement capacity; co-operate effectively during investigations; and scrutinise cases objectively, to promote confidence in case decision-making. The government looks forward to the regulators setting out further detail on how these recommendations will be taken forward in due course.

Key themes of this review

Changing culture - taking the right action

1.9 When firms break the rules, the regulators must act to make sure that they change the way they do business. Holding firms to account by taking tough enforcement action, and so sending a strong deterrent to others, will often be the only appropriate response. But sometimes, prompt, robust supervisory action – stopping firms doing business while they fix problems, or requiring them to quickly pay redress to consumers – will be the better immediate course.

1.10 The government's recommendations will ensure senior consideration of the full range of regulatory options, a focus on identifying and implementing the right regulatory response and consistency of referral decision-making. Increased reporting of the regulators' supervisory interventions will help to change behaviour right across the industry.

1.11 It is critical that meaningful and proportionate sanctions continue to be applied by the regulators. The FCA will commence a review of its penalty setting framework – having regard to the recommendations of the PCBS in relation to penalties[7] – in early 2015.

Leaving no gaps - maintaining effective co-ordination between the FCA and PRA

1.12 Effective co-ordination is essential, but is challenging to measure from an external perspective. The government therefore recommends that information is published about FCA/PRA co-operation. The regulators should also publish information about their approach to joint investigations, and about how they will deal with contested cases in which they both seek to take enforcement action. Taken together, these recommendations will promote effective co-ordination and increase transparency.

Improving the process, enhancing capacity

1.13 Lengthy investigations tie up the regulators' capacity to pursue other enforcement cases, and so undermine credible deterrence. The government's recommendations seek to ensure that investigations can be completed in a fair but timely way, freeing up teams to tackle a wider range of cases.

1.14 This review recommends that the regulators provide more information, more often to the subjects of investigations. That includes more information at the point of referral for investigation, regular periodic updates during investigations and the regulators setting out their findings earlier. The outcome will be increased efficiency through greater discipline, and a faster understanding for all participants in the case, leading to a better prospect of early resolution.

[7] '*Changing banking for good*', Report of the PCBS at paragraph 1132-33

More senior representation, from both sides, is also recommended, as are steps to promote more constructive engagement.

1.15 Alongside this, firms and individuals should be expected and encouraged to admit wrong-doing at an early stage. And discounted financial penalties should only usually be available within the initial settlement window.

1.16 The government also recommends that the regulators' contested case decision-makers regularly review the regulators' processes in settled cases, and speak with firms and individuals who settle those cases, and the relevant enforcement staff. They should identify process lessons and make general, public recommendations.

A system which is fair for all

1.17 Firms and individuals must have confidence that they can challenge the findings of the regulators before objective and independent decision-makers. The government has concluded that an executive-led model may not offer the perception of independence and objectivity required for contested decision-making. This review therefore recommends that the PRA establish an independent contested case decision making committee.

1.18 But the government also recognises that some of those who are subject to enforcement action may prefer to challenge the regulators in a tribunal environment, where they can call evidence and cross-examine witnesses, rather than engaging with the regulators' decision-making procedures for contested cases. And so this review recommends that the regulators put in place a new, clearly signposted, expedited process to permit this.

1.19 Finally, the government recommends strengthening the accountability and efficiency of FCA and PRA decision-makers in contested cases, through a review and public reporting function. If the Treasury Select Committee (TSC) wishes, it should hold pre-commencement hearings for the chairs of the regulators' decision-makers.

Review approach

1.20 Recommendations made in respect of FCA processes, on which respondents to consultation focused, will generally apply to those of the PRA. This review, and the government's recommendations, focus on regulatory enforcement cases, and especially disciplinary cases, consistent with the terms of reference set out in the call for evidence.[8] Whilst certain recommendations will apply also to regulatory market abuse investigations, they will be less relevant to criminal investigations and civil litigation conducted by the regulators, for example, in relation to criminal insider dealing or unauthorised business.

[8] https://www.gov.uk/government/consultations/review-of-enforcement-decision-making-at-the-financial-services-regulators-call-for-evidence

2 Referral decision-making

Introduction

2.1 The success of the FCA's 'credible deterrence' approach depends upon it showing that meaningful, proportionate enforcement action will be taken across a wide range of markets, firms and individuals.[1]

2.2 The PRA's scope for enforcement action is more limited, consistent with the number of firms it supervises and its statutory objectives. A focus on '*ex ante remedial action*' as its primary regulatory tool is important in the PRA context of prudential supervision. Nevertheless, the PRA will take enforcement action in appropriate circumstances. [2]

2.3 Enforcement investigations are expensive and resource intensive.[3] Deciding which cases are selected for investigation, and where limited resources are best deployed to achieve that coverage, is critical to protecting the interests of consumers and the integrity of markets. It is imperative that the regulators make the right decisions about which cases to pursue.

2.4 Investigations are onerous for firms and individuals, and can result in significant and damaging consequences. Consultation has suggested that a key issue is a sense of arbitrariness or unfairness on the part of subjects about case selection decisions by the FCA.[4] That perception is to some extent inevitable; it would be surprising if firms or individuals chose to commend the decisions which led to their investigation. And subjects of investigations are heavily focused on the features of their own cases. They do not appreciate the wider landscape; for example, the problems that supervisors might repeatedly identify in certain areas, which can dictate priorities and require public reinforcement of the regulatory requirements to prevent consumer harm or protect market integrity.

2.5 The government has considered how best to ensure that the regulators' arrangements permit the right case selection decisions to be made. The recommendations in this chapter are intended to optimise the use of enforcement to safeguard consumers and markets, and to provide assurance to subjects, as far as possible, that the wide discretion afforded to the regulators is exercised appropriately.

The purposes of enforcement

2.6 The purposes of enforcement action are numerous. Where misconduct has occurred, those responsible should be held to account, and meaningful, proportionate penalties should be applied. Wrongdoers should also be deterred from repeating their behaviour, and in some circumstances, prevented from doing so by removal from the industry. Where misconduct has resulted in losses to consumers, enforcement action may be an important step towards securing redress.

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[1] It is important to note also that the FCA investigates and commits resource to a substantial number of investigations and cases involving suspected unauthorised business, which occurs outside the regulatory perimeter.

[2] For example: *"[t]he PRA deploys disciplinary powers to advance its objectives in line with its priorities. Use of enforcement powers can achieve this by changing, and promoting high standards of, behaviour among firms; sending a clear signal to a firm, and to the regulated community more widely, about the circumstances in which the PRA considers a firm's behaviour to be unacceptable; and deterring future misconduct. In this way, ex-post enforcement against one firm can help serve a wider preventative purpose."* – The Prudential Regulation Authority's approach to banking supervision, June 2014 – http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf

[3] The 2013/14 FCA Enforcement Annual Performance Account noted that the cost of regulatory cases *'can range from around £250 to over £5m'* - http://www.fca.org.uk/your-fca/documents/corporate/enforcement-annual-performance-account-13-14

[4] This is not a new issue. As the FSA Enforcement Process Review noted in 2005, *'The combination of more resources being devoted to priority areas and the application to enforcement of the FSA's risk-based approach may give rise to an external perception of unfairness or rough justice'* - http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf

2.7 But, more widely, enforcement has a general deterrence value. Unlike most supervisory interventions, enforcement usually results in a public outcome. And so another purpose of enforcement action is to serve a strong reminder to firms and individuals of what will happen if they break the rules.

2.8 From a subject's perspective, this is challenging; that action should be taken against them not only because of their misconduct and its consequences, but also because of the potential for that action to promote compliance among the wider market or industry. Yet in circumstances where there are more than 70,000 firms within the FCA's regulatory perimeter and finite regulatory resources, a strategic approach to enforcement is essential.

2.9 During consultation, respondents had different expectations about the extent to which enforcement should be used as a discretionary, strategic tool. For example, some respondents argued that, if a number of firms were suspected of similar breaches following a thematic review, fairness required all of those firms to be referred for investigation and potential enforcement action. But, plainly, concentrating a significant proportion of enforcement resource into bringing cases against all of the firms in breach of the same regulatory requirements, in a small number of priority areas, would severely limit the reach of deterrence.[5] So, the exercise of discretion is essential.

2.10 The corollary is that there should be a clear expression of the key criteria which influence the exercise of that discretion, reflective of the various purposes of enforcement action. That will enable firms and individuals to better understand the reasons for referral for investigation, and the balance between supervision and enforcement.

2.11 Most importantly, referral decision-making at the regulators must take into account the many purposes that effective and proportionate enforcement action can serve, and the wide range of potential regulatory responses available. Decisions to refer cases for investigation should be taken because investigation and potential enforcement action, rather than supervisory intervention, are considered to be the appropriate regulatory response.

Recommendation

1. **The government recommends that the FCA and PRA each publish referral criteria which explicitly consider whether an enforcement investigation, rather than an alternative regulatory response, is the right course in all of the circumstances. The FCA and PRA should also ensure that their respective referral criteria reflect the various objectives of their enforcement action, including its strategic purpose in publicly reinforcing the regulatory requirements in priority areas.**

2.12 Respondents generally considered that existing FCA referral criteria[6] reflect the key issues that should inform its decision-making. These criteria focus primarily on the impact or potential impact of misconduct, its seriousness and relevance to FCA strategic priorities and objectives.

2.13 Some respondents thought the FCA should take greater account of firms' self-reporting of their misconduct, when making decisions about whether to refer them for investigation.[7] There

[5] The FCA's approach on this point has previously been articulated by the Enforcement and Financial Crime Division (EFCD) Director, Tracey McDermott, in these terms: *'Consistency in the way that the FCA assesses which cases should be investigated by EFCD is important. The process must also be fair. However, fairness does not require that no firm is ever investigated unless every other firm meeting the same criteria has also been investigated. The decision to conduct an Enforcement investigation, rather than using a supervisory tool in a particular area is not, in the view of the FCA, fundamentally a matter which goes to the question of fairness. Rather, this is a question of how the FCA puts into practice its risk-based approach, how it uses its resources effectively and efficiently and how best to achieve credible deterrence.'* A Practitioner's Guide to Financial Services Investigations and Enforcement, 3rd Edition, Sweet and Maxwell, 2014.

[6] http://www.fca.org.uk/firms/being-regulated/enforcement/how-we-enforce-the-law/referral-criteria

[7] One respondent even argued that there should be an absolute policy against enforcement action where a firm has self-reported but has or is remediating, and has put in place effective controls to prevent a recurrence.

is a tension here, insofar as firms are in any event obliged to bring to the attention of the regulator *'anything relating to the firm of which that regulator would reasonably expect notice'*.[8]

2.14 FCA referral criteria include the firm's *'reaction to the breach'*, as a relevant factor. That appears to be appropriate; it encompasses swift reporting of the breach, but also – and arguably more importantly – the remedial action taken in response. The FCA already states that, *'there are instances where Supervision has not referred matters to Enforcement because of the firm or individual's response'*[9] and provides, on its website, anonymous examples of cases in which a firm's subsequent reaction to a breach has led the regulator to conclude that formal enforcement action is not the right regulatory response. Nevertheless, a better understanding of the regulator's approach to these decisions might be achieved by providing more information.

Recommendation

2. The FCA should provide further examples of cases in which a firm's response to a breach of the regulatory requirements has been a factor in deciding not to take enforcement action.

[8] Principle 11 of the FCA's Principles for Business - http://www.fca.org.uk/about/what/regulating/principles-for-businesses
[9] http://www.fca.org.uk/firms/being-regulated/enforcement/how-we-enforce-the-law/cooperating

Box 2.A: The supervision and enforcement interface

Striking an appropriate balance between supervisory intervention and enforcement action is a critical issue for regulators, and relies on co-ordination between the 2 functions.

The PCBS referred to the *'risk of conflicts of interest'*[10] between supervision and enforcement functions, and contemplated whether there may be merit in institutional separation, and in the creation of an enforcement organisation independent of the regulators. It was considered that a separate enforcement body, *'could help address the possibility of conflict or missed opportunities from divided responsibilities between the FCA and PRA…would have clearer objectives and accountability…[and] could address the risk of conflicts of interest with supervisors and could find it easier to initiate investigations without a referral from supervisors.'*[11]

Ultimately, however, the PCBS considered that institutional separation would prove too disruptive, in the immediate aftermath of the FCA and PRA assuming the responsibilities of the FSA. The PCBS also identified that, *'an independent enforcement body would still be reliant on supervisors for many referrals, which could result in fewer cases if there were any problems co-operating with the FCA or PRA.'*[12]

It is clear that there is the potential for tension between the enforcement and supervision functions. The most obvious source is where, an apparent breach of the regulatory requirements having emerged, supervisors consider that a referral for enforcement investigation might be justified, but might impact negatively on their objectives for the firm.

For example, suspected misconduct at a firm may be serious. But, if it pre-dates the arrival of a new senior management team which supervisors consider to be effecting significant organisational and cultural change, then, depending on the circumstances of the misconduct, a question arises as to whether enforcement action is appropriate or whether it may divert the attention of the firm's senior management and so potentially hamper its reforms, in which case a supervisory response might be preferable. That is an entirely legitimate question which must be given appropriate consideration by the regulators.

Supervisors may be more likely to view the breach within the context of their deep understanding of the firm's regulatory history and current approach to compliance. Enforcement staff may be more focused on the specifics of the misconduct and its wider impact.

In those circumstances, it is imperative that a balanced decision is taken in the round, to ensure that the regulator identifies the right regulatory response, consistent with its statutory objectives; whether that is an enforcement investigation, a supervisory response or enforcement and supervision staff working together with a firm to ensure that it takes the appropriate steps to address identified risks.

Full co-operation is therefore a pre-requisite. Issues discovered by supervisors and potentially warranting investigation must be flagged to enforcement staff in the first instance. And once enforcement staff have begun an investigation, supervisory input is critical to assisting enforcement staff's understanding of a firm's business and relevant market practice. Matters discovered by enforcement staff in the course of an investigation will often be relevant to ongoing supervision, and vice versa.

[10] '*Changing banking for good*', Report of the PCBS at paragraph 1197

[11] ibid

[12] ibid at paragraph 1198

Co-operation between the supervision and enforcement functions is likely to be imperilled by institutional separation. Distinct organisations would have different objectives and divergent priorities. It would become harder for those organisations to identify the right regulatory response to a suspected breach. The practical and legal issues arising from separation – for example, in terms of information sharing – would potentially impair the efficient, effective delivery of that response.

Internationally, it is not clear that there are any jurisdictions where the principal financial services regulators' administrative enforcement functions are institutionally separate from the supervisory function. Indeed, at some overseas regulators, the enforcement function sits within the supervisory function.

In the US, the Securities and Exchanges Commission (SEC) implemented a significant reform programme in the wake of delays in identifying the fraud perpetrated by Bernard Madoff. This was in part directed at weaknesses in communication and co-ordination, including between the SEC's enforcement and examination (akin to supervisory) functions. In evidence before a US Senate Committee, a senior SEC official commented that, *'In the Madoff matter, this lack of effective co-ordination resulted in missed opportunities, miscommunications, and a failure to share knowledge and evidence.'*[13]

But aside from the benefits of shared knowledge and evidence in individual cases, there are clear advantages to locating the supervisory and enforcement functions within the same organisation, and sharing the same priorities. Supervisors will be the first to identify behavioural trends or recurring issues, in a particular sector, which lead to risks. Those risks can then inform strategic priorities; and, potentially, addressing those risks may call for enforcement action as a public deterrent to others in the industry. Therefore, co-ordination is key, if the regulator is to respond quickly and proactively to emerging risks. Locating the supervision and enforcement functions in the same organisation, with shared, organisational priorities, optimises co-ordination, and the ability to deliver the right regulatory response.

The government's view is that inevitable tensions between the roles of supervisors and enforcement staff are best resolved where those staff are situated in the same organisation with a clear, unitary set of organisational objectives and priorities. As set out in chapter 4, there is, in fact, a good case, in appropriate instances, for closer co-operation and involvement of supervisors in enforcement investigations than may currently take place.

It is at the decision-making stage, and where there is a clear dispute between the subject and the regulator, that the importance of independent judgment, and its perception, require appropriately independent decision-makers. The issue of objective, independent decision-making is considered further at chapter 6.

Identifying the right regulatory response

2.15 Sometimes, including in cases where breaches are self-reported, misconduct will simply be so serious that there is no credible alternative to enforcement action. The point has been brought into sharp relief in recent years, for example, by action taken by the FCA in respect of attempted LIBOR and FX manipulation.

[13] http://www.sec.gov/news/testimony/2009/ts091009rk-jw.htm

2.16 But in many cases, identifying the right regulatory response is a hugely complex decision, which requires the input of experienced, senior regulators with a sophisticated understanding of all of the tools at their disposal. Those senior regulators will need to balance the merits of a supervisory response against those of an enforcement response. And as the PCBS put it, it is important to ensure that, *'the prospect of ex post enforcement action does not become a replacement for effective supervisory intervention as problems emerge'*.[14]

2.17 A supervisory response might typically include obtaining a firm's agreement to take particular steps to address an issue. This type of response, where it occurs prior to the crystallisation of risk, is referred to by the FCA as 'early intervention'.[15] It often involves supervisors and enforcement staff working together with the firm to secure the appropriate outcome, but prior to, or even without, a formal enforcement investigation being initiated. PRA supervisors and staff from the Regulatory Action Division (RAD), where the PRA's enforcement function sits, also work together in this way to address emerging risks.

Box 2.B: The supervision – enforcement toolkit

Recent FCA thematic review work around financial crime controls[16] illustrates the supervision – enforcement spectrum, and the different options in the regulatory toolkit.

The FCA looked at the controls in place at ten commercial insurance intermediaries and 21 banks, some of which had been included in similar, prior reviews. Improvements and good practice were discovered, but so were a range of weaknesses, some of which were significant.

The FCA needed to assess the right regulatory response for each of the firms involved. In addition to advising individual firms to make specific changes, the FCA used a range of more formal supervisory and enforcement tools to address failings. That resulted in 4 firms agreeing to restrict their business to mitigate the risks posed by the failings, pending the problems being fixed. However, 3 banks were required to commission independent reviews of their systems and controls to ensure that the full extent of issues are understood, and an adequate remediation programme identified and implemented. Most seriously, 2 firms were referred for enforcement investigation. The FCA is also proposing further industry-wide guidance. By publicly describing the action it is taking in respect of these firms, the FCA intends to ensure wider adherence to the regulatory requirements.

2.18 Investigation referral decisions must be taken in the round, with full awareness of current and potential investigations, and ongoing supervisory and enforcement actions, especially in priority areas. Knowledge of firms' current circumstances and their efforts to ensure regulatory compliance is also important. Unsurprisingly, that was a point that industry representatives were keen to emphasise during consultation. And it is a valid one, because the range of potential regulatory options that may be used to address an apparent regulatory breach is extensive, and a firm's reaction to that breach may be a significant factor.

2.19 A small number of respondents suggested that, where referral for investigation is under consideration, potential subjects should have a formal right to make representations prior to that decision being made. But this argument lacks force. A referral decision is ultimately a

[14] *'Changing banking for good'*, Report of the PCBS at paragraph 1186

[15] The FCA has described some of its 'early intervention' work, including: *'One of these concerned very serious deficiencies in an investment bank's systems and controls to prevent money laundering and we obtained a voluntary undertaking that the bank would not take on any new clients until we were satisfied that those issues were resolved'*, FCA annual report 2013/14 - http://www.fca.org.uk/static/documents/corporate/annual-report-13-14.pdf

[16] http://www.fca.org.uk/news/fca-finds-small-firms-need-to-manage-financial-crime-risks-more-effectively

decision to begin an investigation – the statutory threshold for which is low[17] – with a view to ascertaining whether misconduct has occurred. Representations from firms on the suspected misconduct are therefore likely to be premature. And representations on remediation efforts should not be necessary; firms should make abundantly clear to regulators what they are doing to address issues, in the course of ordinary supervisory dialogue.

Box 2.C: Referral decision-making processes at the regulators

The supervisory divisions of the FCA and PRA refer matters for investigation to their respective enforcement divisions. Cases referred by supervisors might typically concern issues identified in the course of the FCA's day to day supervision of firms, or in the course of thematic work. The Markets division of the FCA[18] also refers matters to the Enforcement and Financial Crime Division (EFCD), which come to light through its own market surveillance and supervisory activities, and via Suspicious Transaction Reports.

Within the FCA, 2 dedicated teams are primarily responsible for liaison between EFCD and the referring areas. The intention is to ensure close working relations between EFCD and Supervision and Markets, and the early identification and understanding of potential referral issues. The teams meet with managers in each area of Supervision at least every 6 weeks, in order to understand current priorities and issues, which will ultimately inform decisions about enforcement investigation referrals. Similar arrangements exist between EFCD and the Markets division.

The PRA's enforcement function, RAD, is a much smaller unit than EFCD, and there is no equivalent PRA liaison team. However, meetings take place regularly between RAD management and senior supervisors, with the aim of identifying potential referral issues at an early stage.

Referral decisions at the FCA are formally agreed between the head of the relevant supervisory department (usually the department with responsibility for supervision of the firm or the relevant thematic review) and the head of the enforcement department that would conduct the investigation. The PRA operates a similar decision-making model, whereby the head of RAD will formally agree referral decisions with the head of the relevant PRA supervisory area.

The FCA has recently revised its decision-making framework to incorporate a wider range of EFCD and Supervision or Markets senior management views at an early stage. In most cases, potential referrals will now be considered by a relevant steering group, the members of which will be a range of heads of department from the relevant areas within the supervision and enforcement divisions. That will prioritise cases for referral to enforcement, and ensure full consideration of all potential regulatory responses in each case.

Recommendations

3. To ensure that the right decisions are taken about when to begin enforcement investigations and when to use supervisory tools, the FCA and PRA referral decision-making frameworks should promote:

[17] If the FCA or PRA proposes to appoint investigators under section 97 or section 168 FSMA, there must be *'circumstances suggesting'* a breach, and if it proposes to conduct a *'general investigation'* under section 167 FSMA, there must be *'good reason for doing so'*.

[18] Note that, under current FCA restructuring plans, the market monitoring and enforcement functions will be brought together within a new Enforcement and Market Oversight division – http://www.fca.org.uk/news/fca-new-strategic-approach-to-ensure-sharper-focus-to-regulatory-challenges-ahead

- consideration of appropriate alternative regulatory responses;
- referral to enforcement only where that is considered to be the appropriate regulatory response; and
- consistency of approach to referral decision-making by each regulator.

4. The government believes that identifying the right regulatory response requires a range of expert enforcement and supervision views. The new FCA framework should improve governance, promote good supervision and enforcement co-ordination and assist in evaluating and identifying the appropriate regulatory response. That is critical in the FCA context, given its statutory objectives, enforcement appetite and 'credible deterrence' approach. It may also be appropriate to PRA decision-making, depending on how it develops its approach to enforcement. The FCA should regularly review the performance of its Steering Groups and their composition, and ensure appropriate expertise and seniority of representation.

5. Given the significance of referral decisions, the FCA and the PRA should publicly articulate their frameworks for, and approaches to, taking these decisions, whilst ensuring that they retain the flexibility to make operational adjustments as appropriate.

Transparency of enforcement activities

2.20 Transparency was a significant issue in consultation. The FCA already publishes a good deal of information in its annual report about enforcement outcomes that are linked to strategic priorities, and referencing investigations commenced following thematic reviews.[19] The Enforcement Annual Performance Account also provides a useful summary of both operational and case information.

2.21 Nevertheless, given the profile of enforcement action, the government considers that there is more that can be done to ensure that its strategic purpose is appreciated, and current FCA priorities understood. Greater transparency around the use of both supervision and enforcement tools will drive better behaviour in the industry. In that respect, this review has noted that the US Consumer Financial Protection Bureau produces a periodic *'Supervisory Highlights'* report,[20] which focuses on public enforcement outcomes as well as non-public supervisory action in selected priority areas.

2.22 A number of respondents felt that more information should be published about thematic reviews; specifically, why some cases were referred for investigation but others were not. Care would need to be taken when publishing such information to avoid identifying firms, but there appears to be no reason why general information cannot be provided.

Recommendations

6. The government recommends that the FCA continue to publish information about its enforcement activities to enhance transparency, and that both regulators explore how better information might be provided. That information should relate not only to formal enforcement outcomes, but to 'early interventions', where enforcement staff work with supervisors to persuade firms to take action to address risks.

[19] We note that a 2013 discussion paper suggested that the FCA could, *'provide a more detailed picture of our activities, for example by: saying more about what we are seeking to achieve through our enforcement activities; bringing together themes and explaining why we have focused on particular topics in our work'* - https://www.fca.org.uk/static/fca/documents/discussion-papers/fsa-dp13-01.pdf

[20] http://www.consumerfinance.gov/reports/supervisory-highlights-fall-2014/

7. In its annual report, the FCA should clearly state the enforcement action that it has taken – whether opening investigations or formal outcomes – in priority areas.

8. The FCA should also publish information following thematic reviews, to explain – generally, and without identifying firms – why certain cases were referred for investigation but others were not.

2.23 The FCA previously confirmed, in response to the PCBS' recommendations, that it would conduct a review of its current penalty–setting policy. The government has now agreed with the FCA that that review – which will have regard to the recommendations of the PCBS on penalty setting[21] – will commence in early 2015.

[21] '*Changing banking for good*', Report of the PCBS at paragraph 1132-33

3 Co-operation between the regulators

Introduction

3.1 Effective regulation under the new architecture depends on good co-operation between the FCA and PRA. A Memorandum of Understanding (MoU) between the regulators sets out how they will co-ordinate and consult where an investigation into a dual-regulated firm is undertaken by either or both. At a minimum, in an enforcement context, the regulators will notify or consult each other prior to the appointment of investigators, and before taking or publicising enforcement action. The regulators will also keep each other regularly updated on the progress of investigations.[1]

FCA/PRA consultation

3.2 The FCA ordinarily updates the PRA on the progress of a joint investigation at least every 2 weeks. Where the FCA is otherwise investigating a dual-regulated firm, the PRA are usually updated on at least a monthly basis. However, the frequency and manner of contact between the regulators is usually agreed and scheduled at the outset of a joint or dual-regulated firm investigation. Written records of all updates, which may take place between FCA and PRA enforcement teams, or between FCA and PRA supervisors, are preserved.

3.3 During consultation, some respondents indicated a desire for greater transparency in respect of discussions between the regulators during an investigation of a dual-regulated firm. But fairness does not dictate that subjects must be informed of the content of those discussions, and a disclosure obligation may militate against full and frank discussions between the regulators. However, if agreed between supervisors and investigators from both regulators, it may be helpful, in certain circumstances, for information from those meetings to be shared with firms for ongoing supervisory purposes.

Recommendations

9. Given the importance of consultation and co-ordination between the regulators, updates between the FCA and PRA on enforcement investigations should generally involve representatives from the enforcement and supervisory teams of both regulators, to promote symmetry of information.

10. It is also important that the information does not just flow in one way, and that supervisors are similarly encouraged to bring information to the attention of investigators, where that information might potentially be relevant, for example, to the scope of the investigation. Potentially material information should be communicated promptly, and shared on an ad hoc basis, outside of formal updates, when appropriate.

Joint investigations

3.4 Joint investigations – where both regulators might investigate a dual regulated firm suspected of misconduct arising out of the same circumstances, which adversely affects their respective statutory objectives – are not just a theoretical possibility. The FCA and PRA have

[1] Annex 1 to the Memorandum of Understanding between the FCA and PRA, paragraphs 23-27

already publicly announced 2 such investigations: the 2012 RBS Group IT outage; and the financial difficulties at the Co-operative Bank. The former has now concluded with the FCA and PRA fining RBS, NatWest and Ulster Bank £42 million and £14 million respectively.

3.5 In a joint investigation, the objectives and scope, and in particular the project plan are agreed at the outset by the regulators. The project plan will summarise the issues and suspected breaches under investigation and set out the intended scope, strategy and timetable for the investigation.

3.6 Plainly, a joint investigation has the potential to be more onerous for the subject than an investigation by a single regulator. The FCA has confirmed that, in such cases, investigators will try to ensure that the subject is *'not prejudiced or unduly inconvenienced'* as a result.[2] However, there is a lack of detailed guidance as to how they will conduct these investigations, and only a small number have been commenced to date.

3.7 Experience of joint investigations among respondents is commensurately limited. One respondent welcomed the use of joint information requests by the regulators, as a sensible means of co-ordination, and convenient from the perspective of the subject. However, the respondent expressed concern that requests did not clearly specify which regulator sought which information. That made it difficult to gauge the propriety of the request, in terms of the relevance of the information to the issues under investigation.

3.8 A particular issue that would benefit from guidance from the regulators is how they will approach decision-making in contested cases which follow joint investigations. Under the MoU, the regulators will consult prior to the issue of a decision notice. But fairness and efficiency may require a greater degree of co-ordination between the regulators.

Recommendations

11. Because they may prove especially onerous for subjects, the FCA and PRA should provide more guidance about the conduct of joint investigations. However, the regulators may wish to develop their experience of, and approach to, these types of investigation before setting out detailed guidance.

12. It will often be appropriate and expedient for the regulators to issue joint information requests. However, as a matter of course, the regulators should indicate to which investigation(s) the information sought is relevant, so that subjects can be satisfied that that information is within scope.

13. The regulators should provide guidance as to how they will approach decision-making in contested cases, following joint investigations, to ensure effective co-ordination.

FCA/PRA co-operation

3.9 Co-operation between the regulators is monitored and discussed on a quarterly basis at CEO level, and at Head of Department level. These quarterly meetings include discussion of strategic, operational and process issues relevant to FCA/PRA co-operation in enforcement investigations.

3.10 The FCA and PRA report that co-operation is generally good, insofar as practice is consistent, and reflects the terms of the MoU and underlying arrangements. Case specific issues inevitably occur and, in that event, if unresolved at a working level, they can be escalated to Head of Department, and if necessary, director level.

[2] The FCA Enforcement Guide (EG) 4.35

3.11 External analysis and understanding of PRA and FCA co-operation is inherently challenging. As good quality co-operation is critical, and public reporting is conducive to its maintenance, such reporting is appropriate.

Recommendation

14. The FCA already publishes information about its co-operation with overseas regulators, and should publish high-level information about its co-operation with the PRA.

PRA guidance

3.12 More generally, the FCA provides a great deal of guidance around the conduct of its enforcement investigations. Plainly, the PRA context is entirely different, insofar as it does not yet have a significant enforcement track record, and because it has different objectives.

3.13 The PRA has stated clearly it is committed to forward-looking, judgement-based supervision and that its preference is to use its statutory powers to secure '*ex ante remedial action*' (by intervening early to address emerging risks), rather than *ex post* enforcement action. [3]

3.14 Nevertheless, it is important that the subjects of investigations have a clear idea of the PRA's policy and process, especially in respect of how it conducts investigations and exercises its statutory powers. Respondents to consultation were keen for the PRA to publish more guidance about its approach to investigations. Given that the PRA may outsource its investigations to third parties or to the FCA, it will be important to promote consistency of approach.

Recommendation

15. The government recommends that the PRA develop guidance on its enforcement policy and process, particularly in respect of the conduct of investigations and the exercise of statutory powers.

[3] http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf

4 Subjects' understanding and representations

Introduction

4.1 There is an obvious tension between investigators and subjects at the outset of an investigation. The subject will desire as much information as possible about the reasons for the investigation and its intended scope; the investigation team's understanding of the facts will be limited, and so identifying or emphasising particular areas of focus to the subject may be premature.

4.2 Even as the investigation progresses, investigators may not wish to be forthcoming with their views on material points, for fear of committing themselves to a particular position prior to consideration of all of the evidence, or in some way prejudicing their investigation. Similarly, subjects may perceive tactical advantages in remaining circumspect. For these reasons, constructive dialogue may sometimes prove challenging.

4.3 In consultation, respondents identified improving communication during the investigative phase as key to expediting investigations and resolution of cases. It was not generally felt that the solution lay in introducing new opportunities for formal representations, but in effecting earlier, more constructive discussions so that investigators and subjects were better apprised of their respective positions on material issues.

Initial notice of investigation

4.4 A few respondents considered that more detailed information should be provided to subjects about the suspected misconduct under investigation, and the basis for referral, at the stage at which investigators are appointed. Other respondents considered that the initial documentation provided by the FCA generally included sufficient detail.

4.5 The nature of the investigation, the complexity of the circumstances and how quickly investigators are appointed, among other factors, will set the extent to which the regulators can describe the suspected misconduct and the scope of the investigation.[1]

4.6 For example, the material facts surrounding a firm's breach of its transaction reporting obligations may be apparent to the firm and the FCA at an early stage, and may not be controversial. A more complex example might be the FCA investigation into trading by a number of firms on the foreign exchange markets, announced on 16 October 2013,[2] which subsequently led to the imposition of fines of £1.1 billion.

4.7 Irrespective of the extent to which, in the early stages, the regulators can precisely discern or describe the suspected misconduct, in any case where investigators have been appointed, careful consideration will have been given to the basis for referral to enforcement, and specifically the published referral criteria. To enhance transparency, and consistent with the recommendations set out in chapter 2, it would be helpful for the regulators to explain in writing the basis for referral, by reference to those criteria, within the Memorandum of

[1] It is therefore difficult to be prescriptive as to the level of detail that should be provided within the initial notice of investigation about the suspected misconduct. However, it should permit the subject a reasonable level of understanding about the matters under investigation, albeit clearly, *'there is a limit…as to how specific the FCA can be about the nature of its concerns in the early stages of an investigation'* (EG 4.12)

[2] http://www.fca.org.uk/news/forex-investigation-statement

Appointment of investigators (MoA) or related documents provided at the outset of an investigation.

Recommendation

16. The government recommends that the regulators provide more information within MoAs or in accompanying documents, as to the basis for a subject's referral to enforcement. In particular, explanations for referral should link expressly to the published referral criteria, to enhance transparency.

Scoping meetings

4.8 Respondents considered that investigation teams took different approaches to scoping meetings, and that the value of the meetings could vary as a result. Meetings considered to be less valuable were those that respondents found to be process-heavy, with little discussion of substantive issues relating to the direction of the investigation. Respondents recognised the limitations that existed in terms of the information that might be provided in certain situations, for example, criminal and market abuse investigations.

4.9 The most useful scoping meetings are those that are carefully planned to take into account the specific circumstances of the case,[3] which take place once investigators are in a position to discuss their thinking on the direction and timescale of the investigation. That thinking will be indicative and prone to change, but sharing it may assist in managing subjects' expectations, encouraging good co-operation and promoting discipline among investigators to progress investigations expediently.

4.10 The extent to which material issues might be discussed at scoping stage will of course vary. But in many cases, the subjects of investigations should be able to indicate whether or not they accept part or all of the wrongdoing suspected. Subjects should be encouraged to do so, whilst recognising that the amount of detail provided by investigators about the suspected misconduct will influence their thinking. If the issues in dispute can be narrowed at an early stage, the investigation can proceed far more efficiently.

Recommendations

17. Scoping meetings should usually take place once investigators are in a position to share their indicative plans on the direction of the investigation and timetabling of key milestones, based on the particular circumstances of the case.

18. The government recommends that subjects are expressly invited, at scoping meetings or otherwise at an early stage, to provide an indication as to whether they accept the suspected misconduct, or specific aspects of it. The regulators should consider (potentially in the course of the FCA's forthcoming review of its penalty policy) whether it may be appropriate to expressly incentivise admissions at this stage, within their penalty setting frameworks.

The involvement of supervisors

4.11 The importance of co-operation between the supervision and enforcement functions generally is considered at box 2.A. During consultation, several respondents called for greater co-ordination between enforcement and supervision during the investigatory phase. Their rationale was that supervisors, given their awareness of and exposure to a particular market or

[3] The requirements and expectations of subjects will differ. For example, firms that have been through the enforcement process previously, or have appointed experienced legal advisers, may not consider discussion on the mechanics to be valuable. Whilst information on the process is always provided in writing in any event, for other firms and individuals that discussion may be useful.

firm, were best able to assist their enforcement colleagues' understanding of the firm's business and operations, which would lead to a more efficient investigative approach.

4.12 FCA guidance notes that *'a clear division between the conduct of the investigation…and the need to continue with ongoing supervision…may mean that the investigation does not benefit as much as it might otherwise do from the knowledge of the firm or individuals that the supervisors will have built up, or from their general understanding of the firm's business or sector'.*[4]

4.13 There may be occasions where a particular supervisor's proximity to the circumstances under investigation make it inappropriate for him or her to play a role in that investigation. For example, a supervisor's contemporaneous notes of a meeting with a firm or individual may be relevant evidence. But in most cases referred from supervision, supervisors will have a valuable advisory role to play in, for example, assisting investigators' knowledge of the firm or market. It may also be the case that issues arise in the course of ongoing supervision, which have a bearing on the investigation; they should be brought to investigators' attention as soon as possible.

Recommendations

19. In most investigations referred from supervision, it will be beneficial for supervisors to share information with investigators on the firm's business and relevant market practice issues. However, the appropriateness of the involvement, depending on the particular circumstances of the case, should be considered at the outset and kept under review by senior staff.

20. Where appropriate, supervisors of relationship-managed firms should attend scoping and progress meetings with a firm under investigation.

21. Investigators and supervisors should ensure that they maintain an open dialogue throughout investigations to promote a broad symmetry of information.

Periodic updates

4.14 Enforcement investigations are often lengthy, especially in complex cases. The call for evidence specifically asked whether regular progress meetings should be offered to subjects, and there was overwhelming consensus that periodic updates should be provided.

4.15 Inevitably, there will be periods where investigators are not in regular contact with the subject or their representatives, for example, when investigators are in the process of reviewing a large quantity of evidence. At other times, there may be very frequent contact such that formal updates are unnecessary. But it is important that subjects, especially individuals, for whom the pressure will be greatest, are kept apprised of the progress of investigations, where appropriate. A commitment to providing regular updates will also help to promote discipline on the part of investigators, to help ensure that investigations proceed efficiently.

4.16 Physical meetings may prove unnecessarily burdensome for both investigators and subjects, and updates by telephone, email or in writing will ordinarily suffice. However, subjects should be able to request a physical meeting with the investigators, on a quarterly basis, should they wish. Updates will also provide an opportunity for investigators and subjects to discuss changes to the scope of investigations, albeit investigators should not wait for a scheduled update before communicating a change of scope to a subject.

[4] EG 4.14

Recommendation

22. The government recommends that investigators provide periodic updates to subjects about the progress of investigations in appropriate cases. Updates should focus on the practical steps that have been taken in the investigation to date, and that are intended to be taken in the coming months. Investigators should also reference and update the indicative timeline set out at the scoping meeting. The circumstances of the case may influence how regularly updates should take place, but they should occur on at least a quarterly basis, and subjects should be able to request a face to face meeting.

Constructive dialogue

4.17 Some respondents argued that investigators should describe their emerging thinking as investigations develop to ensure that areas of dispute can be swiftly narrowed. It was recognised that in some investigations, this happened naturally, but in others, dialogue was more limited. It was suggested that, in some instances, subjects did not have real insight into the enforcement case until the very late stages.

4.18 There is some force to the argument that investigators and subjects should engage substantively on particular issues, well in advance of settlement negotiations beginning. The degree to which that will be appropriate will depend on the issue and the case. If, for example, facts are uncontroversial but there is disagreement on the technical application of a particular rule, an early exchange of views may be likely to assist. It will be far more difficult for the regulator to express a view in respect of contentious factual issues, prior to consideration of all of the evidence in the case, including witness interviews.

4.19 There is scope for more consistent constructive interaction between the regulators and the subjects of enforcement investigations. Many of the actions recommended – more information at referral, improved scoping meetings, periodic updates and preliminary meetings prior to settlement – are intended to foster more constructive communication, and so promote efficient investigations and outcomes. Effecting behavioural change – on the part of the regulators and the firms and individuals they regulate – is likely to be more difficult.

4.20 There are steps that the regulators may wish to take to encourage investigators to exercise their judgment and identify points on which to engage with subjects and their representatives at an early stage. These might include, for example, the provision of specific training, and the involvement and attendance of more senior staff in meetings with subjects.

4.21 But greater openness on the part of firms is also required. That might be achieved by the regulator providing guidance and examples of what constitutes good co-operation in the context of its penalty policy. The FCA should consider this in its forthcoming review of its penalty policy, which will commence in early 2015. Encouraging the attendance of firms' senior management at meetings with the regulators may also assist.

Recommendation

23. The government recommends that the regulators consider how best to promote early, constructive engagement between investigators and subjects, and that they consider, for example, the provision of specific training to investigators, increased involvement of senior staff – from the regulators, and from firms under investigation – and encouraging greater co-operation from subjects.

Box 4.A: Comparison between the US and the UK

During consultation, comparisons were drawn between FCA investigations and those conducted by US agencies. Some respondents suggested that, in the US, investigators tended to be more forthcoming in giving views and eliciting representations from subjects on material issues. That willingness, it was suggested, may be attributable to greater involvement of senior staff in meetings with firms.

But there are other factors at play. For example, proffer discussions – whereby individuals and firms initiate discussions with the regulator at an early stage about the potential for witness co-operation and the evidence they may offer – are well established in the US, and equip investigators with a firm idea of the nature and value of individuals' evidence, before it is formally obtained. That allows investigators a clearer picture of the case, earlier on, which in turn facilitates greater openness.

Regulatory investigations in the UK generally rely on formal interviews which, for good reason, tend to occur towards the end of an investigation. There is no equivalent to proffer discussions. Therefore, investigators in the UK may be unable to be as forthcoming as their US counterparts in the early stages of an investigation.

Recent multi-jurisdictional investigations allow some comparison between UK and US approaches. They suggest that firms in the US may be more pro-active in their disclosures to regulators during enforcement investigations than their UK equivalents. For example, firms will often give presentations to regulators on their findings as their internal investigations progress, which will inform the regulators' investigations. That approach is less common in the UK.

The application of legal privilege is broadly similar in the US and UK, but there are some significant differences, which may influence interaction between regulators and subjects. For example, 'bank examiners' privilege' is a recognised concept in the US, which may provide banks with comfort that information given to regulators will not subsequently be disclosed in the course of third party litigation. Whereas the FCA and PRA are subject to statutory restrictions on the disclosure of information obtained in the course of investigations, there is no formal equivalent of this species of privilege.

Time limits for responding to Preliminary Investigation Reports (PIRs) and Warning Notices

4.22 A number of respondents viewed the 28 day period ordinarily permitted by the FCA, for responding to PIRs – which set out in detail the investigators' understanding of the chronology of events under investigation and the nature of the alleged misconduct – as insufficient and disproportionate in complex cases which followed lengthy investigations. However, there was a general view that these difficulties could be mitigated, if subjects had a better understanding of the case against them, prior to receipt of the PIR. The recommendations made elsewhere will ensure that subjects better understand the case against them prior to service of the PIR.

4.23 Respondents were generally less exercised about the time permitted for responding to Warning Notices, notwithstanding that the recently reduced statutory minimum of 14 days is regarded by several respondents as unreasonable. Respondents noted that, in the context of written representations on Warning Notices, the FCA will generally be willing to grant an extension where appropriate.

Recommendation

24. To enhance transparency, the regulators should set out those factors that they might consider relevant to an application for extending the period for responding to a PIR or Warning Notice.

5 Settlement

Introduction

5.1 The 2013/14 FCA Enforcement Annual Performance Account noted that, of 106 cases closed during that year, 50 were concluded by executive settlement. An especially high percentage of cases involving firms are settled. Individuals are less likely to settle, because the consequences of enforcement action (for example, a prohibition from the industry) are likely to be more acute.

5.2 The importance of settlement both to the FCA and to the subjects of enforcement action, especially firms – in terms of resource optimisation and swift resolution (potentially leading to early payment of compensation to consumers, timely market messaging and minimising uncertainty) cannot be underestimated. Unsurprisingly then, respondents to consultation focused heavily on FCA settlement procedures.

Box 5.A: The settlement discount scheme and process

To encourage early settlement, the FCA and PRA operate similar, graduated discount schemes. The extent of the discount given is dependent on the stage at which settlement is agreed. Stage 1 begins once investigators have a clear understanding of the nature and scale of the misconduct, and communicate that understanding in writing to the subject of the investigation, together with their assessment of the appropriate penalty.

28 days is usually regarded by the regulators as a reasonable Stage 1 period, during which a 30% discount will be applied to the proposed financial penalty if a case settles. That discount is considered appropriate by the regulators because of the efficiencies gained by avoiding preparation for a contested case. It is analogous to the credit given for an early guilty plea in sentencing by the criminal courts. After Stage 1 has ended, a 20% or 10% discount will be applied where a case subsequently settles, depending on when settlement is agreed.

Settlement discussions with the FCA and PRA are generally conducted on a 'without prejudice' basis. Decisions on the settlement of FCA cases are taken by 2 members of the FCA's senior management – the Settlement Decision Makers – under its executive settlement process. At the PRA, terms of settlement must be approved unanimously by a committee of executives.

Early notification of Stage 1

5.3 Several respondents commented negatively on the 28 day period ordinarily permitted for reaching settlement during Stage 1. 28 days was said to be too short a period to enable proper consideration and negotiation of complex cases. For large firms, even the practicalities of convening the relevant decision-makers – which may prove necessary several times within that period – could prove challenging. It was argued that where subjects do not have a detailed understanding of FCA case theory, in advance of the provision of settlement papers, those difficulties are compounded.

5.4 But some respondents were supportive of the current arrangements, noting that a short Stage 1 period '*helps to focus minds*'. Many cases will not be overly complex, and 28 days will often constitute a generous period in which to agree terms. Some respondents suggested that a staggered scale, set according to the size and complexity of the case, might be appropriate. However, devising that scale would raise a host of issues, and, as a matter of fairness, the same

period should be generally applicable in all cases, the size and complexity of which will be relative to the subjects' circumstances.

Recommendation

25. After consideration, the government does not recommend a longer Stage 1 period. However, the FCA and PRA should ordinarily be able to provide subjects with a reasonably certain indication that settlement papers will be served shortly, such that they can anticipate the commencement of Stage 1. Regulators should aim to provide 28 days' notice of the commencement of Stage 1, so that administrative arrangements can be made. If, for any reason, service of settlement papers is likely to be delayed, subjects should be notified.

Pre-Stage 1 Preliminary 'Without Prejudice' meetings

5.5 In certain cases, FCA investigation teams will hold a preliminary meeting or discussion with subjects on a 'without prejudice' basis in the period leading up to the commencement of Stage 1. Those meetings provide a useful opportunity for investigators to set out (in general terms) their case theory, and for subjects to understand the regulator's position on material issues.

5.6 This practice may not be appropriate in all cases, but it is consistent with fostering a constructive dialogue, and with promoting early settlement. As a matter of general principle, it is obviously also desirable that case teams take consistent approaches, where possible. Where it is clear from prior discussions between the regulator and the subject that settlement is not going to be possible, then a preliminary meeting is unlikely to be worthwhile or appropriate. There may also be circumstances where a preliminary meeting is not feasible for reasons of expediency; for example, where the expiry of a limitation period is imminent.

Recommendations

26. Preliminary meetings, in the period between notification of the date on which Stage 1 will begin, and its commencement, will prove helpful in most cases. The regulators should consider offering such meetings where it is appropriate to do so. The key legal and factual bases of the case should be summarised by the investigators at preliminary meetings. It will usually be helpful for investigators to identify to subjects the evidence that they regard as key.

27. It is anticipated that preliminary meetings will usually take place prior to decision-makers' approval of terms and penalty parameters. Preliminary meetings should be expressly undertaken on that basis, so that subjects understand that there is the potential for the case to change.

Information provided at Stage 1

5.7 One respondent suggested that, in FCA enforcement cases, the provision of PIRs had declined, and that high level summaries are now preferred, to the disadvantage of subjects. FCA guidance requires only that Stage 1 letters explain the nature of the misconduct and the proposed penalty (as well as the period within which the FCA expects any settlement discussions to be concluded),[1] and so permits a high level approach. The FCA has confirmed that there has been no policy change in this regard.

5.8 There are many cases where the facts are uncontroversial and it is apparent at an early stage that the case will settle, such that the value of a PIR will be limited. In any event, producing a

[1] EG 5.17

formal, detailed PIR is likely to be a lengthy and onerous process, and will not usually be consistent with the exigencies of settlement.

5.9 In nearly all cases, firms and individuals will already be in possession of the key documents in the case, prior to the commencement of Stage 1. But if not, it is plainly critical that these are provided.

Recommendation

28. The regulators should continue to ensure that they identify and, where necessary, provide to subjects, the key evidence on which their case relies, at the commencement of Stage 1.

29. The regulators may wish to provide more specific guidance about the circumstances in which they will provide PIRs.

Extending Stage 1

5.10 The recommendations made elsewhere in this report, particularly for periodic updates and preliminary meetings, will ensure that subjects have a better understanding of the regulators' views prior to Stage 1 beginning, and so promote the early identification of fundamental issues of dispute. A Stage 1 period of 28 days will remain sufficient in the vast majority of cases, but it is nevertheless important that extensions are granted where warranted.

5.11 The thrust of some of the submissions made by respondents was that extensions will tend to be more appropriate in larger cases. But entities involved in those cases will invariably be better resourced than smaller firms. It is right that each application should turn on its individual merits.

Recommendation

30. To enhance transparency, the regulators should set out those factors that they might consider to be relevant to an application for extension of Stage 1. Factors might include, for example, where subjects are, for legitimate reasons, prevented or impaired from properly considering their position on settlement during the 28 day period.

Making representations in settlement negotiations

5.12 It is important to consider the context of settlement negotiations with the regulators. These are not commercial settlement negotiations, and the regulators' approach to negotiations must not simply be to secure the best possible terms, but to achieve the right regulatory outcome. The regulators will need to consider the many purposes of taking meaningful and proportionate enforcement action, including achieving 'credible deterrence'.

5.13 Some respondents perceived an unwillingness on the part of investigators to revisit their findings on material issues, or their assessment of penalty, even in the face of cogent and persuasive representations as to why they should do so. It was argued that investigators are inherently reluctant to return to Settlement Decision Makers – who will have approved the parameters of settlement – with a revised assessment, because by doing so, they are conceding to senior management that they were initially wrong.

5.14 Some respondents argued for Settlement Decision Makers to attend settlement meetings so that subjects might make representations directly. Others sought access to communications between investigators and Settlement Decision Makers, and potentially undermining material; that is to say, evidence held by the regulator which may tend to undermine its findings (to which subjects would be entitled if they contested the case).

5.15 It does not seem practical, sensible or necessary for Settlement Decision Makers to be required to routinely attend settlement meetings. The introduction of a formal right of representation would, to a significant extent, duplicate the Regulatory Decisions Committee

(RDC) process for contested cases.[2] And as with the introduction of disclosure obligations, which can be laborious and extremely time-consuming to discharge, such a change would add a level of formality unsuited to the settlement process. The key advantages of that process are its speed, efficiency and informality, and if those aspects are jeopardised, it becomes very difficult to justify the availability of a settlement discount.

Recommendation

31. It is important that subjects are assured that representations made during settlement, where material to the regulators' assessment of the case or penalty and not previously considered or given sufficient weight, are assimilated by the regulator prior to it reaching a decision. That may be best achieved, in the case of the FCA, by the relevant Enforcement Head of Department, where necessary, acting as a suitably senior conduit between the case team and the Settlement Decision Makers. The government considers that, in most cases, the Head of Department should attend a 'without prejudice' settlement meeting during Stage 1, and where that is not feasible, an appropriately senior substitute should do so.

Reinstating the settlement discount

5.16 Certain respondents suggested that, in contested cases, settlement discounts should be reintroduced where it is clear that a subject would have settled on the basis of the findings and penalty ultimately decided by the RDC i.e. a more favourable basis than that proposed by the FCA during Stage 1.

5.17 Respondents envisage hypothetical situations where, for example, investigators originally propose a fine of £2 million, but the RDC decides, following representations, that a substantially lesser fine, or a less serious characterisation of the misconduct is appropriate. In those circumstances, and where the firm has earlier indicated to enforcement a willingness to settle on terms consistent with a decision that follows contested proceedings, it is argued that the RDC should be able to consider the otherwise 'without prejudice' offer, and reinstate the discount from which the subject would have benefited, had it been accepted.

5.18 Certain practical difficulties flow from that suggestion, not least in determining whether a decision is more or less favourable than the original enforcement proposal. That may require consideration of numerous competing factors including the level of fine, the characterisation of the breach and whether the misconduct is found to be deliberate or reckless.

5.19 But this approach would also create an imbalance, insofar as subjects would have everything to gain from contesting proceedings, having submitted a proposal intended to potentially safeguard a discount, and little to lose. For the regulator, the enforcement team and the decision-maker would each be required to prepare extensively and set aside significant time (because even contested proceedings confined to the issue of penalty would require consideration of numerous legal and factual issues that might inform an assessment), for the preparation of an investigation report and potentially a disclosure exercise. Therefore, any efficiency benefits would be negligible.

5.20 The imbalance could of course be addressed by enabling the decision-maker to apply an uplift to a penalty in prescribed circumstances, but we do not consider that that would be appropriate in the context of regulatory proceedings, or conducive to achieving the right regulatory outcome.

[2] The FCA and PRA processes for contested decision-making are discussed in chapter 6.

Settlement discounts

5.21 During consultation, respondents tended to support the graduated discount scheme, and generally did not call for changes to the levels of incentives offered. There was nevertheless a consensus that, generally, subjects will either settle or not – depending on their attitude to the alleged breach – and so a graduated discount scheme is unlikely to have a significant bearing on whether a case is contested. That is borne out by the fact that the vast majority of cases are settled within Stage 1 – only 9 cases have been settled in Stage 2 or beyond during the last 3 years.

5.22 In the circumstances, a graduated discount scheme may not optimise settlement prospects. The availability of a 30% discount for settlement should serve as a significant incentive to subjects to accept wrongdoing at an early stage, but the fixed 20% and 10% thresholds may temper that incentive.

5.23 There will be difficult cases where the subject accepts aspects of the alleged misconduct, but takes issue with other material aspects of the enforcement case, such that settlement risks becoming protracted. However, our other recommendations – which seek to ensure that the regulator and the subject are apprised of each other's case so that issues of dispute can be narrowed at an early stage – will mitigate that risk. The regulators should in any event be able to apply a discretionary discount outside of Stage 1 in exceptional cases.

Recommendation

32. The government considers that removing the discounts currently available at Stages 2 and 3 will assist in demarcating, at an early stage, between those cases that can be settled, and those that must be contested. The regulators should consider reviewing the graduated discount scheme and applying a discount only to those cases which settle in Stage 1. The regulators may wish to retain the ability to apply a discretionary discount in cases which settle outside Stage 1, where they consider it appropriate.

Ongoing settlement review

5.24 Given the focus on settlement during consultation, and its significance for enforcement, the process must continue to function properly by ensuring fairness for subjects and achieving the right regulatory outcomes. The government recommends that there is a role for the RDC and PRA Decision Making Committee (DMC), following the conclusion of settled cases, in reviewing the regulators' processes, inviting firms and individuals to comment on the process, and speaking with the relevant enforcement staff.

5.25 This would enable the RDC and DMC – without blurring the distinction between the executive settlement and contested case decision-making processes – to review the overall settlement process. The RDC and DMC would also be able to monitor the effect of the changes that the government has recommended in relation to that process. The former members of the PCBS have also called for ongoing review, given the significant number of cases concluded by executive settlement.[3]

5.26 Plainly, there could be no question of re-opening cases, but there may be general, process lessons that the regulators can learn, and which should be articulated annually by the RDC or DMC within the relevant annual report.

[3] Statement by former Members of the Parliamentary Commission on Banking Standards (paragraph 94), 17 November 2014

Recommendation

33. The government recommends that the contested case decision-makers regularly review the regulators' processes in settled cases. The review should include seeking comments from all or a sample of those who have settled FCA and PRA enforcement cases, and speaking with the relevant enforcement staff. The review should also monitor the effectiveness of the recommended changes to the settlement process. The review should identify whether there may be settlement process lessons to be learned, and make generic, public recommendations.

6 Contested case decision-making

Introduction

6.1 Not all cases will settle, and it is critical that there are fair, robust and credible processes in place to decide contested cases. But processes must also be efficient, both for subjects and the regulators.

6.2 The regulators have chosen to deal with enforcement decision-making in contested cases in different ways. As part of its functions, the FCA's Regulatory Decisions Committee (RDC) deals with contested disciplinary cases. It is a committee of the FCA board. The chairman of the RDC is a legally qualified FCA employee. The role is part-time, and the chairman has no other FCA responsibilities. Members of the RDC are otherwise not FCA employees, but have considerable experience in financial service areas including banking, capital markets, insurance, retail distribution, pensions, asset management and compliance, either as practitioners or in other roles.

6.3 The PRA has taken a different approach, which it considers consistent with its preference for *'ex ante remedial action'*,[1] as against *ex post* enforcement action. That approach involves case decisions being taken by Decision-Making Committees (DMCs), usually comprising PRA executives. The constituent decision-makers will vary according to the *'importance, complexity and urgency of the decision'*,[2] with the most significant decisions being taken by the PRA Board (excluding the FCA CEO) sitting as a decision-making committee.

6.4 The subjects of enforcement action have unfettered access to an independent tribunal – the Upper Tribunal (whose members include persons with expertise in financial services) – should they wish to challenge the regulators' decisions.

6.5 The issue of decision-making in contested cases was considered by the PCBS, which recommended the creation of a statutorily autonomous committee to decide banking cases brought by either or both regulators. That committee, the PCBS suggested, should be chaired by a senior judicial figure and should include members with significant banking experience. The PCBS also recommended that such committee include a majority of individuals with neither banking nor financial services experience.

6.6 Presented with these contrasting models, respondents to our consultation had much to say about their respective merits. There was general support for the FCA's RDC framework. A number of respondents expressed concern that DMC members would not approach cases brought by the PRA with the same independence of judgment as RDC members are perceived to apply to FCA cases. Different concerns were expressed about the model proposed by the PCBS; that it would duplicate the role currently played by the Upper Tribunal, and compromise efficiency.

Internal decision-making in contested cases

Jurisdiction

6.7 The PCBS called for the creation of a separate decision-making committee with jurisdiction for both FCA and PRA 'banking' cases. Arguably, a joint FCA/PRA decision-maker would be

[1] http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf
[2] http://www.bankofengland.co.uk/pra/Pages/publications/approachenforcement.aspx

operationally efficient in circumstances where both regulators seek to take enforcement action in respect of the same misconduct. But given the regulators' distinct statutory objectives, and their different areas of regulatory focus, the regulators may require different expertise in their decision-makers. There is also an argument that subjects should have the opportunity to make separate representations before each regulator's decision-makers, given that those decision-makers must approach the case, and make findings, on different bases. The key issue on which co-ordination will be required is that of the impact on firms of the FCA's and PRA's respective regulatory decisions, but that does not necessarily require a joint enforcement decision-making committee.

6.8 Moreover, and given their differing approaches, there is merit in the regulators having separate processes which meet their respective strategic and operational requirements. The government therefore considers that this model remains correct, albeit the FCA and PRA should set out guidance as to how they will co-ordinate in joint contested enforcement cases, in accordance with Recommendation 13.

6.9 It is not clear that there is a sufficient volume of contested banking cases to warrant establishing a separate, specialist decision-maker. A regulator taking different decision-making approaches to the same misconduct (for example, an integrity breach), simply because they occur in, for example, an insurance firm and a bank, may be difficult to justify. Difficult issues would also arise in taking different approaches to 'banking' misconduct and linked misconduct in areas such as inter-dealer broking or asset management. The government therefore does not recommend the creation of a specific 'banking' committee.

Composition and process

6.10 The government agrees with the PCBS that the chair of a regulatory decision-making committee should have significant legal – if not judicial – experience. The committee itself should include sufficient, relevant industry expertise to enable it to decide the proper application of sophisticated regulatory requirements to complex factual circumstances.

6.11 In its report, the PCBS specifically criticised the lack of banking experience held by then RDC members. Since publication of the PCBS report, we note that 2 RDC members have been recruited with specific and significant banking experience. It is nevertheless important that the FCA proactively and regularly reviews the RDC membership to ensure that there is a range of experience that will enable it to decide cases consistently and expertly across the markets where enforcement action is likely to be taken.

6.12 After careful consideration, the government does not share the PCBS' view that a decision-making committee *'should have a lay (non-banking or financial services) majority'*.[3] That is partly because of the niche industry fields often under consideration, the potential for inconsistent decision-making and the inefficiency that might result.[4] However, it is also because lay members are not best utilised in a submissions-based process, which is generally likely to focus on documentary evidence, industry practice and legal argument.

6.13 A more usual role for majority lay decision-makers would be in a traditional tribunal environment where they might, for example, assess the credibility of witness evidence. But moving to that type of process – which was not recommended by the PCBS – would severely impact efficiency and increase costs. For the regulator, that may affect the number of

[3] '*Changing banking for good*', Report of the PCBS at paragraph 1202

[4] During the House of Lords debate on a proposed FSMA amendment which would have established an independent, banking RDC, a former member of the RDC, Lord Eatwell, commented that, *'I am afraid that that [a majority of lay persons], on the old RDC, caused us a lot of difficulty. Many of the cases which were quite complicated, with respect to financial services, took a long time because people who were very bright and committed but who had had no previous connection with the industry took a long time to get up to speed on the relevant issues that were considered.'* Lords Hansard, Column 1462, 27 November 2013.

investigations that can be pursued. For individuals subject to enforcement action, inefficiency and costs may even jeopardise fairness. Moving to a more traditional tribunal process would also substantially duplicate the role played by the Upper Tribunal, which is discussed below.

Current decision-making committees at the FCA and PRA

6.14 For the purposes of this review, the government has scrutinised the current, internal decision-making arrangements in place at the FCA and PRA, including the extent to which their respective frameworks ensure that decision-making committees are: a) functionally independent; and b) perceived to be appropriately objective.

6.15 In respect of the FCA RDC, the general view from consultation was that the current framework offers an appropriate level of objectivity, independence, legal expertise and industry experience. Several respondents noted the frequency with which the RDC amends or revises the findings or penalties proposed by EFCD. Others commended the significant effect of the changes introduced following the 2005 FSA Enforcement Process Review,[5] in ensuring the RDC's operational independence, including the provision of a significant in-house legal function. Moreover, the RDC chairman has extensive legal and judicial experience and the RDC has a range of members drawn from industry and beyond, who are not FCA employees.

6.16 Turning to the PRA's arrangements, the rationale for establishing the executive-led process was to ensure that decisions were taken by those with significant experience of supervising the types of firms for which the PRA has responsibility. However, it is not clear that that rationale offers sufficient justification for the adoption of an executive-led model. That is to say, the PRA's decision-making structure may not offer the functional independence, or the perception of objectivity required for enforcement decision-making. Furthermore, the tiered approach, under which different committees will consider different cases according to the *'importance, complexity and urgency of the decision'*[6] appears unlikely to promote consistency of decision-making.

6.17 The government has carefully considered the PCBS recommendation for a decision-making committee with *'statutory autonomy'*. But the government must also take into account that an independent, autonomous tribunal already exists, in the form of the Upper Tribunal. Moreover, it is the functional independence of the decision-making committee, and the status of its members, which seem more significant in promoting objective decision-making, than the construction or basis of the committee itself. The government is also of the view that, for reasons of operational effectiveness and accountability, the regulators should have discretion over the detailed design of their internal decision-making arrangements, and have the flexibility to adjust them to meet their operational requirements.

6.18 The current legislation therefore permits the regulators that discretion, subject to certain procedural requirements. These include requirements intended to ensure the objectivity of individual decision-makers. Section 395 of the Financial Services and Markets Act 2000 (FSMA) introduces minimum requirements in terms of those who can be involved in statutory notice decision-making in enforcement cases. Decisions must be made by *'a person not directly involved in establishing the evidence on which the decisions is based'* or *'by 2 or more persons who include a person not directly involved in establishing that evidence'*. However the focus is on separation between those establishing the evidence and those making decisions. Arguably in some circumstances there may be a case for requiring separation between those involved in the day to day supervision of a firm, and those deciding whether that firm should be subject to enforcement action in a contested case. The government will review the legislation in due course

[5] http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf

[6] http://www.bankofengland.co.uk/publications/Documents/other/pra/approachenforcement.pdf

with a view to strengthening the requirements on the regulators to ensure their procedures secure appropriate objectivity of decision-making.

Recommendations

34. The government recommends that the PRA establish a functionally independent enforcement DMC, composed of independent members with expertise suited to the PRA's regulatory focus. The PRA should appoint a dedicated chair with significant legal or judicial experience. The government will review the legislation in due course with a view to strengthening the requirements on the regulators under FSMA to ensure their procedures secure objectivity in decision-making in contested enforcement cases.

Access to the Upper Tribunal

6.19 The Upper Tribunal is an integral part of the statutory scheme for financial services regulation. All of those subject to decisions of the FCA and PRA in enforcement matters have an unfettered right to refer enforcement decisions to the Upper Tribunal's Tax and Chancery Chamber. The jurisdiction of the Upper Tribunal requires it, in disciplinary cases, to decide what is the appropriate action for the FCA or PRA to take, and to direct the decision-maker to take that action.

6.20 Hearings before the Upper Tribunal are presided over by senior judges, and substantial industry experience is provided by the Tribunal's lay members, who are appointed on the recommendation of the Lord Chancellor, on the basis of that experience. For the purposes of financial services regulation, it is regarded by the courts as the *'expert tribunal'*.[7]

6.21 The Tribunal has full jurisdiction to make its own determination of the issues before it. In contrast to proceedings before the regulators' decision-makers, witnesses give evidence and are cross-examined on that evidence. Subjects have every opportunity to put forward their version of events and challenge that of the regulators. Upper Tribunal cases, ordinarily heard in public, receive the most thorough scrutiny. The Upper Tribunal therefore provides a critical safeguard on FCA and PRA decision-making in all enforcement cases, and guarantees compliance with Article 6 of the European Convention on Human Rights.

6.22 The PCBS took evidence from other regulators, including the Solicitors Regulatory Authority (SRA) and the General Medical Council (GMC), and referred to their arrangements in relation to the respective, specialist tribunals which hear their cases[8] – the Solicitors Disciplinary Tribunal (the SDT) and the Medical Practitioners Tribunal Service (MPTS). The PCBS noted the institutional separation of these tribunals from the regulators. However, it is important to note that, within the context of financial services regulation, it is the Upper Tribunal, rather than the RDC or DMC, which is the appropriate comparator when considering the SDT and MPTS. The 3 tribunals are equivalent insofar as they provide Article 6 compliance, and follow a traditional, tribunal procedure.

6.23 On the other hand, the RDC and DMC arrangements simply enable a subject to contest their case before the regulators' decision-makers, via a submission based, and relatively cost-efficient procedure. Depending on the decision, the subject may then choose to contest the case in the Upper Tribunal. That 60% of contested cases are resolved at the RDC stage,[9] rather than proceeding to the Upper Tribunal, it was suggested by respondents, underlines that those arrangements are reasonably effective.

[7] R (on the application of Christopher Willford) v Financial Services Authority [2013] EWCA Civ 677, at paragraph 37

[8] The SDT in fact only deals with the most serious cases of misconduct by solicitors. Many less serious cases are disposed of by the SRA itself.

[9] As noted in the call for evidence

6.24 Nevertheless, decisions in FCA and PRA enforcement cases may have very serious consequences, particularly for individuals. Some may well wish to challenge an adverse regulatory decision before an independent tribunal – the Upper Tribunal – where they can directly challenge the case advanced by the regulator, by calling oral evidence and cross-examining witnesses.

6.25 There is no requirement for a regulated person to engage with the regulators' decision-making procedures, and by declining to make submissions to the FCA and PRA decision-makers, the subject does not lose his right to refer the matter to the Upper Tribunal. However, that is not widely understood, nor is there an expedited procedure.

6.26 The government considers that the regulators should put in place a clearly signposted, expedited procedure for subjects to proceed to the Upper Tribunal, without making representations to the decision-maker, if they prefer to challenge the regulator's case within a tribunal environment. On receipt of Warning Notices, subjects should be able to expressly elect not to make representations and to proceed to the Upper Tribunal. That is likely to expedite the current process, at least insofar as the decision-maker can quickly and efficiently issue a Decision Notice, in substantially the same terms as the Warning Notice, and without reconvening the members of the decision-making committee.

Recommendation

35. The government recommends that the regulators put in place a clearly signposted, expedited procedure for subjects to proceed to the Upper Tribunal, without making representations to the decision-maker, if they prefer to challenge the regulator's case within a tribunal environment. The regulators may wish to develop an expedited procedure for the issue of Decision Notices in substantially the same terms as Warning Notices.

Box 6.A: Contested decision-making at other regulators

Comparison of how other conduct regulators resolve contested administrative cases reveals a variety of approaches.

At the Australian Securities and Investments Commission (ASIC), a decision on administrative action is usually taken, once the subject has had an opportunity to make representations, by the head of the relevant enforcement department, or by another senior executive. However, decisions on administrative action in market integrity cases must be taken by the Markets Disciplinary Panel (MDP). The MDP is an independent peer review body, the members of which have substantial markets experience. Appellate jurisdiction lies with the Administrative Appeals Tribunal, which is entirely independent of ASIC and reviews a wide range of Australian government body decisions.

In France, the Board of the Autorité des Marchés Financiers (AMF) initiates enforcement proceedings following an investigation, by serving a 'statement of objections' on the subject, to which the subject is able to respond. The AMF's Enforcement Committee will appoint a rapporteur to consider and present the case before it. The Enforcement Committee is entirely independent of the AMF Board, and proceedings are usually held in public. Decisions of the Enforcement Committee may potentially be appealed to the Paris Court of Appeals or the Conseil d'Etat.

The securities regulator in Hong Kong is the Securities and Futures Commission (SFC). The SFC indicates its intention to take administrative action by issuing a Notice of Proposed Disciplinary Action following an investigation. Subjects who wish to contest that action may make written representations to the SFC. Potentially, they may make oral representations if the SFC considers that fairness requires it. The head of the disciplinary department within the enforcement division will usually make a decision on behalf of the SFC. Thereafter, the subject has a right of appeal to the Securities and Futures Appeals Tribunal (SFAT). SFAT proceedings are entirely independent of the SFC, and chaired by a High Court Judge. Onward appeals are to the Hong Kong Court of Appeal.

In the Netherlands, at the Authority of the Financial Markets (AFM), investigations are carried out by supervisors. Findings are subject to review by the legal department, prior to the case being passed to an administrative fines officer for consideration. If that officer considers that administrative action is appropriate, he will advise the subject, who will be given the opportunity to respond. The Executive Board of the AFM will decide whether to impose a fine, having considered the recommendation of the administrative fines officer. Subjects may seek internal review by the AFM. Decisions may be appealed to the court, and ultimately the Trade and Industry Appeals Tribunal.

At the US SEC, administrative proceedings take place before an Administrative Law Judge (ALJ). Following a full, public hearing, similar to a non-jury trial in a federal district court, the subject and the SEC submit proposed findings of fact and law. The ALJ, who may order sanctions, disgorgement and relief, will then issue an 'Initial Decision'. The 'Initial Decision' can be appealed by either the SEC or the subject. Appeals are heard by the Commission itself (there are 5 SEC Commissioners appointed by the US President), which conducts a *de novo* review. Onward appeals are to the US Court of Appeals.

Performance

Accountability

6.27 The government agrees with the PCBS recommendation that the regulators' enforcement decision-makers should publish an annual performance report. Potentially, an RDC report might sit within the wider FCA annual report or Enforcement Annual Performance Account. Annual reporting for the PRA DMC might also be appropriate, depending on the volume of cases with which it deals.

6.28 The government also agrees with the PCBS that the Chairs of the regulators' decision-making committees should be accountable to Parliament. Currently, the appropriate forum would be the TSC, which is able to call the regulators to give evidence before it, albeit legislative confidentiality restrictions prevent discussion of specific cases. Future chairs of the RDC and DMC could be subject to pre-commencement hearings, to enhance accountability.

Recommendations

36. The government recommends that the RDC, and potentially the DMC, report annually on their performance. Content might include the results of the annual operational review (at Recommendation 38), and of the review of settled cases (at Recommendation 33).

37. In addition, the TSC might consider requiring the attendance of future RDC and DMC Chairs on a pre-commencement basis.

Efficiency

6.29 Our call for evidence highlighted the length of time that contesting cases before the RDC appears to add to the enforcement process. The FCA Enforcement Annual Performance Account 2013/14[10] records a sizeable reduction, with *'Average length of cases referred to RDC'* taking 31.8 months (as opposed to 37.8 months in the previous year). By comparison, settled cases took on average 20.4 months.

6.30 The difference between the length of time taken to conclude settled cases versus contested cases before the RDC is, on its face, striking. However, that difference is to some extent natural. Contested cases require additional work from investigators prior to their submission to the RDC, including the preparation of PIRs and disclosure reviews to identify material that might potentially undermine the regulator's case. In complex cases involving many thousands of pages of documents, these duties are onerous and time-consuming, which partly explains why contested cases take far longer than settled cases.

6.31 Consultation respondents nevertheless focused on means for improving RDC efficiency, including expanding the RDC membership or increasing the time commitment of individual members, and adding more legal advisers or administrative staff. Plainly these are operational matters, and the adequacy of RDC resource is best judged by the FCA. On the RDC membership in particular, there is an important balance to be struck between ensuring there are enough RDC members to deal expediently with cases, whilst providing each individual member with regular exposure to case decision-making.

[10] http://www.fca.org.uk/your-fca/documents/corporate/enforcement-annual-performance-account-13-14

Recommendations

38. Currently, there is no regular, published review of RDC or DMC composition and resource. A review should take place regularly, the results of which should be published. The review should consider:

- the extent to which the RDC and DMC membership includes expertise appropriate to the areas in which the FCA and PRA are likely to take enforcement action;
- their operational performance, including the time taken to deal with contested cases following submission of papers by investigators; and
- the sufficiency of resource generally – the size of membership, the available administrative and legal staff – to deal with cases efficiently.

39. When publishing their reviews, the regulators should confirm the steps they are taking to address any perceived problems or deficiencies.

Box 6.B: Efficiency in other jurisdictions

Comparative analysis in this area is limited and must be considered in the context of different legal systems, cultures and approaches to enforcement. But the European Securities and Markets Authority conducted a study in 2012 of market abuse sanctioning in EU member states.[11] The study showed that between 2008 and 2010, the FSA took, on average, either less than 1 year or between 1 and 2 years to conclude administrative market abuse cases. That compared favourably with several other EU member states, including France and Germany, where cases took on average either 2 to 3 or 3 to 5 years.

The US SEC publishes information in relation to the length of its investigations. In 2013, the average length of time between the opening of a matter under inquiry or an investigation and the commencement of an enforcement action was 21 months.[12]

The Ontario Securities Commission publishes similar information. In 2013-2014, the "*average length of time from intake to the commencement of a proceeding*" was 15.9 months.[13] However, in the 3 years prior to that, the figure was between 21.8 months and 20.3 months.

[11] http://www.esma.europa.eu/system/files/2012-270.pdf
[12] http://www.sec.gov/about/secpar/secafr2013.pdf#contents
[13] http://www.osc.gov.on.ca/documents/en/About/rpt_2014_osc-annual-rpt_en.pdf

7 Summary of responses to consultation

7.1 Respondents to the call for evidence included FCA and PRA authorised firms and approved persons, law firms and counsel commonly instructed in FCA enforcement cases, consumer representative groups, FCA practitioner panels and trade bodies.

7.2 They focused principally on FCA enforcement decision-making. That was inevitable; only very few respondents have had any experience of PRA enforcement decision-making to date. However, a number of respondents made observations on the PRA's decision-making model, insofar as it differs from the FCA's model.

7.3 Generally, respondents expressed a reasonable level of satisfaction with the current FCA enforcement decision-making processes and arrangements, and there seems to be no desire for fundamental reform. Nevertheless, a range of improvements were suggested. As the majority of respondents represent the financial services industry, or act as advisers to that industry, it is perhaps unsurprising that in most cases, suggested improvements appear intended to enhance the fairness of the process, from the perspective of the subject of the investigation or action.

7.4 A number of respondents chose to comment on what they perceive to be escalating fines imposed by the FCA. However, the FCA will review its current penalty setting framework and policy beginning in early 2015. Accordingly, representations relating to FCA penalty policy are not included in the summary below.

Do current enforcement processes and supporting institutional arrangements provide credible deterrence across the spectrum of firms and individuals potentially subject to the exercise of enforcement powers by the regulators? If not, what is the impediment to credible deterrence and where does it arise?

7.5 Most respondents considered that the FCA's current enforcement decision-making processes and arrangements supported, or did not impede, the delivery of credible deterrence through its overall approach to enforcement (and particularly, through the imposition of significant fines and the focus on individual accountability). However, one respondent commented that a significant number of smaller (especially retail) firms appeared to fall '*below the [Enforcement] radar*'.

Are the criteria for referring a case from the FCA supervisory function to the enforcement function clear and used appropriately? Are all key criteria identified? If not, what improvements could be made? Should the FCA give certain factors more weight than others?

7.6 Generally, respondents considered that the FCA enforcement referral criteria were uncontroversial, and reflected the issues that should be considered by the regulator in deciding whether to commence an investigation. A small number of respondents suggested minor amendments to those criteria, or additional criteria, for example: to specifically reference self-reporting by firms, which reflected a wider view that insufficient credit was given for self-reporting in the enforcement process, notwithstanding the regulatory obligation to self-report; and, reflecting the increase in cases where the regulator may have an interest alongside other domestic or overseas agencies, a requirement to consider whether the FCA was best placed to investigate, in light of any investigation(s) being undertaken by other agencies.

7.7 On the whole, respondents were more concerned about obtaining assurance that the criteria were being applied appropriately and consistently in referral decision-making, absent

which, a sense of unfairness or arbitrariness could prevail. It was suggested that such assurance was not always obtained, because the reasons for referral were not fully communicated to the subjects of investigations (beyond the legal basis for investigation). Similarly, several respondents noted that the regulated community had little insight into cases in which the regulator had not taken action, and so meaningful comparison of how the referral criteria are being applied is in practice challenging.

7.8 Some respondents therefore considered that the FCA should routinely provide more information as to how it applied referral criteria, both to the subjects of investigations, and to the regulated community more generally. It was suggested by some respondents that the FCA could publish more (anonymised) information about cases in which it had decided not to take enforcement action and that, in investigations which followed thematic work, comparative analysis could be provided to subjects, to better explain the bases for their referral.

7.9 Several respondents considered there to be a lack of transparency in respect of the referral process, and around the internal governance arrangements to which referral decision-making is subject. Many respondents considered it essential that referral decisions are taken, and seen to be taken, in the round, with adequate input from supervisors. This would ensure that all factors – for example, supervisors' knowledge of post-breach remediation steps – help inform decision-making. Respondents felt unsighted on whether all relevant factors and potential regulatory responses were fully considered at referral stage. A few respondents suggested that those being considered for referral should have a formal right to make representations to the regulator prior to a referral decision being taken.

7.10 Among some respondents, there appeared to be a lack of understanding of, or agreement with the use of enforcement as a strategic tool, and the exercise of discretion by the FCA in its referral decision-making. A few respondents were of the view that all ostensibly similar cases should be treated the same by the regulator, in terms of whether supervisory or enforcement action is taken. As one respondent put it, *'…in the interests of ensuring that all firms are dealt with equally, all firms believed to have been engaged in a particular practice should be referred to Enforcement at the same time'*.

Should the PRA say more publically about its enforcement processes? In particular, should the PRA publish enforcement referral criteria?

7.11 Respondents supported the publication of referral criteria by the PRA, and considered that more information, comparable to that provided by the FCA, should be published generally about its approach to enforcement.

Are the enforcement sections of the FCA/PRA MoU being applied in practice? If not, please give specific examples of implementation deficiencies.

Is the MoU the most effective way to deliver effective co-ordination? If not, what alternative mechanism should be developed for enforcement cases?

7.12 Respondents generally did not comment, or felt unable to comment on the extent to which the MoU is working in practice, and no particular issues were identified. However, a number of respondents considered that more specific guidance (below the level of the MoU) should be provided in respect of how the regulators co-ordinate in enforcement matters (for example, to reflect their distinct, respective interests in joint investigations), and some respondents called for greater transparency (for subjects) in respect of consultations between the regulators on specific cases.

Is the scope of investigations made sufficiently clear to those subject to them?

Should the regulators offer the opportunity for regular progress meetings during the investigation?

Are there sufficient opportunities for individuals and firms to make representations?

7.13 Respondents' views were mixed on the adequacy of information provided by FCA enforcement at the outset of investigations, and several suggested that the position varied significantly, depending on the nature of the case and the personnel involved.

7.14 Scoping meetings were often felt to be formulaic, overly focused on process, and adding little to subjects' understanding – either of the basis for their referral to enforcement, or of the precise scope of the investigation. However, some respondents reported that the meetings could be productive, and there was a clear view that they potentially offered a valuable opportunity for constructive dialogue, whereby areas of dispute could be narrowed, and investigators' understanding could be improved, leading to more focused evidence-gathering.

7.15 Respondents' suggestions for improvement included convening scoping meetings at a later stage, once case teams had developed their understanding of material issues, and ensuring the attendance of supervisors at those meetings. However, most respondents attributed their dissatisfaction with scoping meetings to a reticence, on behalf of some enforcement staff, to elaborate beyond the information provided within the formal legal basis for the investigation set out in MoAs. Whilst it was generally acknowledged that, in some instances, it would be difficult and/or inadvisable for investigators to disclose more information, respondents felt that investigators could often be more forthcoming at this stage.

7.16 Some respondents felt that the regulators should set out 'service level agreement' – style investigation timeframes, indicating how long they would usually take to investigate cases of differing complexity. Others considered that the better course was for investigators to provide an indicative, bespoke schedule at the beginning of each investigation, taking into account the particular circumstances of the case.

7.17 Whilst there was an acknowledgement that complex cases inevitably took time, some respondents highlighted the pressure that lengthy investigations brought to bear on individual subjects, and suggested that insufficient allowance was made for this in the conduct of FCA investigations. The proper approach to investigations involving individuals attracted some comment, with respondents expressing different views. Some preferred that the regulator should cast a wide net at the outset of the investigation, and provide a clear indication about those individuals whose actions may come under scrutiny, whilst others considered that it was more appropriate for the regulator to consider the position of individuals once it had developed an understanding of the circumstances of the misconduct at a firm. Some respondents considered that potential unfairness arose where an investigation against a firm proceeded to settlement negotiations, and the firm accepted findings which had damaging consequences for individuals (investigations into whom were at a less advanced stage).

7.18 There was near unanimous consensus that the regulator should, in appropriate cases, offer periodic meetings to update subjects on the progress of investigations. It was felt that an ancillary benefit would be to help foster better dialogue between the regulator and the subject. As well as covering investigation progress, several respondents considered that these meetings would provide useful opportunities, in appropriate cases, for the regulator to set out its evolving thinking on material issues in the case. Respondents argued that, if the regulator was able to set out its position as the investigation progressed, then subjects would be able to respond on key points, leading to the narrowing of areas of dispute, and so resulting in quicker investigations, settlements and outcomes.

7.19 In fact, a desire to improve dialogue by making it more constructive was perhaps the dominant theme among respondents during consultation. This was seen as a cultural issue; enforcement staff were considered, in some cases, to be overly cautious about making statements that might bind them to a particular position, or otherwise impact negatively on their case. However, as with scoping meetings, respondents noted that some enforcement teams were routinely more open and therefore (in the view of respondents) more constructive. It was generally considered that including more experienced staff within investigation teams would assist in developing a more confident approach, conducive to better dialogue.

7.20 A few respondents called for more access to FCA senior management during the enforcement process, manifesting itself in opportunities to make representations about the appropriateness of referral prior to a referral decision being taken, and prior to the commencement of settlement discussions.

7.21 Some respondents considered that the number of cases in which the FCA issued a PIR had declined, and one considered that PIRs should be prepared and provided prior to Stage 1 in every case, without exception.

7.22 Two respondents called for changes to be made to the oral representations process in contested cases, such that subjects were afforded a right to reply (to points made by FCA enforcement) or closing submission before the RDC. However, the current policy specifically allows for that,[1] and that that is the practice is borne out by commentary.[2]

Does the time allotted for making representations strike the right balance between fairness and speed?

7.23 A number of respondents took the view that the usual 28 day period for responding to a PIR was insufficient in a complex case, particularly in circumstances where the investigation had taken many months and the subject, pending receipt of the PIR, had little insight into the detail of the FCA case.

7.24 Whilst some respondents considered that the 28 day Stage 1 settlement period served to focus minds, others took the view that it imposed practical difficulties on large corporates in terms of their ability to convene appropriately senior individuals to meet and make what might be very significant decisions. A mooted solution was that enforcement should provide 28 days' notice of the likely commencement of Stage 1, to enable firms to plan appropriately.

7.25 Respondents were generally less exercised about the time permitted for the preparation of written representations to the RDC. Whilst the recent reduction of the statutory minimum period (from 28 days to 14) was referenced, it was also generally acknowledged that a reasonable approach was taken to the granting of extensions.

Should the regulators publish factors they will take into account when considering whether to grant extra time?

7.26 Respondents were generally in favour of the publication of factors on which subjects might base applications for extension to the Stage 1 period, with several noting that extensions were very rarely granted. Some considered that the FCA's approach, whereby extensions to Stage 1 are granted in *'exceptional circumstances'* only,[3] is overly strict, and one considered that there should be a general presumption in favour of granting an extension. Some respondents

[1] DEPP 3.2.18

[2] 'A Practitioner's Guide to Financial Services Investigations and Enforcement, 3rd Edition, Sweet and Maxwell, 2014, p252

[3] EG 5.19

considered that factors such as multi-jurisdictional interest or negotiation of redress should weigh in favour of a Stage 1 extension. One respondent favoured being able to appeal to the RDC or Upper Tribunal in circumstances where an application to extend Stage 1 was declined.

Settlements are faster and more efficient than exhausting the decision making process. They often deliver fairness to consumers by providing earlier opportunity for redress. Is it appropriate to give a discount for early settlement? Should there be any types of case where such discounts are not available? Could the settlement process be changed to offer clearer incentives to settle after the time limit for receiving a 30% discount has expired? Do you agree with the incentives given?

Do the current approaches to settlement also deliver fairness to firms and individuals subject to enforcement action, bearing in mind that settlement is a voluntary process? If not, what improvements could be made better to balance the interests of all parties?

7.27 There was a general consensus that the settlement process was successful, consistent with the fact that the majority of FCA enforcement cases settle during Stage 1. Very few respondents expressed views about the way in which the discount scheme is currently structured.

7.28 However, a number of respondents considered that the application of the settlement process favoured the FCA, and, in some instances, was capable of unfairly pressuring subjects into settlement. The circumstances or features of the settlement process, a combination of which were felt to exert pressure upon firms to settle included: subjects having little insight into the FCA's case prior to the commencement of Stage 1; the 28 day period for Stage 1 and the FCA's *'exceptional circumstances'* approach towards granting extensions of that period; the asymmetry of the information available to enforcement and to the subject during Stage 1; the limited involvement of FCA enforcement senior management in negotiations following approval of settlement papers – perceived by some respondents to result in a reluctance or inability on behalf of investigation teams to revisit their findings to reflect representations made by subjects; and a lack of accountability where it was felt that FCA enforcement had pitched its case or the penalty too high at the settlement stage.

7.29 A range of measures were suggested as a means of rebalancing the interests of FCA enforcement and subjects at settlement including: greater transparency around the internal settlement decision-making process; investigators to set out their findings during a without prejudice meeting prior to commencement of Stage 1; entitling subjects to the same information to which Settlement Decision Makers have access; providing subjects with full disclosure of evidence and undermining material at the commencement of Stage 1; formalising a process for subjects to make representations during Stage 1, for consideration by senior management; involving an independent decision-maker or mediator during settlement; enabling referral to the RDC of discrete issues blocking settlement and mandating the RDC to reintroduce the Stage 1 discount, if its decision is more favourable to the subject than the terms proposed by enforcement for settlement purposes.

Since the changes made by the FSA in 2005, FCA executives make early settlement decisions and the RDC takes the decisions on the issue of statutory notices in contested cases. How does this compare with the PRA's executive-based approach? Could further changes be applied to either regulator's processes to improve the balance between fairness, transparency, speed and efficiency?

Should the composition of the RDC/DMC be changed? If so, why and how?

Almost 40% of cases considered by the RDC are subsequently referred to the Upper Tribunal. Does the RDC process duplicate too much the Tribunal process for firms and individuals who are likely to refer a Decision Notice to the Tribunal? What changes could be made to make the process more proportionate and/or efficient, consistent with the delivery of the regulatory objectives?

7.30 Generally, respondents were supportive of the role played by the RDC in FCA enforcement decision-making, and several called for the establishment of a similar committee within the PRA. Objections to the PRA model were on the basis that respondents saw no reason, in principle, for the FCA and PRA to take different approaches towards enforcement decision-making in contested cases. Concerns were also expressed about responsibility for enforcement decision-making falling to PRA executives who may not be perceived to be sufficiently independent, and whose other responsibilities may prevent them from applying the necessary time and focus to enforcement cases.

7.31 For the RDC itself, a small number of respondents favoured greater independence – potentially achievable through the model recommended by the PCBS – but with the firm caveat that that should not entail public hearings. However, there was clear support for retaining the current RDC framework and institution, to avoid duplicating the role of the Upper Tribunal, and potentially adding time, expense and complexity to a process widely regarded as fundamentally sound.

7.32 Noting the statistics referred to in the call for evidence, which suggested that the RDC process could significantly delay enforcement case outcomes, a number of respondents advocated better resourcing – in terms of administrative and legal resource available to the RDC, or expansion of RDC membership. Respondents also highlighted the importance of the RDC continuing to ensure that it has an appropriate range and depth of relevant financial services expertise among its membership. Several respondents also called for the RDC to operate more flexibly, in response to the demands of a particular case, such that, rather than considering representations on each and every aspect, it might examine only those issues that remained in real dispute on conclusion of the settlement process.

7.33 Respondents did not consider the RDC process to be duplicative of that of the Upper Tribunal, noting important differences including: publicity; that the RDC does not hear evidence; and that RDC meetings are commensurately shorter and less costly than Upper Tribunal hearings. Several respondents considered that the 40% statistic (of cases considered by the RDC and subsequently referred to the Tribunal) should be regarded as a positive indicator of the RDC's success. Several more highlighted that, notwithstanding that the RDC very rarely fails to issue a Decision Notice following the issue of a Warning Notice, *'it often amends, refines and clarifies the findings or alters the financial penalty'*.

What more could the UK learn from international practice?

Are there specific features of other jurisdictions' enforcement processes which might be introduced in the UK?

7.34 Respondents did not comment widely on practices in other jurisdictions. One respondent referred to a practice in Hong Kong, whereby investigators provide subjects with a 'terms of reference' document at the commencement of an investigation, which is said to convey

considerably more detail on scope than would be provided in the UK. Others pointed to the Hong Kong SFC's focus on harm and restitution in its approach to enforcement.

7.35 Several respondents commented on different practices in the US. One commended the 'Wells submission' process and the use of informal white papers by the SEC to understand subjects' representations, and to narrow the issues in dispute at a relatively early stage. The same respondent considered that the FCA and PRA should reconsider their position in respect of 'no admissions' settlements. Others commented unfavourably on the SEC's approach to penalties and the use of whistle-blowers, whilst some felt that investigators from US agencies (generally) were bolder in setting out their evolving case theories and debating issues with subjects than their UK counterparts, potentially attributable to the involvement of more senior staff.

HM Treasury contacts

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If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gsi.gov.uk