

Report of the Independent Investigation into the  
Financial Conduct Authority's Regulation of London  
Capital & Finance plc

The Rt. Hon. Dame Elizabeth Gloster DBE

23 November 2020

(Revised on 10 December 2020 – see overleaf)

Presented to Parliament pursuant to section 82 of the  
Financial Services Act 2012



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### **Legal disclaimer**

This Report has been prepared by the Rt. Hon. Dame Elizabeth Gloster DBE (“**Dame Elizabeth**”) in her capacity as the independent investigator appointed by the Financial Conduct Authority (the “**FCA**”) pursuant to the direction dated 22 May 2019 (the “**Direction**”) from HM Treasury (the “**Treasury**”) requiring the FCA to conduct an investigation (the “**Investigation**”) into the relevant events relating to the regulation of London Capital & Finance plc (“**LCF**”).<sup>1</sup>

As described in more detail in **Appendix 3** of this Report, Dame Elizabeth has been assisted by a support team (the “**Investigation Team**”) in the conduct of the Investigation, including in the preparation of this Report. The views, conclusions and recommendations attributed (directly or indirectly) to the Investigation in this Report are those of Dame Elizabeth for which she takes responsibility and they are based on the documents, information and materials provided to the Investigation by the FCA and others. No representation or warranty is given as to the accuracy or completeness of any documents, information or materials; other people considering the same documents, information and materials might reach different conclusions from those reached by Dame Elizabeth. To the extent permissible by law, Dame Elizabeth and the Investigation Team accept no liability or responsibility, whether in contract, in tort (including negligence), under statute or otherwise, in respect of any loss or damage (whether direct or indirect) suffered by any party: (i) as a result of, or in connection with the content of, or any omissions from, this Report; and/or (ii) as a result of any actions taken or decisions made by any person as a consequence of the views, conclusions and recommendations contained in this Report. This disclaimer extends, but is not limited to, any references to or comments upon legal or regulatory requirements, standards, or guidance which reflect the views of Dame Elizabeth.

If, and to the extent, this Report includes any legally privileged material, such inclusion does not constitute any wider or general waiver of privilege. Any legally privileged documents, information or materials provided to the Investigation by the FCA and others have been provided for the specific purpose of conducting the Investigation.

**Please note: Dame Elizabeth delivered the report to the FCA on 23 November 2020. Between 7 and 9 December 2020, the FCA, HM Treasury and the Serious Fraud Office requested that a small number of non-material redactions should be made prior to publication. Dame Elizabeth considered each of the suggested redactions and made a number of consequential minor amendments; and the Investigation Team also corrected certain minor typographical and similar errors. For the avoidance of doubt, none of the changes made after 23 November 2020 affected the substance of, or conclusions in, the Report.**

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<sup>1</sup> A copy of the Direction is enclosed at **Appendix 1** to this Report and can also be found at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/803967/LCF\\_Direction\\_to\\_FCA.PDF](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/803967/LCF_Direction_to_FCA.PDF) (accessed on 21 November 2020).

## Acknowledgments

This Report has been possible as a result of the hard work, support and cooperation of a number of individuals and groups. Dame Elizabeth is grateful to all those who have corresponded with and/or made submissions to the Investigation. Section 7 of **Chapter 1** (Introduction and background) of this Report, provides a more detailed overview of all individuals, groups and organisations that have engaged with the Investigation.

As explained in more detail in Section 9 of **Chapter 1** (Introduction and background) of this Report, the Investigation has received a significant volume of information from the individual investors who invested with LCF (the “**Bondholders**”). Dame Elizabeth appreciates that the collapse of LCF has had a significant impact on the physical and mental wellbeing of a number of Bondholders and she wishes to thank all Bondholders who have engaged with the Investigation, whether via email, letter, in person at the Bondholders’ meeting in January 2020 or otherwise. Bondholder engagement with the Investigation has been of substantial assistance in relation to a number of the issues being considered by the Investigation, including what Bondholders were told regarding the FCA’s regulation and oversight of LCF’s activities.

A group of Bondholders (the “**Bondholder Group**”) prepared a detailed written submission which it provided to the Investigation in October 2019. The Bondholder Group has supplemented its submission as matters have progressed. Dame Elizabeth is grateful to the members of the Bondholder Group for their work which has been critical to the Investigation Team’s understanding of some of the key issues.

During the course of the Investigation, certain Bondholders represented by the law firm Shearman & Sterling LLP (“**Shearman & Sterling**”) started judicial review proceedings against the Financial Services Compensation Scheme (the “**FSCS**”) in connection with compensation decisions arising from the collapse of LCF. Shearman & Sterling has updated the Investigation regarding the progress of those proceedings. Dame Elizabeth is grateful to Shearman & Sterling and the Bondholders it represents for the information provided.

The Investigation has been reliant on a team within the FCA (the “**FCA Investigation Liaison Team**”) to coordinate document requests, interviews and other logistics. Dame Elizabeth considers that the FCA Investigation Liaison Team has worked hard to assist the progress of the Investigation. Dame Elizabeth would like to record her gratitude to the members of the FCA Investigation Liaison Team for their assistance and cooperation throughout the Investigation. The fact that there have been considerable and repeated delays in the FCA’s provision of documentation (as to which see **Chapter 1** (Introduction and background) of this Report) does not detract from this comment.

Finally, this Report is the result of much hard work by the Investigation Team. Dame Elizabeth wishes to express her gratitude to the team for its work throughout the Investigation and its assistance in the production of this Report.

## TABLE OF CONTENTS

	<b>Page</b>
PART A: INTRODUCTION, EXECUTIVE SUMMARY AND KEY EVENTS.....	1
CHAPTER 1: INTRODUCTION AND BACKGROUND.....	1
1. Introduction .....	1
2. Start and scope of the Investigation.....	4
3. Other issues raised by the collapse of LCF and the Investigation’s approach to them .....	5
4. Note on legislation and applicable FCA rules and policies.....	9
5. Note on certain terminology used in this Report.....	10
6. Note on standard of proof applied in this Report .....	11
7. Conduct of the Investigation.....	12
8. Extension to the deadline for completion of the Investigation.....	14
9. Bondholder engagement .....	21
10. Observations on the representations made by the FCA and others .....	24
11. Individual responsibility of the FCA’s senior management.....	25
12. Structure of this Report.....	29
CHAPTER 2: EXECUTIVE SUMMARY .....	31
1. The Investigation’s primary conclusion .....	31
2. Significant gaps and weaknesses in the FCA’s policies and practices.....	31
3. Answers to questions posed in the Direction.....	35
4. The FCA’s resources and priorities .....	46
5. Summary of Recommendations.....	47
CHAPTER 3: KEY EVENTS IN THE FCA’S REGULATION OF LCF .....	50
1. Introduction .....	50
2. Regulatory transactions .....	51
3. Financial promotions .....	56
4. Significant information and intelligence .....	70
5. Conclusion.....	81
PART B: PRELIMINARY ISSUES .....	83
CHAPTER 4: INTRODUCTION TO THE PRELIMINARY ISSUES .....	83
1. Overview of the preliminary issues .....	83
CHAPTER 5: THE FCA’S FINITE RESOURCES AND PRIORITISATION .....	85
1. Introduction .....	85

## TABLE OF CONTENTS

(continued)

	<b>Page</b>
2. Broader issues with which the FCA had to deal during the Relevant Period.....	86
3. The FCA’s finite resources.....	88
4. The Investigation accepts that the FCA did have to prioritise and that it did so .....	91
5. The FCA’s finite resources do not excuse or mitigate the failures described in subsequent chapters of this Report.....	92
6. Conclusion.....	93
<b>CHAPTER 6: THE FCA’S APPROACH TO THE PERIMETER .....</b>	<b>95</b>
1. Introduction .....	95
2. The powers which the FCA had, and the policies it stated it had adopted, to regulate and/or intervene in relation to unregulated activities carried on by regulated firms .....	98
3. Failures of the FCA’s regulation of LCF involving inadequate consideration of Perimeter risks .....	101
4. The FCA was entitled, and recognised it was entitled, to look and act beyond the Perimeter .....	103
5. The FCA understood that there were problems and risks associated with a regulated firm carrying on unregulated activity .....	105
6. Responsibility for lack of consideration of Perimeter risks in dealing with LCF.....	110
7. The FCA’s resources and legal remit do not excuse or mitigate the above failures.....	112
8. Conclusion.....	114
<b>CHAPTER 7: THE FCA’S AWARENESS OF MINI-BONDS AND THE RELATED RISKS.....</b>	<b>115</b>
1. Introduction .....	115
2. Examples of the FCA identifying mini-bonds as carrying particular risks for consumers .....	116
3. LCF used mini-bonds in an unusual way .....	129
4. Activity by the FCA in relation to mini-bonds post the Relevant Period.....	132
5. Conclusion.....	133
<b>CHAPTER 8: THE “DELIVERING EFFECTIVE SUPERVISION” AND “DELIVERING EFFECTIVE AUTHORISATIONS” PROGRAMMES .....</b>	<b>135</b>



## TABLE OF CONTENTS

(continued)

	<b>Page</b>
1. Introduction .....	135
2. Scope of consideration by the Investigation of the Programmes .....	137
3. FCA’s supervisory strategy for firms previously regulated by the OFT prior to DES and DEA .....	138
4. The genesis of the DES and DEA Programmes .....	145
5. The FCA’s response to the PA Report and the Programmes .....	149
6. Executive Committee and Board oversight of the DES programme.....	152
7. Closure of the DES programme and outstanding issues.....	158
8. Insufficient consideration of interim measures or a look back.....	161
9. Delivering Effective Authorisations .....	169
10. Conclusion .....	172
PART C: ANALYSIS OF ISSUES IN THE DIRECTION.....	174
CHAPTER 9: APPROPRIATENESS OF LCF’S PERMISSIONS.....	174
1. Introduction .....	174
2. Public statements made by the FCA on authorisation.....	175
3. LCF carried on regulated activity for which it did not have permission .....	177
4. The FCA granted LCF permissions for business which it did not carry on .....	180
5. The handling of the Initial Authorisation Application .....	183
6. Failures in the FCA’s handling of the First VOP Application .....	186
7. Conclusion .....	202
CHAPTER 10: ADEQUACY OF THE FCA’S SUPERVISION OF LCF.....	204
1. Introduction .....	204
2. Public statements made by the FCA on supervision .....	205
3. Failure to appreciate the significance of red flags .....	207
4. The FCA’s approach to the Perimeter contributed to failures in supervising LCF .....	215
5. Inadequate training of individuals in the Supervision Division .....	217
6. Failure to consider LCF’s marketing strategy .....	218
7. Conclusion .....	221
CHAPTER 11: FCA RULES AND POLICIES RELATING TO LCF’S FINANCIAL PROMOTIONS .....	222

## TABLE OF CONTENTS

(continued)

	<b>Page</b>
1. Introduction .....	222
2. The FCA’s rules in respect of LCF’s financial promotions were appropriate if complied with.....	224
3. Monitoring LCF’s financial promotions.....	226
4. Intervening in respect of LCF’s financial promotions.....	231
5. Conclusion .....	241
CHAPTER 12: INFORMATION PROVIDED BY THIRD PARTIES .....	242
1. Introduction .....	242
2. Existence of Policies Question .....	242
3. Receipt of Information Question .....	254
4. Application of Policies Question.....	255
5. FCA’s representations as to third-party information.....	255
6. Conclusion .....	258
CHAPTER 13: OTHER MATTERS OF IMPORTANCE TO THE INVESTIGATION .....	259
1. Introduction .....	259
2. Non-regulation of LCF’s ISA products .....	260
3. The FCA’s failure appropriately to regulate LCF is not excused or mitigated by the risk associated with LCF’s products.....	266
4. The FCA Register and initiatives to inform the public of the risk of fraud.....	268
5. The Auditors’ Statement on LCF’s accounts did not excuse or mitigate the FCA’s failures.....	275
6. FCA staff must have a greater awareness of the FCA’s role in combatting fraud.....	277
7. The FCA’s intervention against LCF in late 2018 .....	280
8. Conclusion .....	290
PART D: RECOMMENDATIONS.....	291
CHAPTER 14: RECOMMENDATIONS.....	291
1. Introduction .....	291
2. Recommendations regarding the FCA’s policies and practices .....	293
3. Recommendations regarding the regulatory regime.....	302
APPENDIX 1: THE DIRECTION .....	309

## TABLE OF CONTENTS

(continued)

	<b>Page</b>
APPENDIX 2: THE PROTOCOL.....	312
APPENDIX 3: THE INVESTIGATION TEAM.....	318
1. Introduction .....	318
2. Rt. Hon. Dame Elizabeth Gloster DBE .....	318
3. James Petkovic .....	319
4. KV Krishnaprasad .....	320
5. Dechert LLP, London Office .....	320
6. Lansons .....	322
APPENDIX 4: GLOSSARY.....	324
APPENDIX 5: ANALYSIS OF WHETHER LCF WAS CONDUCTING REGULATED ACTIVITY .....	332
1. Introduction .....	332
2. Why these issues are dealt with in this Appendix 5 .....	332
3. The definition of “regulated activity” under FSMA.....	333
4. LCF may have carried on limited regulated activity for which it did not have permission .....	335
5. LCF’s issuing of its bonds did not constitute regulated activity .....	338
6. Conclusion.....	351
APPENDIX 6: INFORMATION WHICH THE FCA RECEIVED FROM THIRD PARTIES DURING THE RELEVANT PERIOD REGARDING LCF’S CONDUCT .....	352
1. Introduction .....	352
2. Communications to the Customer Contact Centre .....	352
3. Calls to the Contact Centre which alleged that LCF was engaged in fraud or serious irregularity .....	357
4. Calls to the Contact Centre which made enquiries as to whether LCF was operating a scam .....	371
5. Communications to the Contact Centre and the Financial Promotions Team which suggested that LCF’s financial promotions were misleading.....	373
6. Calls to the Contact Centre which made general enquiries about LCF’s permissions.....	374
7. Other information the FCA received from third parties .....	377
8. Conclusion.....	379

## TABLE OF CONTENTS

(continued)

	<b>Page</b>
APPENDIX 7: SUMMARY CHRONOLOGY .....	380
APPENDIX 8: DETAILED CHRONOLOGY .....	386
1. Introduction .....	386
2. Chronology .....	386
APPENDIX 9: RECENT DEBATE AND REFORMS IN RESPECT OF THE FINANCIAL PROMOTIONS REGIME .....	428
APPENDIX 10: THE FCA'S ASSIGNMENT OF RESPONSIBILITIES .....	431
2. Introduction .....	431
3. Applying the Senior Managers Regime to the FCA 2016.....	431
4. Applying the Senior Managers Regime to the FCA 2018.....	438
APPENDIX 11: STONETURN REPORT ON LCF'S FINANCIAL INFORMATION .....	442

## **PART A: INTRODUCTION, EXECUTIVE SUMMARY AND KEY EVENTS**

### **CHAPTER 1: INTRODUCTION AND BACKGROUND**

#### **1. Introduction**

- 1.1 This Report sets out the views, conclusions and recommendations of Dame Elizabeth<sup>2</sup> following her formal appointment by the FCA in July 2019 to investigate the relevant events relating to the FCA’s regulation of LCF between 1 April 2014 and 30 January 2019 (the “**Relevant Period**”).
- 1.2 LCF was incorporated on 12 July 2012 under the name South Eastern Counties Finance Limited.<sup>3</sup> On 3 September 2012, LCF obtained a consumer credit licence from the Office of Fair Trading (the “**OFT**”) to carry on “*consumer credit (lending)*” and “*consumer hire*”.<sup>4</sup> The OFT regulated LCF’s consumer credit activities from 3 September 2012 until 31 March 2014. On 1 April 2014, consumer credit regulation transferred from the OFT to the FCA.<sup>5</sup> Accordingly, the Relevant Period runs from the start of the FCA’s regulation of LCF through to the appointment of administrators on 30 January 2019.<sup>6</sup>

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<sup>2</sup> As explained in the Legal Disclaimer at the beginning of this Report, although Dame Elizabeth has been assisted by the Investigation Team, the views, conclusions and recommendations attributed to the Investigation in this Report are those of Dame Elizabeth for which she takes responsibility. Those conclusions and recommendations also reflect the views of members of the Investigation Team.

<sup>3</sup> Certificate of Incorporation, 12 July 2012, available at Companies House (see: <https://beta.companieshouse.gov.uk/company/08140312/filing-history> (accessed on 22 November 2020)). Companies House records show that LCF changed its name a number of times before it became London Capital & Finance plc in November 2015. Details of the various name changes are set out in the detailed chronology at **Appendix 8** of this Report.

<sup>4</sup> Slides for the meeting between Independent Investigation Team & FCA, 20 September 2019, at slide 13.

<sup>5</sup> *Ibid.*, at slide 14.

<sup>6</sup> A summary of key events relevant to the Investigation is set out in **Chapter 3** (Key events in the FCA’s regulation of LCF), a summary chronology of LCF’s history focused on the products it offered is set out at **Appendix 7** and a more detailed chronology is provided at **Appendix 8**. The confirmation of the appointment of administrators by LCF was published in the Gazette on 4 February 2019 (see: <https://www.thegazette.co.uk/notice/3200833> (accessed on 22 November 2020)).

## Chapter 1: Introduction and background

- 1.3 Throughout the Relevant Period, LCF's primary business appears to have been commercial lending funded by issuing various bonds<sup>7</sup> in its own name to the Bondholders.<sup>8</sup> LCF's bonds were issued for up to five years and at rates of interest that varied depending upon the terms of the bond and the bond issue.<sup>9</sup> Her Majesty's Revenue & Customs ("HMRC") approved LCF to manage Individual Savings Accounts ("ISAs") on 1 November 2017.<sup>10</sup> Shortly thereafter, LCF began to offer products which it claimed to be ISAs, alongside its non-ISA wrapped products.<sup>11</sup> By the time of the FCA's intervention in December 2018, LCF had raised in excess of £237 million from approximately 16,700 investment products issued to 11,625 Bondholders.<sup>12</sup>
- 1.4 The FCA conducted an unannounced site visit at LCF's premises on 10 December 2018<sup>13</sup> as a result of serious concerns regarding LCF's conduct, including issues with the accuracy of the firm's financial promotions. Following this intervention, the FCA imposed various requirements, including restrictions preventing LCF from issuing or approving further

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<sup>7</sup> The bonds issued by LCF during the Relevant Period are sometimes referred to as "mini-bonds". Indeed, in the wake of the collapse of LCF, the FCA added a page to its website covering mini-bonds (see: <https://www.fca.org.uk/consumers/mini-bonds> (accessed on 22 November 2020)). However, as that FCA webpage notes: "[t]here is no legal definition of a 'mini-bond'..." Further, a common theme in the correspondence received by the Investigation from Bondholders is that they did not consider that they were investing in mini-bonds. Accordingly, this Report avoids the use of the term mini-bond unless absolutely necessary. The FCA's knowledge and awareness of the risk of mini-bonds during the Relevant Period is discussed further in **Chapter 7** (The FCA's awareness of mini-bonds and the related risks).

<sup>8</sup> Joint administrators' Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 Insolvency Act 1986, 25 March 2019, at pages 5 and 6 (see: <https://smithandwilliamson.com/media/3772/lcf-joint-administrators-proposals.pdf> (accessed on 22 November 2020)).

<sup>9</sup> *Ibid.*, table 7.1, at page 9.

<sup>10</sup> *Ibid.*, at page 6.

<sup>11</sup> *Ibid.*, at page 6 and table 7.1, at page 9. LCF's literature also stated its bonds were secured by a debenture over the assets of LCF, which was to be held by an allegedly independent security trustee for the benefit of Bondholders and that its bonds were non-transferable. It has since emerged that there are serious questions as to whether the security trustee was independent from LCF. The High Court, Chancery Division has granted an application to remove the trustee: [2019] EWHC 3339 (Ch) (see: <https://www.bailii.org/ew/cases/EWHC/Ch/2019/3339.html> (accessed on 22 November 2020)). Furthermore, as explained in **Chapter 13** (Other matters of importance to the Investigation) and **Appendix 5** of this Report, a question has been raised in judicial review proceedings which are ongoing as at the date of drafting this Report as to whether LCF's ISA-wrapped products could be non-transferable given the requirements of the relevant ISA legislation.

<sup>12</sup> Joint administrators' Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 Insolvency Act 1986, 25 March 2019, at pages 5 to 7.

<sup>13</sup> Slides for the meeting between Independent Investigation Team & FCA, 20 September 2019, at slide 60.

## Chapter 1: Introduction and background

financial promotions.<sup>14</sup> The FCA's subsequent concerns regarding the viability of LCF's business resulted in a suggestion by the FCA that the firm should obtain advice regarding its solvency. LCF's directors appointed administrators on 30 January 2019 with the consent of, among others, the FCA.<sup>15</sup>

1.5 LCF's administrators' first report in March 2019 stated that “[t]here are a number of highly suspicious transactions involving a small group of connected people which have led to large sums of the Bondholders' money ending up in their personal possession or control”.<sup>16</sup> Since the end of the Relevant Period, concerns regarding the conduct of LCF's business have also resulted in criminal investigations by the FCA and the Serious Fraud Office (the “SFO”).<sup>17</sup> As at the date of this Report, those criminal investigations are ongoing and the Investigation has taken appropriate steps to ensure that, to the extent possible, it has not hindered or prejudiced the conduct of, or actions resulting from, those investigations.<sup>18</sup> In addition, there have been a number of court actions arising out of the collapse of LCF.

1.6 In their progress report dated 26 February 2020, LCF's administrators estimated that the return to Bondholders from the assets of LCF could be as low as 25% of their investment.<sup>19</sup> As at the date of this Report this figure had not been updated by the administrators.<sup>20</sup>

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<sup>14</sup> Second Supervisory Notice from the FCA to LCF, 17 January 2019 (see: <https://www.fca.org.uk/publication/supervisory-notices/second-supervisory-notice-london-capital-and-finance-plc-2019.pdf> (accessed on 22 November 2020)).

<sup>15</sup> Joint administrators' Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 of Insolvency Act 1986, 25 March 2019, at page 5.

<sup>16</sup> *Ibid.*

<sup>17</sup> Details of the FCA investigation can be found online (see: <https://www.fca.org.uk/news/news-stories/london-capital-and-finance-plc> (accessed on 22 November 2020)). Details of the SFO investigation can be found online (see: <https://www.sfo.gov.uk/cases/london-capital-finance-plc/> (accessed on 22 November 2020)).

<sup>18</sup> The Investigation has acted in accordance with paragraph 6(2) of the Direction: “[t]he Investigator must liaise with the [SFO] and the FCA in order that reasonable precautions are taken to ensure that the ongoing joint SFO/FCA investigation and any subsequent prosecution or regulatory action by the SFO and/or FCA are not prejudiced by the Investigation or written report”.

<sup>19</sup> Joint administrators' progress report for the period from 30 July 2019 to 29 January 2020, 26 February 2020, at page 4 (see: <https://smithandwilliamson.com/media/6517/lcf-progress-report-january-2020-final.pdf> (accessed on 22 November 2020)).

<sup>20</sup> Joint administrators' progress report for the period from 30 January 2020 to 29 July 2020, 26 August 2020, at page 5 explained that the 25% figure “is constantly being reviewed and will be updated when it is clear to the administrators that a different percentage is more appropriate” (see: <https://smithandwilliamson.com/media/7695/lcf-progress-report-july-2020-final.pdf> (accessed on 22 November 2020)).

## 2. Start and scope of the Investigation

- 2.1 The collapse of LCF has received significant media and political attention because of its impact on retail investors and the questions about the regulatory framework which the case raises.<sup>21</sup> On 19 March 2019, the then Chair of the Treasury Select Committee<sup>22</sup> asked the FCA Board (the “**Board**”) to consider whether the FCA should commission an investigation into the regulatory issues arising from LCF.<sup>23</sup> On 28 March 2019, the Non-Executive Directors (“**NEDs**”) of the FCA “*agreed that the FCA should invite HM Treasury to direct the FCA to commission a review into the regulation of mini-bonds and the failure of [LCF] under section 77 [of the Financial Services Act 2012] on grounds of the public interest*”.<sup>24</sup>
- 2.2 On 22 May 2019, the Treasury issued the Direction which states that it considers “*it is in the public interest that the [FCA] should undertake an investigation into relevant events relating to the regulation of [LCF]...*”<sup>25</sup> Pursuant to the Direction, the FCA formally appointed Dame Elizabeth to lead the Investigation on 10 July 2019.<sup>26</sup>
- 2.3 The Direction required the Investigation to focus on “*whether the FCA discharged its functions in respect of LCF in a manner which enabled it to effectively fulfil its statutory objectives*”.<sup>27</sup> In particular, the Direction provided that the Investigation must consider the following matters:
- (a) whether the permissions that LCF were granted were appropriate for the business activities that it carried on;<sup>28</sup>

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<sup>21</sup> See: <https://www.bbc.co.uk/news/uk-england-47454328> (accessed on 22 November 2020).

<sup>22</sup> Rt. Hon. Nicky Morgan MP (as she was at the time).

<sup>23</sup> Letter from the Rt. Hon. Nicky Morgan MP to Mr Charles Randell CBE, 19 March 2019 (see: <https://old.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/Chair-to-Chair-of-FCA-re-LCF-190319.pdf> (accessed on 22 November 2020)).

<sup>24</sup> Minutes of FCA Board Meeting, 28 March 2019, at paragraphs 5.1 to 5.5 (see: <https://www.fca.org.uk/publication/minutes/fca-board-28-march-2019.pdf> (accessed on 22 November 2020)).

<sup>25</sup> The Direction was made pursuant to the Treasury’s powers under sections 77(1) and (2) and 78(5) and (6) of the Financial Services Act 2012.

<sup>26</sup> See: <https://www.fca.org.uk/transparency/independent-investigation-london-capital-finance> (accessed on 22 November 2020).

<sup>27</sup> Paragraph 3(1) of the Direction.

<sup>28</sup> Paragraph 3(1)(d) of the Direction.



## *Chapter 1: Introduction and background*

- (b) whether the FCA adequately supervised LCF's compliance with its rules and policies;<sup>29</sup>
- (c) whether the FCA had in place appropriate rules and policies relating to the communication of financial promotions by LCF;<sup>30</sup>
- (d) whether –
  - (i) the FCA had established appropriate policies for responding to information provided by third parties regarding the conduct of LCF,
  - (ii) the FCA received such information during the Relevant Period,
  - (iii) those policies were properly applied;<sup>31</sup> and
- (e) any other matters that Dame Elizabeth might deem relevant to the question as to whether the FCA had discharged its functions in a manner which enabled it effectively to fulfil its statutory objectives.<sup>32</sup>

2.4 Accordingly, the primary focus of the Investigation has been on whether the FCA discharged its regulatory responsibilities effectively in respect of LCF.

### **3. Other issues raised by the collapse of LCF and the Investigation's approach to them**

3.1 The collapse of LCF raises a number of other issues. These include:

- (a) individual Bondholders' entitlement to compensation from the FSCS<sup>33</sup> and/or compensation pursuant to the FCA's own complaints scheme;<sup>34</sup>

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<sup>29</sup> Paragraph 3(1)(a) of the Direction.

<sup>30</sup> Paragraph 3(1)(b) of the Direction.

<sup>31</sup> Paragraph 3(1)(c) of the Direction.

<sup>32</sup> Paragraph 3(2) of the Direction.

<sup>33</sup> The FSCS is running a separate investigation to consider this question (see: <https://www.fscs.org.uk/failed-firms/lcf/> (accessed on 22 November 2020)). As noted in the Acknowledgments section of this Report, the Investigation is also aware of ongoing judicial review proceedings brought by a group of Bondholders in respect of the FSCS's compensation decisions. The Investigation understands the High Court recently granted the claimant Bondholders permission to proceed with their claim against the FSCS (see the 17 September 2020 update on the FSCS website: <https://www.fscs.org.uk/failed-firms/lcf/> (accessed on 22 November 2020)).

<sup>34</sup> The FCA's current Complaints Scheme is available at: <https://www.fca.org.uk/publication/corporate/complaints-scheme.pdf> (accessed on 22 November 2020). However, the Investigation is aware that the FCA recently consulted about introducing a revised complaints scheme (see: <https://www.fca.org.uk/publication/consultation/cp20-11.pdf> (accessed on 22 November 2020)). Although Dame Elizabeth did not formally respond to the consultation, she wrote to the Chair of the

## Chapter 1: Introduction and background

- (b) whether Bondholders, or certain individual, or categories (classes) of individual, Bondholders should otherwise receive compensation for their losses on an *ex gratia* or other basis, because of the failings in, or the quality of, the FCA's regulation of LCF;
- (c) the recovery of Bondholders' investments from the assets of LCF and potential civil proceedings to recover funds from other sources;<sup>35</sup>
- (d) criminal liability of those involved in or connected to the running of LCF;<sup>36</sup> and
- (e) the work of the auditors in their respective audits of LCF's accounts.<sup>37</sup>

3.2 Important as they are, these issues do not form part of the Investigation and this Report does not make any direct findings in respect of them. To the extent this Report addresses these issues indirectly, the views and findings of the Investigation are not legally determinative, nor do they bind any other parties considering these issues (including the Court).

3.3 In particular, it should be emphasised that issues (a) and (b) listed above, namely those of possible redress for Bondholders, whether by way of entitlement, or as a result of an *ex gratia* or other payment, are not within the remit of this Investigation. Those are decisions for others. It has been suggested by the FCA, in its representations, that, in order for Bondholders to be entitled to receive compensation for their losses, they would need to establish a causal link between the deficiencies in the FCA's regulation of LCF during the Relevant Period and the losses incurred by Bondholders. The Investigation does not necessarily agree with that proposition, but does not consider that it is within its remit to consider or determine that question. The Investigation can state that it has not considered, or determined, the evidential issue as to whether there was a causal link between the

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FCA in September 2020 to express her concern about the potential for the proposals set out in the consultation paper adversely to impact on any complaints which might be made by Bondholders after publication of this Report.

<sup>35</sup> These issues are being considered by the administrators of LCF. For example, the Joint administrators' progress report for the period from 30 January 2020 to 29 July 2020, 26 August 2020, at pages 4 and 5.

<sup>36</sup> As noted at paragraph 1.5 of this **Chapter 1**, the FCA and SFO are conducting criminal investigations which remain ongoing as at the date of this Report.

<sup>37</sup> On 24 June 2020, the Financial Reporting Council announced that it had begun three investigations into the audits of LCF for the one month period ended 30 April 2015, the year ended 30 April 2016 and the year ended 30 April 2017 (see: <https://www.frc.org.uk/news/june-2020/frc-launches-investigations-into-three-audit-firms> (accessed on 22 November 2020)).

deficiencies in the FCA's regulation of LCF during the Relevant Period and the losses incurred during that period by Bondholders, either as a class, a series of classes, or individually. As the FCA pointed out in its representations,<sup>38</sup> specific evidence, which the Investigation has not considered, would be necessary to determine those types of causation issues.

3.4 It does not follow that all causal conclusions are outside the purview of the Investigation. To give some examples, the Investigation has concluded that:

- (a) the failure of the FCA senior management to implement and embed operational change at the lower levels of the organisation contributed to the FCA's failures of regulation in respect of LCF;<sup>39</sup>
- (b) the FCA's failure to respond appropriately to information provided by third parties regarding LCF occurred because of deficiencies in the relevant FCA policies;<sup>40</sup>
- (c) the FCA Case Officer's inadequate training was one of the reasons for the FCA's deficient handling of LCF's first Variation of Permission application submitted in October 2016 (the "**First VOP Application**");<sup>41</sup> and
- (d) had the FCA acted more timeously in late 2018, further Bondholders' funds would not have been invested in the products offered by LCF.

3.5 Furthermore, the following is, in the Investigation's view, self-evident: had some or all of the FCA's failures in regulation outlined in this Report not occurred, then it is, at the least, possible that the FCA's actions would have prevented LCF from receiving the volume of investments in its bond programmes which it did. For instance, had possible irregularities by LCF been detected (and their significance appreciated) by the FCA<sup>42</sup> sooner than late 2018, then the FCA *should*, in the Investigation's view, have intervened (or taken other regulatory action) earlier. On any basis, it is, at the least, possible that the FCA would have intervened

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<sup>38</sup> See paragraphs 4.16 to 4.20 of the FCA's representations.

<sup>39</sup> See paragraphs 1.7(d), 6.3 and 8.2 of **Chapter 6** (The FCA's approach to the Perimeter).

<sup>40</sup> See paragraph 4.1 of **Chapter 12** (Information provided by third parties).

<sup>41</sup> See paragraphs 6.14 to 6.19 of **Chapter 9** (Appropriateness of LCF's permissions).

<sup>42</sup> Whether as part of the FCA's authorisation or supervision of LCF as described in this Report.

sooner than it in fact did. Such earlier intervention may, in turn, have prevented LCF from receiving investments in its bond programme sooner, thereby reducing the exposure of investors to LCF's collapse. This is particularly so in circumstances where the FCA's actions in late 2018/early 2019 *did* result in LCF not receiving further investments from investors in its bond issues.

3.6 The Investigation does not comment on the *likelihood* that, at any particular point in time, different action by the FCA *would have* resulted in LCF being prevented from receiving further investor funds with the result that Bondholders' exposure would have been less than it in fact was. Such considerations are best left to those determining compensation in respect of particular investments by Bondholders in the light of the totality of the facts relevant to any particular claim.<sup>43</sup> Nonetheless, the above demonstrates that the Investigation considers that the FCA's failures may be relevant to arguments that the FCA in some real sense "*caused*" Bondholders' losses.

3.7 The collapse of LCF raises wider policy, economic and legislative questions regarding the structuring, regulation and marketing of corporate bonds. The corporate bond market is large,<sup>44</sup> with bond issuances structured and marketed in diversified ways and issued by a variety of companies of all sizes. For this reason, this topic carries broad policy, economic and legislative implications which have the potential to impact on legitimate capital raising by companies, and, in particular "SMEs".<sup>45</sup> This topic is largely outside the scope of this

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<sup>43</sup> Assuming, of course, that establishing a causal link is relevant to whatever compensation procedure (if any) is applicable.

<sup>44</sup> A recent Bank of England, Staff Working Paper (No. 803) began as follows: "[t]he structure of the financial system has changed materially over the past ten years. Market-based finance – the system of markets and non-bank financial institutions that provide financial services to the real economy – has become increasingly important. In the UK, non-bank institutions now account for almost 50% of the UK financial system's total assets, up by 13 percentage points since 2008. **Further, during the past five years, nearly three quarters of net finance raised by UK corporates has come from capital markets, as compared to just a third during 2008-2012, with most of such finance coming from the corporate bond market...** These developments have had numerous benefits. For example, they have helped mitigate the effect of the reduced provision of credit by banks on the real economy. They have also supported the sharing of risk across the financial system, increasing the diversity of funding and sources available to the corporate sector..." (emphasis added). The paper also stated: "[a]s of end-2015, the total amount outstanding of UK corporate bonds was £1.7trn... Bonds issued by UK private non-financial firms account for about a third of the UK corporate bond universe. Non-financial firms issuing corporate bonds are major contributors to UK GDP, accounting for around 50% of total UK business investment..." (see: Simulating stress in the UK corporate bond market: investor behaviour and asset fire-sales, Y. Baranova, G. Douglas and L. Silvestri, June 2019, at pages 2 and 7 (see: <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2019/simulating-stress-in-the-uk-corporate-bond-market-investor-behaviour-and-asset-fire-sales.pdf> (accessed on 22 November 2020))).

<sup>45</sup> Usually defined as a small to medium-sized enterprise; that is to say a company with no more than 500 employees.

Report, although the Investigation does recommend<sup>46</sup> that the Treasury should consider whether regulation should be extended to the type of non-transferable bonds issued by LCF.<sup>47</sup> (As explained in **Appendix 5** to this Report, in the Investigation’s view, LCF did not carry on regulated activity by issuing its bonds.)

3.8 Accordingly, this Report focuses on the FCA’s regulation of LCF during the Relevant Period. As will be evident from the chapters which follow, the failures in regulation identified in this Report consist of the FCA failing to scrutinise LCF’s business and financial information adequately, and failing to appreciate the significance of “red flags”<sup>48</sup> which indicated that something was seriously wrong with LCF’s business. The identification of these failures does not require the Investigation to consider the broader topic of how legislation should permit corporate bond issuances to be structured and marketed. It is important that legitimate capital raising by companies of all sizes is not unduly hindered, or constrained, and, for that reason, such broader questions require careful consideration and consultation in arenas other than this Investigation.

#### **4. Note on legislation and applicable FCA rules and policies**

4.1 The Direction states that the Investigation must consider certain aspects of the FCA’s “rules” and “policies”.<sup>49</sup> The Direction does not, however, define these terms. In the circumstances, the Investigation considers that, for the purposes of this Report, these terms should be understood in the following manner:

- (a) *Rules*: these are the publicly available rules and guidance set out in the FCA Handbook and other legislation, rules and regulations contained in or made under the Financial Services and Markets Act 2000 (as amended) (“**FSMA**”);<sup>50</sup> and

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<sup>46</sup> See Recommendation 11 of **Chapter 14** (Recommendations).

<sup>47</sup> In addition to other recommendations regarding the regulatory framework (as to which see Section 3 of **Chapter 14** (Recommendations)).

<sup>48</sup> The term “red flag” is used to denote a warning or indicator of danger or potential misconduct.

<sup>49</sup> Paragraph 3(1)(a) of the Direction requires the Investigation to consider “*whether the FCA adequately supervised LCF’s compliance with its rules and policies*”.

<sup>50</sup> The current version of the FCA Handbook can be accessed online (see: <https://www.handbook.fca.org.uk/handbook>) (accessed on 22 November 2020).

- (b) *Policies*: these are the policies, procedures, statements, guidance and training materials which are produced by and available to FCA staff which describe how the FCA and its staff should perform their roles and responsibilities at the FCA, including how to assist the FCA in complying with its statutory objectives together with their practical interpretation and application.

4.2 Unless otherwise stated, this Report quotes legislation and FCA Handbook provisions as they were on 1 April 2014, the beginning of the Relevant Period.

## **5. Note on certain terminology used in this Report**

5.1 A glossary of key defined terms and other important terminology used in this Report is set out in **Appendix 4**. However, the Investigation wishes to highlight and define in this introductory chapter certain terminology that appears throughout this Report.

5.2 This Report refers in many sections to the fact that the FCA should have looked at LCF and its business ‘as a whole’ or ‘holistically’. By that, the Investigation means that the FCA should have made an assessment of the firm and its business, taking account of all relevant factors. This obligation on the FCA to look at the firms it regulates as a whole arises from a basic principle of regulation, namely the fit and proper test in paragraph 2E to Schedule 6 of FSMA. Under this test, an authorised firm must be a fit and proper person having regard to all the circumstances, including, for example whether those who manage its affairs have the necessary skills, experience and probity, whether its business is conducted in a sound and prudent manner, and the need to minimise the extent to which its business could be carried on for purposes connected with financial crime.

5.3 Examples of the FCA employing a holistic approach in its consideration of LCF would include, but are not limited to:

- (a) looking not solely at the regulated business of a firm, but also at its unregulated business, where that unregulated business had a significant impact on the firm’s fitness and propriety; this might, in appropriate circumstances, include looking at the firm’s financial position, business model, and solvency (as distinct from not considering its unregulated business at all, or considering it solely in terms of its impact on the regulated business);

- (b) cross-referencing individual and, apparently, minor problems with each other to see if a pattern emerged (as distinct from considering each problem in isolation from the others and signing it off based on a risk assessment for that single problem); and
- (c) proactively considering whether what appears to be a technical rule breach might be symptomatic of a more substantive or systemic failure (as distinct from looking at the breach on a narrow, reactive basis).

## 6. Note on standard of proof applied in this Report

- 6.1 The Investigation has made factual determinations throughout this Report. In so doing, it has employed the standard of proof ordinarily used in civil legal proceedings of “balance of probabilities”. In other words, the Investigation has determined that facts have been proved if their existence is more likely than not. Where the Investigation has drawn inferences from the available evidence,<sup>51</sup> or postulated what would have happened if certain events had occurred,<sup>52</sup> these assessments have also been made in accordance with the balance of probabilities standard.
- 6.2 The Investigation’s findings are not legally binding, nor do they determine civil or criminal liability. As such, the Investigation is not bound by legislation or other legal authority to apply any particular standard of proof.<sup>53</sup> Nor is any standard of proof mandated by sections 77 and 78 of the Financial Services Act 2012,<sup>54</sup> the Direction or the Protocol. Nonetheless, in view of the objective of the Investigation, and the nature of the factual determinations that it has made, the Investigation has concluded it is appropriate to apply the balance of probabilities standard.

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<sup>51</sup> See, for example, paragraphs 4.3 to 4.11 of **Chapter 3** (Key events in the FCA’s regulation of LCF).

<sup>52</sup> See, for example, paragraphs 5.9 and 5.10 of **Chapter 9** (Appropriateness of LCF’s permissions).

<sup>53</sup> See Beer, *Public Inquiries* (Oxford University Press: 2011) at [9.53]-[9.72]. See also occasions when a “flexible and variable” standard of proof has been applied e.g. *Report of the Baha Mousa Enquiry* (Sir William Gage) at [1.114] (Chapter 6). See also *Report of the Azelle Rodney Inquiry* (Sir Christopher Holland) at [1.12]; *First Report of the Shipman Inquiry* (Dame Janet Smith) at [9.43]; *Report of the Bloody Sunday Inquiry* (Lord Saville), standard of proof ruling dated 11 October 2004 at [27]; *Report of the Mid Stratfordshire NHS Foundation Trust Public Inquiry* (Robert Francis QC) (volume 1) at [95]; *Report of the Undercover Policing Inquiry* (Sir Christopher Pitchford) standard of proof ruling dated 17 December 2015 at [35].

<sup>54</sup> Pursuant to which the Direction was given.

## **7. Conduct of the Investigation**

7.1 The Investigation has been conducted pursuant to a protocol agreed between the FCA and Dame Elizabeth (the “**Protocol**”).<sup>55</sup> Among other matters, the Protocol gave the Investigation the ability to request any relevant documents within the FCA’s power, custody or possession. At the outset of the Investigation, the FCA provided the Investigation with various documents identified by the FCA as being directly or indirectly relevant to the regulation and oversight of LCF during the Relevant Period. Those documents included a detailed chronology of the FCA’s contact with LCF.

7.2 Subsequently, the Investigation has obtained documents and information from the FCA through four primary methods:

- (a) presentations and demonstrations by relevant teams within the FCA to enable the Investigation to understand, among other things, the structure and composition of the various divisions involved in regulating LCF throughout the Relevant Period and the systems and databases that might hold documents and information relevant to the Investigation;
- (b) the provision to the FCA of search terms relevant to the issues being considered by the Investigation, which the latter required the FCA to run across the FCA systems which held documents and information relevant to the Investigation; the FCA provided documents responsive to these search terms in accordance with its legal obligations (e.g. some documents were redacted in accordance with the FCA’s duties under applicable data protection and financial services legislation);
- (c) targeted data and information requests; and
- (d) interviews with current and former FCA employees, directors and advisers who were involved in, or had responsibility for, the regulation, supervision and/or authorisation of LCF during the Relevant Period.

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<sup>55</sup> A copy of the Protocol is included as **Appendix 2** to this Report and it is also available online: <https://www.fca.org.uk/publication/corporate/protocol-independent-investigation-london-capital-finance.pdf> (accessed on 22 November 2020).



*Chapter 1: Introduction and background*

- 7.3 As a result of the methods described at paragraph 7.2 above, the Investigation has:
- (a) received and reviewed in excess of 45,000 documents from the FCA in response to search terms and targeted document and information requests;
  - (b) conducted interviews with 28 FCA employees, two former FCA employees, one adviser, and one current and one former non-executive member of the Board;<sup>56</sup> certain individuals were interviewed on more than one occasion; although Dame Elizabeth did not have the power to compel individuals to attend interviews (see paragraph 14 of the Protocol), no one refused an interview request from the Investigation.
- 7.4 The Investigation has also gathered evidence from the following sources:
- (a) as discussed at Section 9 of this Chapter, and as noted in the Acknowledgments section at the outset of this Report, the Investigation has received a significant volume of information from Bondholders, including a detailed written submission from the Bondholder Group; and
  - (b) correspondence and/or meetings with:
    - (i) the Treasury;
    - (ii) HMRC;
    - (iii) the FSCS;
    - (iv) the Financial Ombudsman Service (the “FOS”);
    - (v) the Financial Services Consumer Panel;
    - (vi) the Advertising Standards Authority (the “ASA”);
    - (vii) LCF’s auditors;
    - (viii) industry bodies and trade associations;

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<sup>56</sup> In accordance with footnote 1 of the Protocol, the transcripts of the interviews conducted by the Investigation have not been made available to the FCA. The Investigation considers these transcripts to be confidential, save to the extent that they are quoted or referred to in this Report. References in this Report to interviews with those individuals below Director-level have been anonymised appropriately.

- (ix) independent financial advisers;
- (x) law firms representing either Bondholders or interested parties; and
- (xi) various other interested individuals and groups.

7.5 The documents and information provided by those outside of the FCA have been important in understanding the wider context and the significance of the issues arising from the collapse of LCF. Dame Elizabeth is grateful to everyone who has engaged with the Investigation.

7.6 In respect of the criticisms made in this Report, the Investigation has followed the procedure set out in paragraphs 24 and 25 of the Protocol. Accordingly, no current or former FCA employees below Director-level have been identified in this Report. Insofar as this Report criticises any individuals, groups of individuals whose members are identifiable, or organisations (including the FCA), such persons were provided with a reasonable opportunity to make representations in relation to the proposed criticisms. Their responses were carefully considered by the Investigation before the finalisation of this Report.

## **8. Extension to the deadline for completion of the Investigation**

8.1 Pursuant to the Direction, the Investigation was due to be completed “*within a period of 12 months beginning on the date upon which the Investigator is appointed by the FCA*”.<sup>57</sup> As the FCA appointed Dame Elizabeth on 10 July 2019, the Investigation planned to deliver this Report on or before 10 July 2020. However, a combination of factors, arising from the FCA’s delay in producing documents and information to the Investigation, resulted in Dame Elizabeth writing to the Chair of the FCA on 15 May 2020 to notify him formally that the duration of the Investigation would need to be extended as her revised target date for the production of this Report had changed to 30 September 2020.<sup>58</sup>

8.2 The timeline of events, which led to the deadline for completion of the Investigation being extended to 30 September 2020, was as follows:

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<sup>57</sup> Paragraph 7(1) of the Direction.

<sup>58</sup> Letter from Dame Elizabeth to Mr Charles Randell CBE, 15 May 2020. A copy of the letter was made publicly available by the FCA (see: <https://www.fca.org.uk/publication/correspondence/dame-elizabeth-gloster-letter-to-charles-randell.pdf> (accessed on 22 November 2020)). Mr Charles Randell’s response to Dame Elizabeth on 26 May 2020 was also made publicly available (see: <https://www.fca.org.uk/publication/correspondence/charles-randell-letter-to-dame-elizabeth-gloster.pdf> (accessed on 22 November 2020)).

## Chapter 1: Introduction and background

- (a) Following review of the initial materials and a background presentation prepared by the FCA, the Investigation provided the FCA with additional search terms<sup>59</sup> to be run across the various systems holding documents and information relevant to the Investigation on 27 September 2019.<sup>60</sup>
- (b) Having previously raised concerns in relation to delays in the production of responses to document and information requests in mid-November 2019,<sup>61</sup> Dame Elizabeth wrote to the FCA Investigation Liaison Team on 3 December 2019 stating that the Investigation had yet to receive the majority of documents responsive to the search terms provided on 27 September 2019.<sup>62</sup>
- (c) The FCA Investigation Liaison Team escalated Dame Elizabeth’s concerns to the Chair of the FCA.<sup>63</sup> In an email on 5 December 2019, the Chair of the FCA explained to Dame Elizabeth that his team had updated him “*on the document retrieval and technology issues which are inhibiting [the FCA’s] ability to respond promptly to [the Investigation’s] information requests*”. The email also explained that the FCA’s Executive Committee (“**ExCo**”) was taking urgent steps to supplement the resources available to the FCA Investigation Liaison Team and to ensure that the technological difficulties were overcome as soon as possible.<sup>64</sup>
- (d) Dame Elizabeth and the Chair of the FCA spoke and exchanged further correspondence in the first half of December 2019 regarding the FCA’s delays in providing the Investigation with documents and information. In an email on 12 December 2019, the Chair of the FCA expressed his regret over “*the delays in responding to [the Investigation’s] specific information requests and to the*

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<sup>59</sup> The Investigation had been informed of initial search terms used by the FCA to identify the materials discussed at paragraph 7.1 of this **Chapter 1** (Introduction and background).

<sup>60</sup> Email from the Investigation Team to the FCA Investigation Liaison Team, 27 September 2019.

<sup>61</sup> Email from Dame Elizabeth to the FCA Investigation Liaison Team, 15 November 2019.

<sup>62</sup> Email from Dame Elizabeth to the FCA Investigation Liaison Team, 3 December 2019.

<sup>63</sup> Paragraph 19 of the Protocol notes that the Chair of the FCA is the contact for escalation of issues in circumstances where Dame Elizabeth considers that “*the FCA is not providing [her] with the co-operation or information that [she reasonably requires] to fulfil [her] responsibilities*”.

<sup>64</sup> Email from Charles Randell CBE to Dame Elizabeth, 5 December 2019.

## Chapter 1: Introduction and background

*broader provision of data*". He also explained the delays were as a result of "*a number of unexpected technology challenges which have hampered [the FCA's] ability to deliver data in a timely manner*".<sup>65</sup>

- (e) Throughout December 2019 and into January 2020, the FCA continued to produce documents responsive to the search terms provided by the Investigation at the end of September 2019.
- (f) The Investigation had planned to conduct interviews with junior FCA employees in December 2019 and January 2020, but that depended on receiving relevant documents and information from the FCA sufficiently in advance of that window. As a result of the delays described above, the Investigation was only in a position to begin the interviews of junior FCA employees in March 2020.
- (g) As a consequence, the interviews were impacted by the COVID-19 pandemic and by the FCA's implementation of a policy (in line with UK Government guidance) the day before the interviews were scheduled to begin, which asked employees to work from home. Accordingly, the in-person interviews of junior FCA employees scheduled for March 2020 had to be cancelled. From that point in March and throughout April 2020, the Investigation worked with the FCA Investigation Liaison Team to agree an appropriate protocol to cover the various technological, logistical and security issues arising from conducting interviews remotely.
- (h) The interviews with the junior FCA employees eventually started in May 2020 and the interviews with senior leadership at the FCA were conducted from mid-June through to September 2020.
- (i) As explained in Dame Elizabeth's letter to the Chair of the FCA on 15 May 2020,<sup>66</sup> had there not been delays in the provision of documents and information to the Investigation, the COVID-19 pandemic would have had little (if any) impact on the timetable for delivery of this Report.

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<sup>65</sup> Email from Charles Randell CBE to Dame Elizabeth, 12 December 2019.

<sup>66</sup> Letter from Dame Elizabeth to Mr Charles Randell CBE, 15 May 2020, at paragraph 9.

8.3 Following Dame Elizabeth’s letter of 15 May 2020, which set a revised target date for delivery of this Report of 30 September 2020, there were further delays by the FCA and developments which required additional amendments to the timetable for completion of this Investigation. Accordingly, Dame Elizabeth explained in a conversation with the Chair of the FCA in early August 2020 that a further extension would be necessary and, by a letter dated 21 August 2020, she formally confirmed a revised deadline for completion of the Investigation of 23 November 2020.<sup>67</sup> The issues which led to further amendments to the timetable were:

- (a) The FCA Investigation Liaison Team began an audit of the data provided to the Investigation at the end of April 2020 to identify any documents responsive to the Investigation Team’s search terms or information requests that had not been provided.<sup>68</sup> The letter sent by the Chair of the FCA to Dame Elizabeth on 26 May 2020 stated that this data assurance work had “*resulted in some limited additional documentation being identified, which [the FCA is] in the process of providing*”.<sup>69</sup>
- (b) During the course of preparing responses to information requests made by the Investigation Team in June and July 2020, the FCA Investigation Liaison Team identified a technical issue which produced an additional 1,200 files that potentially should have been provided at a much earlier date to the Investigation Team.<sup>70</sup>
- (c) In the circumstances, the FCA Investigation Liaison Team did not provide approximately 3,500 documents identified by the data assurance work to the Investigation Team until 17 July 2020. Obviously, the Investigation Team needed to review these documents and consider them in the context of the Investigation.

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<sup>67</sup> Letter from Dame Elizabeth to Mr Charles Randell CBE, 21 August 2020. A copy of the letter was made publicly available by the FCA (see: <https://www.fca.org.uk/publication/correspondence/dame-elizabeth-gloster-letter-to-charles-randell-21-august-2020.pdf> (accessed on 22 November 2020)). The FCA also published Mr Charles Randell’s response of 22 August 2020 (see: <https://www.fca.org.uk/publication/correspondence/charles-randell-letter-to-dame-elizabeth-gloster-22-august-2020.pdf> (accessed on 22 November 2020)).

<sup>68</sup> Letter from the FCA’s Executive Director of Risk & Compliance Oversight to Dame Elizabeth, 31 July 2020.

<sup>69</sup> Letter from Mr Charles Randell CBE to Dame Elizabeth, 26 May 2020.

<sup>70</sup> Letter from the FCA’s Executive Director of Risk & Compliance Oversight to Dame Elizabeth, 31 July 2020.

## *Chapter 1: Introduction and background*

- (d) The first interviews with relevant members of the FCA’s senior leadership team in office during the Relevant Period were conducted in mid-June 2020. Those interviews raised some new and important issues also requiring substantial additional work. In particular, during the course of these interviews, it became clear that relevant members of the FCA’s senior leadership team during the Relevant Period considered certain programmes, designed and implemented from 2016 onwards, to be an important part of understanding the FCA’s regulation of LCF.<sup>71</sup> Prior to mid-June 2020, the FCA had provided the Investigation Team with limited documentation explaining the relevance of these programmes.<sup>72</sup> Throughout June and July 2020, the FCA provided a substantial volume of additional material regarding these programmes.<sup>73</sup> The Investigation Team also made document and information requests to understand: (i) the Board and executive-level committee (e.g. ExCo) awareness of these programmes; (ii) the issues which resulted in the creation of these programmes; and (iii) the relevance of these programmes to the FCA’s regulation of LCF during the Relevant Period. The materials produced by the FCA throughout June and July 2020 resulted in the Investigation Team having to review hundreds of additional documents about these programmes.
- (e) Because of the additional materials which were provided to the Investigation Team, further FCA delays and the identification of a significant new line of enquiry at a late stage in the Investigation, Dame Elizabeth determined in early August 2020 that, despite the best efforts of the Investigation Team, it would no longer be possible to deliver this Report by 30 September 2020. This was

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<sup>71</sup> Specifically, the senior leadership team was referring to the Delivering Effective Supervision and Delivering Effective Authorisation programmes which were designed with the objective of overhauling and improving the FCA’s approaches to supervision and authorisations respectively. The Delivering Effective Supervision and Delivering Effective Authorisation programmes are discussed in more detail in **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes) of this Report.

<sup>72</sup> For example, the report by an external management consultancy from July 2016 – which was one of the primary catalysts for the “Delivering Effective Supervision” programme – was only provided to the Investigation Team on 12 June 2020 at the request of the Executive Director of Supervision – Retail and Authorisations shortly before his interview with the Investigation Team.

<sup>73</sup> For example, the materials provided by the FCA in the light of the email sent by the Executive Director of Supervision – Retail and Authorisations on 17 June 2020.

particularly the case in circumstances where paragraph 25 of the Protocol requires Dame Elizabeth to allow those criticised in this Report a “*reasonable opportunity*” to make representations regarding relevant criticisms and the FCA had expressed its view that a period of longer than two weeks would likely be required for any such representations process.<sup>74</sup>

- (f) By a letter to the Chair of the FCA dated 21 August 2020,<sup>75</sup> Dame Elizabeth formally confirmed that a revised deadline would be necessary due to the issues outlined above. Dame Elizabeth’s letter explained that she anticipated being in a position to start the representations process by no later than 28 September 2020 and this process would take four weeks, meaning that it would be completed on or before 26 October 2020. Dame Elizabeth’s letter provided a further four week window following completion of the representations process in which the Investigation Team would finalise and deliver this Report. Accordingly, the letter explained that Dame Elizabeth would, absent further significant developments, deliver this Report on or before 23 November 2020.

8.4 The FCA’s delays and errors in providing documentation to the Investigation Team continued into August and September 2020:

- (a) On 5 August 2020, the FCA Investigation Liaison Team disclosed a report to the Investigation Team that had been prepared in January 2020 and had been identified at the time as responsive to one of the Investigation Team’s information requests. The covering email sent with the report explained that the report should have been provided much earlier and that this had not happened due to human error.<sup>76</sup>
- (b) On 11 September 2020, the FCA Investigation Liaison Team wrote to the Investigation Team to provide an update on further data audit work. The letter explained that a technical issue had been identified which meant that a further 454

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<sup>74</sup> Letter from Mr Charles Randell CBE to Dame Elizabeth, 31 July 2020.

<sup>75</sup> Letter from Dame Elizabeth to Mr Charles Randell CBE, 21 August 2020.

<sup>76</sup> Email from the FCA Investigation Liaison Team to the Investigation Team, 5 August 2020 at 11:01am.

documents needed to be provided to the Investigation Team and that these documents should have been provided at an earlier stage.<sup>77</sup> In a letter dated 22 September 2020, the Investigation Team informed the FCA Investigation Liaison Team that, after receipt of the 454 documents, the Investigation Team would not accept additional documents from the FCA (other than in response to any new or outstanding document requests from the Investigation Team).<sup>78</sup>

8.5 The FCA’s various delays in providing the Investigation with key documents and information were regrettable and have had a significant impact on the timing of this Report. However, for the avoidance of doubt, the Investigation does not consider that these delays were intentional or the result of deliberate non-cooperation by the FCA.

8.6 The delays do, however, raise serious questions as to the adequacy of the FCA’s technology systems. Indeed, in his letter of 22 August 2020, the Chair of the FCA explained that “[the FCA is] *frustrated by the limitations of [its] legacy technology systems in retrieving information*” and that those issues are “*being addressed through a multi-year and multi-million-pound investment programme*”.<sup>79</sup> The FCA’s representations stated that “[t]he FCA’s digital challenges stem from the fact that [the organisation] inherited a legacy estate from the FSA, which in turn included legacy systems from several other regulatory bodies which had come together to form the FSA in 2000”.<sup>80</sup> Given that Part 5 of the Financial Services Act 2012 sets out a framework for investigations such as this one and the FCA has shown a willingness to appoint independent investigators outside of that framework,<sup>81</sup> it is foreseeable that the FCA will, in the future, need to be in a position to retrieve and provide historic documents and information promptly and comprehensively. The FCA has explained that there are various programmes underway to address the organisation’s digital

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<sup>77</sup> Letter from the FCA Investigation Liaison Team to the Investigation Team, 11 September 2020.

<sup>78</sup> Letter from the Investigation Team to the FCA Investigation Liaison Team, 22 September 2020.

<sup>79</sup> Letter from Mr Charles Randell CBE to Dame Elizabeth, 22 August 2020.

<sup>80</sup> See paragraph 9.21(a) of the FCA representations.

<sup>81</sup> For example the independent review into the FSA’s (and subsequently the FCA’s) approach to, implementation and oversight of the Connaught Income Fund Series 1 (see: <https://www.fca.org.uk/transparency/independent-review-connaught-income-fund-series-1> (accessed on 22 November 2020)).



challenges.<sup>82</sup> In the circumstances, the FCA should ensure these programmes are delivered as soon as possible and that work is undertaken to ensure that they achieve their objectives.

## **9. Bondholder engagement**

9.1 Engagement with Bondholders has been very helpful to the Investigation. As described in more detail below, information and evidence provided by the Bondholders, particularly about their interactions with the FCA, have informed many of the findings expressed in this Report.

9.2 In July 2019, the Investigation set up an email address (the “**Investigation Inbox**”)<sup>83</sup> to which Bondholders were invited to send any information they had about the FCA’s regulation of LCF. Since then, the Investigation Inbox has received 1,700 emails from over 1,000 individuals. While a vast majority of these were from Bondholders, the Investigation Inbox also received queries, information and offers for assistance from various other individuals including independent financial advisers, journalists, lawyers, accountants, academics, compliance professionals, industry bodies and Members of Parliament (who made submissions on behalf of their constituents). The Investigation is grateful to all those who have contributed.

9.3 On 23 January 2020, the Investigation held a public meeting for Bondholders in London (the “**Bondholders’ Meeting**”). The primary purpose of the Bondholders’ Meeting was for the Investigation to hear directly from Bondholders. Bondholders were made aware of the event via the Investigation Website, direct emails from the administrators, and through the media. At the meeting, Dame Elizabeth and other members of the Investigation Team also answered questions from Bondholders. Approximately 175 Bondholders attended the Bondholders’

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<sup>82</sup> The FCA referred to its data strategy (see: <https://www.fca.org.uk/publications/corporate-documents/data-strategy> (accessed on 22 November 2020)).

<sup>83</sup> Details of the Investigation Inbox were provided on the FCA website (see: <https://www.fca.org.uk/transparency/independent-investigation-london-capital-finance> (accessed on 22 November 2020)) and on the website set up by the Investigation (see: <https://london-capital-and-finance-investigation.org.uk/> (accessed on 22 November 2020)) (the “**Investigation Website**”). In view of the fact that the Investigation Inbox was hosted using FCA systems, some Bondholders expressed concern about whether it was accessible to the FCA. The Investigation received written confirmation from the FCA that it did not have access to the Investigation Inbox. The Investigation is in the process of winding down the Investigation Inbox and the Investigation Website in light of the completion of the Report.

Meeting in person. For the benefit of those unable to attend in person, the event was live-streamed via the Investigation Website, and a recording was available to watch thereafter.<sup>84</sup>

9.4 Information received via the Investigation Inbox and the Bondholders' Meeting has allowed the Investigation to hear Bondholders' views about the FCA's regulation of LCF and the impact of LCF's failure more generally. Although it is not feasible to set out an exhaustive account of Bondholders' communications with the Investigation in this Report, they reveal the following predominant themes:

- (a) First, a substantial proportion of the Bondholders said that they would not have invested in LCF had it not been for the fact that it was regulated by the FCA. Many of them felt that the FCA's regulation gave them a degree of comfort that their money was safe. Many Bondholders also pointed out that LCF had been using its FCA-authorized status in its promotional materials and others pointed out that it was not clear to them that the FCA did not regulate the investment products offered by LCF. Many of the Bondholders who contacted the Investigation said that they relied on LCF's status as a firm authorized and regulated by the FCA in deciding to proceed with their investment.
- (b) Second, a significant number of Bondholders felt strongly that the FCA had failed to perform its regulatory function in relation to LCF. Some felt that LCF should not have been authorized at all whereas others said that the FCA was culpable in having ignored warnings about LCF.
- (c) Third, the majority of Bondholders were concerned about compensation. Many of them said that all Bondholders deserve to be compensated. Some felt that the FCA ought to be held liable for their losses whereas others were of the view that the FSCS, or, failing that, the Government, must step in. The Investigation does not have the power to make decisions as to whether individual Bondholders or indeed certain classes of Bondholders, will or should receive compensation. The Investigation assumes that its conclusions regarding the FCA's conduct in connection with LCF will inform appropriate decision makers (whether in

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<sup>84</sup> A recording of the Bondholders' Meeting was made available via the Investigation Website.

Government or elsewhere) in relation to the issue as to whether compensation should be paid to Bondholders.

- (d) Fourth, a number of Bondholders viewed the fact that LCF was offering ISAs as another indicator that it was a legitimate business subject to scrutiny by both the FCA and HMRC.
- (e) Fifth, those Bondholders who searched for LCF on the Financial Services Register (the “**Register**”)<sup>85</sup> maintained by the FCA found it difficult to use and commented that it was not clear that LCF’s bonds were unregulated. Other Bondholders described similar issues when calling the FCA’s Customer Contact Centre.
- (f) Sixth, the huge impact of LCF’s failure on the lives of Bondholders was another recurring theme. Several Bondholders said that they had lost most of their life savings, while others described the devastating impact that LCF’s failure had had on their physical and mental wellbeing.

9.5 As stated in the Acknowledgments section at the outset of this Report, on 9 October 2019, the Investigation received a detailed written submission from the Bondholder Group (the “**Bondholder Group Submission**”).<sup>86</sup> This comprehensive and informative submission, among other things, provided an overview of the interaction which Bondholders had had with LCF from receipt of marketing and promotional material through to transferring funds to LCF in connection with their investment. Having reviewed the Bondholder Group Submission, the Investigation held a follow-up meeting with its authors on 4 December 2019 in order to clarify certain aspects of the submission and to obtain a fuller understanding of their views in relation to the issues within the remit of the Investigation.

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<sup>85</sup> The Register maintained by the FCA can be accessed online (see: <https://register.fca.org.uk/> (accessed on 5 November 2020)). The FCA is required to maintain such a register pursuant to section 347 of FSMA. The Register accessible as at the date of this Report is different from the Register available throughout the Relevant Period. The FCA launched a redesigned version of the Register on 27 July 2020 (see: <https://www.fca.org.uk/news/press-releases/fca-launches-enhanced-financial-services-register-protect-consumers> (accessed on 22 November 2020)).

<sup>86</sup> The authors of the Bondholder Group Submission have indicated that they wish to remain anonymous. As such, they are not identified in this Report.

**10. Observations on the representations made by the FCA and others**

10.1 As noted at paragraph 7.6 (above), the Investigation has conducted a representations process in accordance with paragraphs 24 and 25 of the Protocol, pursuant to which those individuals, groups or organisations criticised in the draft report were given a reasonable opportunity to make representations in respect of those criticisms.

10.2 As part of that process, the Investigation has received extensive representations from the FCA itself and from others who have been criticised, or arguably criticised, in the draft report. All these representations have been carefully considered by the Investigation and, in certain cases, where the Investigation considered it appropriate to do so, have been expressly referred to in the relevant chapter(s) in this Report where the point at issue is addressed.<sup>87</sup> The Report necessarily does not expressly refer to, or deal with, every representation which has been made. All representations have, however, been taken into consideration in the drafting of the final Report.

10.3 Certain headline points made in the representations justify a brief mention at this stage:

- (a) The FCA and others stressed that the draft report had not adequately recognised that “*the FCA must necessarily prioritise and take a risk-based approach*”. The Investigation does not consider that it was within the terms of its remit or, indeed, otherwise appropriate for it to have conducted an in-depth investigation into the entirety of the functions and workings of the FCA during the Relevant Period, or to have conducted a retrospective analysis as to whether the prioritisation decisions taken by the FCA were correct at the time when they were taken. As it was directed to do, the Investigation has concentrated on the FCA’s regulation of LCF; and it has concluded that the FCA failed to discharge its statutory objectives in that regulation. The Investigation appreciates that, during the Relevant Period, the FCA had an extremely heavy workload and that, necessarily, difficult decisions had to be made as to prioritisation, estimation of risk and allocation of

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<sup>87</sup> In expressly referring to a particular representation, the Investigation makes no criticism of the individual, group or organisation that made it; they were perfectly entitled to make any representation that they saw fit. Dame Elizabeth found the representations process to be a helpful exercise.

finite resources. However, in the Investigation's view, those factors did not excuse the FCA's failures in relation to the regulation of LCF. These matters are addressed more fully in **Chapter 5** (The FCA's finite resources and prioritisation) of this Report.

- (b) The FCA's representations suggested that the Investigation had made inappropriate use of hindsight. The Investigation disagrees. While it is correct that the Investigation does have the benefit of hindsight (which is inevitable in investigations of this kind which are looking at historic issues), the Investigation has reviewed the actions in the Relevant Period by reference to the contemporaneous circumstances, considering what was known (or should have been known) at the relevant time.
- (c) A number of participants in the representations process asked the Investigation not to make findings about individual responsibility for the FCA's deficiencies in regulating LCF. The Investigation wishes to record its disappointment with this suggestion, which is misconceived for a number of reasons, including the fact that the FCA is a regulator which certainly expects key individuals at regulated firms to take responsibility when a failure has occurred. The individual responsibility issues are addressed in Section 11 below.

## **11. Individual responsibility of the FCA's senior management**

- 11.1 As noted above, a number of participants in the representations process asked the Investigation not to make findings about individual responsibility for the FCA's deficiencies in regulating LCF. For example, the Investigation was asked "*to delete references to "responsibility" resting with specific identified/identifiable individuals*".<sup>88</sup> Similarly, the Investigation was told that criticism of senior managers who were recruited to overcome structural, cultural or institutional difficulties was "*likely to have the undesirable consequence of discouraging people from taking on and tackling difficult and vital roles*

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<sup>88</sup> Representations on behalf of Andrew Bailey, paragraph 21.

*within public bodies*".<sup>89</sup> The findings in this Report are certainly not intended to have that effect. In any case, it is difficult to see why an individuals' willingness to take on challenging tasks in public bodies should absolve them from accountability. A further comment was that "*it is neither necessary nor... appropriate for individuals to be identified as bearing particular responsibility for the matters which are the subject of the criticisms in the draft Report*".<sup>90</sup> The Investigation does not agree with these suggestions for the reasons set out below.

11.2 First, it was represented to the Investigation that there was "*an inherent ambiguity*" in the use of the word "*responsibility*".<sup>91</sup> For the avoidance of doubt, the findings of individual responsibility in this Report are not conclusions about the personal *culpability* of any individuals or groups of individuals. In particular, the fact that the Investigation has identified an individual as being responsible for one aspect of the FCA's deficient regulation of LCF does not necessarily mean that the individual had specific knowledge of the relevant problem(s), or that the individual failed to take reasonable steps to address them. The Investigation has not made findings about personal culpability (as opposed to responsibility) because it has not found it necessary to do so in order to answer the questions put to it. To have done so would have required an analysis of detailed evidence relating to the specific actions or omissions by relevant individuals, the circumstances in which they were taken and the extent of their knowledge at the relevant time. The Investigation has not considered these matters. It follows that the Investigation has also not made findings about whether there was any causal connection between the actions or omissions of specific individuals within the FCA and losses suffered by Bondholders.<sup>92</sup> In this Report, the term "*responsibility*" is used in the sense in which that term is employed in the FCA Statements of Responsibility and the FCA Management Responsibilities Map. In short, it refers to a sphere of activities or functions of the FCA for which a senior manager bears ultimate accountability. Relevant

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<sup>89</sup> Representations on behalf of Megan Butler, paragraph 2(a).

<sup>90</sup> Representations on behalf of Jonathan Davidson, paragraph 3.

<sup>91</sup> Representations on behalf of Andrew Bailey, paragraph 23.

<sup>92</sup> See paragraphs 3.3 to 3.5 above.

extracts describing how the FCA assigned responsibility during the Relevant Period are set out in **Appendix 10**.

11.3 Second, it was said that the scope of the Investigation “*does not require the attribution of “responsibility” to particular individuals within the FCA, but rather is directed at whether the FCA (as an organisation)” discharged its functions.*<sup>93</sup> The Investigation disagrees. Addressing responsibility of the senior management<sup>94</sup> of the FCA for its failures in regulating LCF is well within the remit of the Investigation:

(a) The Direction asked the FCA to appoint an independent person to investigate the “*circumstances surrounding*”<sup>95</sup> “*the supervision of LCF by the FCA*”.<sup>96</sup> These “*circumstances*” plainly include the role that senior individuals within the FCA played in supervising LCF.

(b) Moreover, paragraph 3(2) of the Direction provides that “*the Investigator may also consider any other matters which they deem relevant to the question of whether the FCA discharged its functions in a manner which enabled it to effectively fulfil its statutory objectives*”. For the reasons provided in paragraphs 11.4(b) and 11.5 below, accountability of the FCA’s senior management is a matter relevant to whether the FCA effectively fulfilled its statutory objectives in relation to LCF.

11.4 Third, it was suggested that since “*investigations of this type are generally directed at identifying “lessons learned” following a high-profile financial failure, it is normal for such investigations to focus on identifying institutional rather than individual failures*”.<sup>97</sup> As to this:

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<sup>93</sup> Representations on behalf of Andrew Bailey, paragraph 22.

<sup>94</sup> Pursuant to paragraph 24 of the Protocol, the Investigation is required not to identify publicly FCA employees below Director-level. This Report does not do so.

<sup>95</sup> See paragraph 2(1) of the Direction.

<sup>96</sup> See the definition of “*the relevant events*” in paragraph 1 of the Direction.

<sup>97</sup> Representations on behalf of Andrew Bailey, paragraph 22.

## Chapter 1: Introduction and background

- (a) The primary role of the Investigation is not to identify the “*lessons learned*”. As paragraph 9(b) of the Direction provides, that is a matter for the FCA.<sup>98</sup> As explained above, the key question for the Investigation is whether the FCA effectively fulfilled its regulatory responsibilities in respect of LCF.<sup>99</sup>
- (b) It is also not correct to say that investigations of this nature are required to focus exclusively on institutional, rather than individual, failure. The following observations of the Treasury Committee in relation to the Davis Inquiry Report’s<sup>100</sup> findings about the FCA are instructive in this regard:<sup>101</sup>

*“Simon Davis reached conclusions about the responsibility of certain individuals for the events of the 27 and 28 March. However, it is not clear from his report where individual responsibility lies for the failures of the FCA’s Executive Committee and Board. Instead, he concludes that the Board and the Executive Committee are collectively responsible for their respective failures. This is a well-rehearsed and unfortunate mantra. The Committee has heard it often from regulated firms, and particularly banks. One of the key conclusions of the Parliamentary Commission on Banking Standards was that “a buck that does not stop with an individual stops nowhere” .... Mr Davis should have paid closer attention to individual responsibility in reaching his conclusions.”*

11.5 Fourth, it was suggested that “*no benefit arises (and the... report’s findings and conclusions are not strengthened) by the attribution of responsibility to particular individuals*”.<sup>102</sup> This assertion is inconsistent with the FCA’s own approach to the public accountability of its senior management:

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<sup>98</sup> See paragraph 9(b) of the Direction.

<sup>99</sup> See paragraph 3(1) of the Direction.

<sup>100</sup> Report of the Inquiry into the events of 27/28 March 2014 relating to the press briefing of information in the Financial Conduct Authority’s 2014/15 Business Plan dated 20 November 2014 (see: <https://www.fca.org.uk/publication/corporate/davis-inquiry-report.pdf> (accessed on 22 November 2020)).

<sup>101</sup> House of Commons Treasury Committee, “Press Briefing of the FCA’s Business Plan for 2014/15: Thirteenth Report of Session 2014-15” (published on 27 March 2015): <https://publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/881/881.pdf> (accessed on 18 November 2020), paragraph 183.

<sup>102</sup> Representations on behalf of Andrew Bailey, paragraph 22.



- (a) In March 2015, the Treasury Committee recommended that the FCA publish a ‘Responsibilities Map’ allocating responsibilities to individuals within the FCA. The Committee stated that the FCA’s allocation of individual responsibility should be compliant, as far as possible, with the Senior Managers Regime that the FCA and PRA apply to banks.<sup>103</sup>
- (b) In 2016, the FCA published a document applying the fundamental principles of the Senior Management Regime to the FCA’s senior staff.<sup>104</sup> This document contained the ‘FCA Statements of Responsibility’ and the ‘FCA Management Responsibilities Map’. It states that the FCA’s “*senior management should meet standards of professional conduct as exacting as those we require from regulated firms*”<sup>105</sup> and “*reaffirm[ed]... the FCA’s commitment to individual accountability*”.<sup>106</sup>
- (c) The FCA’s policy regarding the public accountability of its senior management is also reflected in paragraph 24 of the Protocol for this Investigation, which states that “[i]t is the policy of the FCA that employees at Director and above should be publicly accountable for the FCA’s performance...”

11.6 For these reasons, the Investigation considers that it would have been inappropriate for it not to have made findings about the responsibility of the FCA’s senior management for the deficiencies in the FCA’s regulation of LCF.

## 12. Structure of this Report

12.1 The remainder of this Report consists of the following chapters:

- (a) **Chapter 2** is an executive summary of the Investigation’s conclusions and recommendations.

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<sup>103</sup> House of Commons Treasury Committee, “Press Briefing of the FCA’s Business Plan for 2014/15: Thirteenth Report of Session 2014-15” (published on 27 March 2015), at paragraph 184 (see: <https://publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/881/881.pdf> (accessed on 22 November 2020)).

<sup>104</sup> FCA application of the Senior Managers Regime, 2016. See also, FCA application of the Senior Managers Regime, 2018.

<sup>105</sup> *Ibid.*, at page 3.

<sup>106</sup> *Ibid.*, at page 4.

*Chapter 1: Introduction and background*

- (b) **Chapter 3** provides an overview of key events related to LCF during the Relevant Period.
- (c) **Chapters 4 to 8** address certain preliminary issues which provide necessary context for the issues being considered by the Investigation.
- (d) **Chapters 9 to 13** analyse the issues that have been considered by the Investigation.
- (e) **Chapter 14** outlines the recommendations made by the Investigation.

## **CHAPTER 2: EXECUTIVE SUMMARY**

### **1. The Investigation’s primary conclusion**

- 1.1 Paragraph 3(1) of the Direction states that the primary question for the Investigation is “*whether the FCA discharged its functions in respect of LCF in a manner which enabled it to effectively fulfil its statutory objectives*”. For the reasons summarised in this Executive Summary, and as explained in more detail in the rest of this Report, the Investigation has concluded that the FCA did *not* discharge its functions in respect of LCF in a manner which enabled it effectively to fulfil its statutory objectives. In all the circumstances, the Investigation concludes that the Bondholders, whatever their individual personal circumstances, were entitled to expect, and receive, more protection from the regulatory regime in relation to an FCA-*authorised* firm (such as LCF) than that which, in fact, was delivered by the FCA. The following chapters of this Report explain why this was the case.
- 1.2 Sections 2 to 4 below summarise the Investigation’s key findings. Section 5 summarises the Investigation’s recommendations.

### **2. Significant gaps and weaknesses in the FCA’s policies and practices**

- 2.1 The root causes of the FCA’s failure to regulate LCF appropriately were significant gaps and weaknesses in the policies<sup>107</sup> and practices implemented by the FCA to analyse the business activities of regulated firms. These failings can be grouped into three broad categories. The FCA’s inadequate regulation of LCF during the Relevant Period was the cumulative result of each of these deficiencies.
- 2.2 First, the FCA’s approach to its regulatory perimeter (the “**Perimeter**”)<sup>108</sup> was unduly limited. In general, the FCA did not sufficiently encourage its staff to look outside the Perimeter when dealing with FCA-*authorised* firms such as LCF. This made it possible for

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<sup>107</sup> Section 3 of **Chapter 1** (Introduction and background) explains the use of the term “*policies*” in this Report.

<sup>108</sup> This Report adopts the meaning of the Perimeter as set out in Mr Bailey’s foreword (in his capacity as then CEO of the FCA) to the FCA’s Perimeter Report 2018/19 published in June 2019 at page 3: “[t]he question of what and who the FCA regulates is important for users and providers of financial services, and for society as a whole. This boundary is also referred to as ‘the FCA perimeter’. The FCA perimeter determines which firms require our authorisation. It also affects the level of protection consumers can expect for the financial services and products they purchase” (see: <https://www.fca.org.uk/publication/annual-reports/perimeter-report-2018-19.pdf> (accessed on 22 November 2020)).

LCF to use its authorised status to promote risky, and potentially fraudulent, non-regulated investment products to unsophisticated retail investors.

2.3 LCF was a regulated firm, but the majority (if not all) of its revenue was generated from non-regulated activities. The Investigation has concluded<sup>109</sup> that LCF's bond business did not constitute "*regulated activity*".<sup>110</sup> As a result of the FCA's approach to the Perimeter, this core aspect of LCF's business was not subject to sufficient scrutiny. For example:

- (a) The FCA's approach to LCF's First VOP Application<sup>111</sup> was overly focused on regulated activity. While the First VOP Application was being considered by the FCA, the FCA received the Anonymous Letter<sup>112</sup> which raised allegations of fraud and other irregularities in respect of LCF. Despite the clear allegations in the Anonymous Letter, the FCA failed to consider whether LCF's business activities (including its non-regulated activities) were indicative of fraud or other irregularities. A member of the Authorisations Division with responsibility for reviewing the First VOP Application received a copy of the Anonymous Letter. Despite this, the individual did not take any steps to consider the issues raised in the Anonymous Letter in the context of the First VOP Application or otherwise. When interviewed by the Investigation, the individual said that allegations of fraud would be "*principally a matter for the police*".<sup>113</sup>
- (b) Similarly, the FCA's Contact Centre policy documents were unclear about whether call-handlers should refer allegations of fraud or serious irregularity

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<sup>109</sup> The reasons for this conclusion are set out in **Appendix 5** of this Report. The Investigation is aware that judicial review proceedings are ongoing which address whether LCF's bond issuances constituted regulated activity. The Investigation's conclusions are not binding or legally determinative of this issue which can ultimately only be resolved by the Courts rather than this Investigation. Similarly, the Investigation's conclusions on this issue have no bearing on whether the Bondholders are entitled to compensation from FSCS.

<sup>110</sup> As defined in section 22 of FSMA. The meaning of the phrase "*regulated activity*" is considered in paragraphs 3.1 to 3.7 of **Appendix 5** of this Report.

<sup>111</sup> The First VOP Application is described in Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>112</sup> The Anonymous Letter is described and defined in Section 4 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>113</sup> When pressed on where responsibility lay for responding to allegations regarding FCA-authorized firms, the Case Officer stated that responsibility would rest with the Supervision rather than the Authorisations Division (Interview Transcript X, at page 25). As explained in **Chapter 10** (Adequacy of the FCA's supervision of LCF), the FCA's Supervision Division considered the matter primarily one for the police and also failed to properly consider LCF's business following receipt of the letter.

regarding the non-regulated activities of FCA-regulated firms to the Supervision Division. As a result, in the extensive sample of call materials reviewed by the Investigation in connection with LCF, call-handlers on many occasions failed to refer allegations of fraud or irregularity regarding LCF's non-regulated bond business to the Supervision Division. For instance, the Contact Centre received three calls on 22 July 2016<sup>114</sup> and another call on 10 July 2017<sup>115</sup> raising detailed allegations against LCF. None of them was referred to the Supervision Division.

- 2.4 The FCA's flawed approach to the Perimeter resulted in LCF being able to use its FCA-regulated status to present an unjustified imprimatur of respectability to the market, even in relation to its non-regulated bond business.
- 2.5 Second, the FCA failed to consider LCF's business holistically.<sup>116</sup> Instead, FCA staff analysed LCF's breaches as though they were isolated issues. In particular, they did not consider whether, and if so how, these issues were indicative of broader concerns with LCF's business. For example, LCF had repeatedly breached the FCA's financial promotion rules by using its FCA-authorized status to attract investors to its non-regulated bond business. The FCA's Financial Promotions Team had raised concerns regarding LCF's financial promotions in correspondence on 18 January 2016, 2 September 2016, 5 April 2017, 1 June 2017, 12 June 2017 and 18 August 2017.<sup>117</sup> Nevertheless, these breaches did not result in a referral to the Supervision or Enforcement Divisions for further review. As a result, the FCA did not consider whether LCF's breaches might be symptomatic of a more serious problem. In particular, it failed to question, in any meaningful way, whether LCF might have obtained, or used, its FCA-authorized status in order to attract investors to its unregulated bond business.

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<sup>114</sup> As discussed in paragraphs 3.6 to 3.14 of **Appendix 6**.

<sup>115</sup> As discussed in paragraphs 3.21 to 3.23 of **Appendix 6**.

<sup>116</sup> The meaning that the Investigation ascribes to this expression is explained in paragraph 4.2 of **Chapter 1** (Introduction and background) above.

<sup>117</sup> See Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) for an overview of the Financial Promotions Team's correspondence regarding LCF's financial promotions.

2.6 Third, FCA staff who reviewed materials submitted by LCF had not been trained sufficiently to analyse a firm's financial information to detect indicators of fraud or other serious irregularity. This weakness permeated various aspects of the FCA's regulation of LCF during the Relevant Period. For instance:

- (a) A member of the Authorisations Division with responsibility for reviewing LCF's First VOP Application had no accountancy (or other relevant) qualifications. When interviewed, the individual said that training to analyse company accounts was mainly "*on-the-job*".<sup>118</sup> As a consequence, although this member of the Authorisations Division noticed a number of potentially concerning aspects about LCF's business, they did not cause the individual to question whether there was something fundamentally wrong.
- (b) Similarly, in interview, a supervisor in the FCA's Supervision Division told the Investigation that, "*I don't believe to the best of my knowledge that there is much training around how to identify financial crime*".<sup>119</sup> Members of the Financial Promotions Team were also not trained to read financial information to recognise unusual or suspicious entries.<sup>120</sup>
- (c) It is telling that the FCA staff in the Listing Transactions Team and the Intelligence Team, who eventually appreciated the risks posed by LCF (in late 2018), had backgrounds directly relevant to reading financial information to recognise indicators of fraud or other serious irregularities.<sup>121</sup>

2.7 As a cumulative result of these failures, the FCA did not appreciate the true nature of LCF's business or the risks that it posed to consumers. Neither did the FCA appreciate the significance of an ever-growing number of red flags, which were indicative of serious

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<sup>118</sup> Interview Transcript Z, at page 6.

<sup>119</sup> Interview Transcript AD, at pages 7 to 8.

<sup>120</sup> One FCA employee was asked in interview "*do you receive in the financial promotions team any training on how to read company accounts to determine if a company is a risky or potentially fraudulent company?*". The employee responded "[n]o." (Interview Transcript AA, at page 3).

<sup>121</sup> The staff member in the Listing Transactions Team was a qualified accountant (Interview Transcript A, pages 3 to 4). The staff member in the Intelligence Team came to the FCA from a previous role with an accreditation from the law enforcement agency which required him to maintain CPD requirements on a sixth-month basis (Interview Transcript B, at pages 7 to 8).

irregularities in LCF's business. This occurred at a time when LCF's unregulated bond business was growing at a rapid pace and substantial funds were being invested by Bondholders.

### 3. Answers to questions posed in the Direction

3.1 By paragraph 3 of the Direction, the Investigation was asked to consider five questions regarding the FCA's regulation of LCF during the Relevant Period. The Investigation has reached the following conclusions in respect of these questions:

(1) *Were the permissions granted to LCF appropriate for its business activities?*

3.2 The permissions granted to LCF were not appropriate for the business that it carried on:

- (a) First, as explained above, in the Investigation's view, LCF's bond business was not a regulated activity. However, in certain limited instances, LCF may have carried out regulated activity by: (i) advising actual or potential investors in relation to their investments in LCF; and/or (ii) arranging for the disposal of an existing investment (for example, by making arrangements to switch a stocks and shares ISA to an LCF bond). LCF did not have permission for these activities. However, the Investigation considers that the FCA cannot be criticised for being unaware that LCF carried on regulated activities in these limited instances. In any event, given the narrow scope of these activities, this issue is of limited significance to the Investigation.
- (b) Second, and more importantly, the FCA granted LCF permissions for regulated activities that it *did not* carry on. This ought to have been evident to the FCA. LCF repeatedly submitted documents to the FCA which showed that LCF was not generating any revenue from regulated activities and had no clients from regulated activities. LCF's regulatory business plan dated 4 October 2016 stated that its actual revenue from regulated business in 2015 and 2016 was £0.<sup>122</sup> Other documents and regulatory filings provided by LCF to the FCA during the Relevant Period presented a similar picture. These documents did not lead the FCA to

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<sup>122</sup> London Capital & Finance plc, Regulatory Business Plan, 4 October 2016, at page 8.

reconsider LCF's permissions, although the FCA had the power to do so.<sup>123</sup> While an authorised firm's lack of regulated activity may not have been an obvious concern *per se*, in the case of LCF its true significance would have been appreciated if it had been considered in conjunction with the nature and scale of LCF's unregulated business. These unutilised permissions enabled LCF to benefit from its FCA-authorised firm status in respect of its unregulated business. Many Bondholders said that, but for this, they would not have invested in LCF.<sup>124</sup>

- (c) Third, the FCA should not have approved LCF's First VOP Application without more. As explained in paragraph 2.3(a) above, the FCA's approach to the First VOP Application was overly focused on LCF's regulated activities. Further, if it had been properly analysed, LCF's financial information would have raised questions about the ability of LCF to meet its financial obligations as they fell due, the rapid growth of LCF's business, the credibility of LCF's business model (including its undercapitalization) and the reliability of the information submitted by LCF, among other matters. Partly due to the inadequate training of a member of the Authorisations Division with primary responsibility for the First VOP Application,<sup>125</sup> these concerns were not detected or explored.

3.3 The second and third of these failures are of particular significance to the Investigation since the FCA-authorisation provided LCF with a badge of respectability. This played a crucial role in attracting investment in LCF's bonds.

(2) *Did the FCA adequately supervise LCF's compliance with its rules and policies?*

3.4 The FCA did not adequately supervise LCF's compliance with the FCA's rules and policies. In general, the FCA's approach to supervising LCF was contrary to the "*pre-emptive approach*" described in the FCA Handbook.<sup>126</sup>

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<sup>123</sup> See sections 55L and 55J of FSMA and SUP 7.2.2.G.

<sup>124</sup> See paragraph 9.4(a) of **Chapter 1** (Introduction and background).

<sup>125</sup> As to which, see paragraph 2.6(a) above.

<sup>126</sup> See 1A.3.1G of the Supervision section of the FCA Handbook.



- 3.5 The FCA adopted a limited strategy towards supervising the approximately 50,000 firms which were transferred to the FCA from the OFT in April 2014. As a result, firms such as LCF were not subject to any proactive supervision during the Relevant Period. As early as 2016, the FCA had recognised that it ought to be conducting proactive supervision of flexible firms such as LCF. However, a programme of proactive supervision of flexible firms was not embedded and effective by the end of the Relevant Period.
- 3.6 As explained in **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks), the FCA was aware throughout the Relevant Period that mini-bonds carried particular risks to consumers.<sup>127</sup> Individuals within the FCA also knew that LCF was using mini-bonds to fund (or ostensibly to fund) loans to SMEs, which was an unusual use of mini-bonds.<sup>128</sup> Despite this, the FCA did not undertake a review or further investigation of LCF’s bond business. As a result, the FCA’s supervision of LCF was purely reactive, as opposed to being proactive.
- 3.7 In the event, even such limited reactive supervision was not carried out effectively. For example:
- (a) The FCA did not react appropriately (or at all) to express allegations received from third parties that LCF was engaged in fraud or seriously irregular conduct: see paragraphs 3.9 to 3.11 below and **Appendix 6** of this Report.
  - (b) The FCA was aware that LCF repeatedly breached the financial promotions rules. However, the Financial Promotions Team (which formed part of the Supervision Division) handled each case separately rather than considering whether the pattern of conduct was indicative of poor culture or systems and controls, or even misconduct, at LCF.
  - (c) The FCA failed to consider LCF’s business as a whole in the light of information which showed that LCF was not carrying out the regulated activity for which the FCA had granted it permission: see paragraph 3.2(b) above.

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<sup>127</sup> See **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks).

<sup>128</sup> This included members of the Authorisations, Supervision and Financial Promotions Divisions (see: Interview Transcript E, at page 12; Interview Transcript X, at page 18; and Interview Transcript O, at page 18).

3.8 The FCA's flawed approach to the Perimeter contributed to the Supervision Division's inadequate supervision of LCF. Thus, the Supervision Division did not take adequate steps to supervise LCF because its core activity fell outside the Perimeter. The Financial Promotions Team also operated within unduly narrow terms of reference. It perceived its role as limited to checking whether the wording of a financial promotion was, on the face of it, fair, clear or misleading.

*(3) FCA's handling of information from third parties regarding LCF*

3.9 The FCA's handling of information from third parties regarding LCF was wholly deficient. This was an egregious example of the FCA's failure to fulfil its statutory objectives in respect of the regulation of LCF.

3.10 The FCA failed to respond to repeated allegations by third parties that LCF might be engaged in fraud or serious irregularity. These warnings included at least 15 calls from a single individual between 15 July 2016 and 22 February 2018, voicing detailed concerns about LCF. The details of these calls, and others of a similar nature, are summarised in **Appendix 6** of this Report. They merit careful study by readers of this Report.

3.11 The root cause of the FCA's failure to handle third-party information regarding LCF properly was an absence of appropriate internal policies. Thus:

- (a) Contact Centre policy documents were unclear about whether call-handlers should refer allegations of fraud or irregularity regarding the non-regulated activity of FCA-authorized firms more widely within the Supervision Division. As a result, on various occasions, call-handlers failed to pass on allegations of fraud or serious irregularity regarding LCF: see paragraph 2.3(b) above.
- (b) The Supervision Division did not have satisfactory policies in place as to how allegations of fraud or serious irregularity should be pursued. For example, there was no policy which required staff in the Supervision Division to interrogate a firm's financial information following an allegation of fraud or serious irregularity. The staff were encouraged to adopt a "*common sense*" approach

instead.<sup>129</sup> FCA policies were especially deficient as to how allegations of fraud or irregularity in relation to the non-regulated activity of an FCA-authorized firm should be pursued by the Supervision Division. For example, on one occasion, the Supervision Division did not pursue allegations of fraud or illegality which were referred to it from the Contact Centre, because they related to non-regulated activity of LCF. The supervisor's note stated: "[c]oncerns relate to firm's unregulated activities. Reg history checked. Considered as within risk tolerance."<sup>130</sup>

- (c) Contact Centre policies also failed to state clearly that call-handlers should not reassure callers in respect of FCA-authorized firms' non-regulated activities based on their FCA-authorized status. As a result, call-handlers sometimes reassured callers that LCF's bonds were reputable; that purported reassurance was based solely, and erroneously, on LCF's FCA-authorized status.<sup>131</sup> Contact Centre policy documents also failed to state with sufficient clarity that investments in LCF's bonds were not protected by the FSCS. The result was that, in a limited number of instances, call-handlers incorrectly advised callers that LCF's bonds benefitted from FSCS protection.<sup>132</sup>

*(4) Did the FCA have in place appropriate rules and policies relating to the communication of financial promotions by LCF?*

- 3.12 The FCA had appropriate rules to regulate the communication of financial promotions by LCF. The FCA also had sufficient powers under the relevant legislation to monitor LCF's financial promotions and to intervene if there was a breach. However, the FCA did not have in place appropriate policies.<sup>133</sup>

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<sup>129</sup> Interview transcript G, at page 24.

<sup>130</sup> Case Detail 20 July 2018 (Document with Control Number 125069).

<sup>131</sup> See paragraph 4.2 to 4.4 of **Appendix 6**.

<sup>132</sup> See paragraph 6.2 to 6.6 of **Appendix 6**.

<sup>133</sup> The meaning that the Investigation ascribes to the terms "rules" and "policies" was explained in paragraph 3.1 of **Chapter 1** (Introduction and background).

- 3.13 COBS 4.2.1R of the FCA rules required a firm to ensure that a financial promotion was fair, clear and not misleading. This was an appropriate rule. Had LCF complied with it, it would not have been able to issue promotions that misled investors about the risks associated with its bonds. The ‘fair, clear and not misleading’ rule was supplemented by appropriate guidance. For instance, COBS 4.2.4G stated that a firm should ensure that a financial promotion “*that names the FCA... as its regulator and refers to matters not regulated by... the FCA... makes clear that those matters are not regulated by the FCA....*”.
- 3.14 The FCA had appropriate powers which could have been used to monitor LCF’s financial promotions. These included the extensive investigatory powers under sections 165, 167 and 168 of FSMA.<sup>134</sup> The FCA also had sufficient powers to intervene in respect of LCF’s financial promotions in the event that there was a breach.<sup>135</sup>
- 3.15 The FCA’s policies in respect of intervention in case of a breach of the financial promotion rules were too cautious. For example:
- (a) The FCA’s “*repeat offenders*” policy was not sufficiently robust. The FCA considered a firm a “*repeat offender*” if it had breached the financial promotions rules three times or more within a rolling 12-month period. In respect of serious repeat offenders, the FCA would require an attestation from an individual with a significant influence function that the individual was content that the firm’s procedures were sufficient and that its staff were adequately trained to sign off financial promotions. However, there were doubts within the FCA as to whether attestations were enforceable and, in any event, even after multiple breaches, the FCA only threatened LCF with the attestation requirement.<sup>136</sup>

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<sup>134</sup> Section 165 of FSMA provided the FCA the power to require an authorised person to provide specified information or documents or information or documents of a specified description. Section 167 provided the FCA the power to appoint persons to conduct a general investigation on its behalf into the business of an authorised person. Section 168 of FSMA provided the FCA the power to appoint persons to carry out investigations in particular cases, which included where the FCA considered that there were circumstances suggesting that a person may have contravened a rule made by the FCA (section 168(4) and (5) of FSMA) or where an offence under sections 89-90 of the FSA 2012 (section 168(2) and (3)) had been committed.

<sup>135</sup> For instance, FCA’s power under sections 137S, 55J and 55L of FSMA.

<sup>136</sup> As explained in Section 4 of **Chapter 11** (FCA rules and policies relating to LCF’s financial promotions), the “*repeat offenders*” policy was replaced in early 2018 in favour of using “*the most appropriate tool to fit the circumstances of a particular case*”. This policy lacked clarity.

- (b) In early 2018, the attestation procedure was abandoned. Instead, the FCA decided that it would use “*the most appropriate supervisory tool to fit the circumstances of a particular case.*”<sup>137</sup> This policy lacked clarity. In particular, it did not provide any guidance to FCA staff as to when they should consider breaches of the financial promotion rules to be an indicator of a more serious problem or what further steps should be considered where such concerns were identified.
- (c) The FCA’s policy regarding the use of the banning power under section 137S of FSMA was also too cautious. The FCA had not used the section 137S power between its introduction in 2012 and the FCA’s intervention against LCF in late 2018. Instead, the FCA issued “*minded to ban*” letters to firms prior to invoking section 137S. If the firm cured the breach, as firms often did, the FCA would not exercise its power to issue a direction under section 137S.<sup>138</sup> The Investigation recognises that, since the events relating to LCF, the FCA has used its banning power more frequently.

3.16 The consequence of the inadequate policies outlined above was that the FCA failed to take appropriate action in response to LCF’s repeated breaches of the financial promotion rules. Apart from repeatedly writing to LCF asking it to cure its breaches, the FCA did not take any action against LCF until late 2018.

(5) *Other matters*

3.17 Pursuant to paragraph 3(2) of the Direction, the Investigation was asked to consider “*any other matters which they may deem relevant to the question of whether the FCA discharged its functions*”. The Investigation has considered six such matters and its conclusions in respect of each are set out in the following paragraphs.

3.18 First, the fact that LCF’s bonds could be acquired in an ISA wrapper was crucial for attracting investors.<sup>139</sup> When LCF obtained approval to act as an ISA manager in November

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<sup>137</sup> See paragraph 4.18 of **Chapter 11** (FCA rules and policies relating to LCF’s financial promotions).

<sup>138</sup> See Section 4 of **Chapter 11** (FCA rules and policies relating to LCF’s financial promotions).

<sup>139</sup> See paragraph 9.4(d) of **Chapter 1** (Introduction and background).

2017, and started to market its bonds as ISA-eligible, its sales significantly increased.<sup>140</sup> LCF bonds were promoted as “*innovative finance ISAs*” (“**IFISA**”). IFISA was a new structure introduced in 2016. However, LCF’s bonds did not comply with the legislative requirements for IFISAs. Due to a lacuna in the way in which ISAs are regulated, this non-compliance was not considered by the FCA or the HMRC. The Investigation does not consider that, in and of itself, this merits criticism of either body. Rather, the non-compliance arose as the result of a gap in the allocation of ISA-related responsibilities between the FCA and HMRC. However, if the FCA had appreciated the significance of the other red flags identified in this Report, it would have been appropriate for the FCA also to consider whether LCF’s ISA products complied with legislative requirements as part of a wider review of LCF’s business.<sup>141</sup>

- 3.19 Second, the FCA’s failures of regulation are not excused or mitigated by the risk associated with LCF’s products. LCF’s rates of return were generally favourable given the market conditions at the time. However, the FCA had access to a range of information which suggested that LCF bonds carried a degree of risk beyond that which was demonstrated by the high rates of return (for example, risk arising from potential fraud or serious irregularity). It would have been far more difficult for the Bondholders to have appreciated this risk.
- 3.20 Third, the FCA has pointed to the Register and ScamSmart website as tools which were designed to inform members of public of potential risks. The Investigation considers that the availability of these tools does not excuse or mitigate the FCA’s deficiencies in regulating LCF. The Register was deficient in two respects during the Relevant Period: (i) it failed to present information in a manner intelligible to the public; and (ii) it failed to warn consumers of the risk of unregulated products sold by FCA-authorized firms.<sup>142</sup> As a result, far from dissuading investors, LCF’s appearance on the Register encouraged investors’ belief that

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<sup>140</sup> Joint administrators’ Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 Insolvency Act 1986, 25 March 2019, table 7.1, at page 8 (see: <https://smithandwilliamson.com/media/3772/lcf-joint-administrators-proposals.pdf> (accessed on 22 November 2020)).

<sup>141</sup> This is what, in fact, happened when the Intelligence Team escalated concerns regarding LCF’s business in late October 2018. For example, one of the issues on which the Intelligence Team and the Supervision Division sought advice from the FCA’s General Counsel’s Division in late October/early November 2018 was whether LCF was complying with the IFISA regime. See, for example, the entry for 12 November 2018 in the chronology in **Appendix 8**.

<sup>142</sup> See paragraph 4.6 of **Chapter 13** (Other matters of importance to the Investigation).

LCF had a badge of respectability deriving from its authorised status, including in respect of its unregulated bond business. Similarly, LCF was not identified in the FCA Warning List or on the ScamSmart website during the Relevant Period. Nor did the ScamSmart website warn consumers about the risks associated with mini-bonds during the Relevant Period. Thus, ScamSmart did not dissuade investors from proceeding with their investments in LCF.<sup>143</sup>

3.21 Fourth, the fact that LCF's accounts contained annual statements from the firm's auditors that the accounts gave a true and fair view of LCF's affairs does not change the Investigation's conclusion that the FCA's regulation of LCF during the Relevant Period was deficient. The FCA's position was fundamentally different from that of LCF's auditors because the FCA: (i) was responsible for regulating LCF; and (ii) had access to information (including clear warnings about LCF from third parties) that was unlikely to be available to LCF's auditors. In any event, the Investigation has seen no evidence that anyone within the FCA relied on any auditors' statements when assessing or reviewing LCF's business (to the extent that any such assessment occurred during the Relevant Period).<sup>144</sup>

3.22 Fifth, the FCA needs to raise awareness among its staff of the important role it plays in combatting fraud. As noted in paragraph 2.3(a) (above) the individual with primary responsibility for reviewing LCF's First VOP Application did not pursue allegations of fraud set out in the Anonymous Letter because the individual viewed the issue as "*principally a matter for the police*".<sup>145</sup> Similarly, paragraph 2.3(b) (above) explains that allegations of fraud in relation to LCF's business activities were not appropriately handled by the FCA's Contact Centre. As part of its statutory objectives, the FCA is responsible for ensuring that the UK financial system is not being used for financial crime.<sup>146</sup> The FCA's public statements confirm this.<sup>147</sup> Further, the FCA has significant powers to tackle financial crime by FCA-authorised firms, even when the alleged criminal activities fall outside the

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<sup>143</sup> See paragraphs 4.13 to 4.25 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>144</sup> See section 5 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>145</sup> See paragraph 6.23 of **Chapter 9**.

<sup>146</sup> See paragraph 6.4 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>147</sup> See paragraph 6.6 of **Chapter 13** (Other matters of importance to the Investigation).

Perimeter. These include the FCA’s power to vary or cancel an authorised person’s permissions or impose requirements prohibiting or restricting the disposal of an authorised person’s assets.<sup>148</sup>

3.23 Sixth, the fact that the FCA intervened against LCF in December 2018 does not excuse its earlier failures. Indeed, the Investigation considers that the FCA ought to have intervened much earlier. There are commendable aspects of the FCA’s work in relation to the intervention in December 2018 (for example, the work done by individuals in the Listing Transactions and Intelligence Teams). Nevertheless, there were also some further failures by the FCA. Examples of the commendable work and the failures are:

- (a) Although the FCA’s Listing Transactions Team raised concerns regarding LCF’s business model in September 2018, these concerns were not adequately pursued by the Supervision Division. A supervisory case was opened on 11 September 2018, but no significant further steps were taken. This was because the Supervision Division initially assessed LCF as a relatively low priority case and the relevant supervisor was subject to very heavy workloads at the time.<sup>149</sup>
- (b) Around 15 October 2018, the Intelligence Team “*stumbled across*”<sup>150</sup> intelligence regarding possible irregularities at LCF in the context of (an unrelated) search on an external intelligence database. The relevant member of the Intelligence Team told the Investigation that he was reviewing a report focused on another firm on a non-public database accessible to the FCA. That report referred to LCF. The FCA staff member observed, “[i]f [the report] didn’t mention LCF, it’s entirely possible that nobody would have looked at it...”.<sup>151</sup>
- (c) In short, the good work done by the Listing Transactions Team was negated by the Supervision Division’s failure to appreciate the significance of the concerns and their delay in acting. Fortunately, the Intelligence Team was able to review

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<sup>148</sup> See paragraph 6.8 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>149</sup> See paragraph 7.11 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>150</sup> See paragraph 7.8 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>151</sup> See paragraph 7.8 of **Chapter 13** (Other matters of importance to the Investigation).



and action adverse intelligence available from external sources regarding LCF and the risk that it posed. The work of the Intelligence Team was ultimately the trigger for the FCA's unannounced visit to LCF's offices in December 2018.

- (d) Shortly before the Intelligence Team identified adverse intelligence in relation to LCF, the FCA had received a business plan from LCF in connection with its second Variation of Permission application (the "**Second VOP Application**"). The business plan specifically stated: "[p]resently [LCF] receives inbound investments via its bonds of £10m to £15m per calendar month into unregulated business".<sup>152</sup> This suggests that any potential consumer detriment was increasing at a significant rate per month. Although it does not appear that the relevant teams within the FCA appreciated that the value of monthly inbound consumer funds could be in excess of £10 million, they did note that there was potential ongoing consumer detriment as well as potential misconduct at LCF. However, despite that, and the fact that concerning intelligence was escalated to the Supervision Division on 18 October 2018, the FCA took no formal steps against LCF until the unannounced visit on 10 December 2018. The Investigation accepts that a site visit of the type and scale required in the case of LCF takes a lot of coordination and planning. The Investigation also accepts that there were specific safety concerns regarding this site visit which the FCA needed to consider.<sup>153</sup> However, the Investigation does not consider that these points wholly mitigate or excuse the FCA's delay in taking formal action against LCF. In interview, one of the primary team members for the site visit agreed that the timeline for this visit had been "*a little bit frustrating*".<sup>154</sup>
- (e) In advance of the unannounced site visit on 10 December 2018, the FCA gave consideration to freezing LCF's assets.<sup>155</sup> The FCA had also identified that there

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<sup>152</sup> See section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>153</sup> As explained in Section 7 of **Chapter 13** (Other matters of importance to the Investigation), the unannounced site visit was delayed due to firearms concerns.

<sup>154</sup> Interview Transcript AD, at page 22.

<sup>155</sup> This is also what happened in practice: the FCA ensured there were measures in place to freeze LCF's assets once it intervened.

was a web of companies that appeared to have connections to LCF and its directors. Despite this, the Investigation has not seen evidence that the FCA considered what other actions it could have taken against the web of companies and individuals connected to LCF *before* its unannounced site visit on 10 December 2018. Once LCF was aware that the FCA was investigating or acting against it, there was a real risk that any assets LCF had placed with potentially connected companies or individuals would be dissipated. It is possible that even if the FCA had considered the issue, it may have decided that no action should be taken before the site visit. However, the FCA should have at least *considered* actions against connected persons before the site visit given the risk of dissipation of assets.

#### **4. The FCA's resources and priorities**

- 4.1 During the Representations Process, the FCA emphasised its limited resources and its need to prioritise those resources. The Investigation accepts that: (i) the FCA had finite resources during the Relevant Period; and (ii) the FCA's regulatory remit was broad. The Investigation also accepts that: (i) it was necessary for the FCA to prioritise which forms of actual or potential harm it would respond to; and (ii) it would not have been possible for the FCA to address every issue or prevent all forms of harm, even in sectors where the FCA had identified particular risks.
- 4.2 While the Investigation accepts that prioritisation was necessary, the Investigation has not sought to consider whether the FCA's decisions on prioritisation were appropriate. To do so would have required a broad review of the totality of the FCA's activities and resources during the Relevant Period. Such a broad review was outside the remit of the Investigation.
- 4.3 The Investigation has, however, considered whether issues such as the FCA's finite resources and its need to prioritise excused or mitigated the regulatory deficiencies which occurred in the case of LCF. The Investigation has concluded that they did not. LCF was an extreme case where the FCA was aware of multiple red flags (including multiple allegations of fraud) in relation to LCF during the Relevant Period. The FCA nonetheless repeatedly failed to investigate these red flags (or to consider their cumulative significance) prior to the work conducted in the lead up to the unannounced site visit in late 2018. The Investigation

considers that these failures cannot be excused or mitigated by reference to the FCA's finite resources and the need to prioritise.<sup>156</sup>

## 5. Summary of Recommendations

5.1 Paragraph 9 of the Direction envisages that the Investigation can make recommendations in the light of the findings in this Report.

5.2 The Investigation's recommendations are set out in full in Part D (**Chapter 14** (Recommendations)) of this Report. They are split into two categories: (i) recommendations targeted at the FCA's policies and practices; and (ii) recommendations focused on the regulatory regime.<sup>157</sup>

5.3 In summary, the recommendations targeted at the FCA's policies and practices are as follows:

- (a) *Recommendation 1:* the FCA should direct staff responsible for authorising and supervising firms, in appropriate circumstances, to consider a firm's business holistically.<sup>158</sup>
- (b) *Recommendation 2:* the FCA should ensure that its Contact Centre policies clearly state that call-handlers: (i) should refer allegations of fraud or serious irregularity to the Supervision Division, even when the allegations concern the non-regulated activities of an authorised firm; (ii) should not reassure consumers about the non-regulated activities of a firm based on its regulated status; and (iii) should not inform consumers (incorrectly) that all investments in FCA-regulated firms benefit from FSCS protection.
- (c) *Recommendation 3:* the FCA should provide appropriate training to relevant teams in the Authorisation and Supervision Divisions on: (i) how to analyse a firm's

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<sup>156</sup> **Chapter 5** (The FCA's finite resources and prioritisation) of this Report sets out the Investigation's analysis in more detail.

<sup>157</sup> As explained in Section 1 of **Chapter 14** (Recommendations), the Investigation's conclusions and recommendations are necessarily based on the rules and policies that were in force during the Relevant Period. It is not within the remit of this Investigation to assess whether changes to the FCA's policies and practices in the 22 months after the Relevant Period have addressed the deficiencies identified in this Report.

<sup>158</sup> The meaning that the Investigation ascribes to the requirement that the FCA should assess a firm's business 'as a whole' or 'holistically' was explained in paragraph 5.2 of **Chapter 1** (Introduction and background) of this Report.

financial information to recognise circumstances suggesting fraud or other serious irregularity; and (ii) when to escalate cases to specialist teams within the FCA.

- (d) *Recommendation 4:* the senior management of the FCA should ensure that product and business model risks, which are identified in its policy statements and reviews<sup>159</sup> as being current or emerging, and of sufficient seriousness to require ongoing monitoring, are communicated to, and appropriately taken into account by, staff involved in the day-to-day supervision and authorisation of firms.
- (e) *Recommendation 5:* the FCA should have appropriate policies in place which clearly state what steps should be taken or considered following repeat breaches by firms of the financial promotion rules.
- (f) *Recommendation 6:* the FCA should ensure that its training and culture reflect the importance of the FCA's role in combatting fraud by authorised firms.
- (g) *Recommendation 7:* the FCA should take steps to ensure that, to the fullest extent possible: (i) all information and data relevant to the supervision of a firm is available in a single electronic system such that any red flags or other key risk indicators can be easily accessed and cross-referenced; and (ii) that system uses automated methods (e.g. artificial intelligence/machine learning) to generate alerts for staff within the Supervision Division when there are red flags or other key risk indicators.
- (h) *Recommendation 8:* the FCA should take urgent steps to ensure that all key aspects of the Delivering Effective Supervision (“DES”) programme that relate to the supervision of flexible firms are now fully embedded and operating effectively.
- (i) *Recommendation 9:* the FCA should consider whether it can improve its use of regulated firms as a source of market intelligence.

5.4 In summary, the recommendations targeted at the regulatory regime are as follows:

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<sup>159</sup> Whether published internally or externally.

*Chapter 2: Executive summary*

- (a) *Recommendation 10:* HM Treasury should consider addressing the lacuna in the allocation of ISA-related responsibilities between the FCA and HMRC.
- (b) *Recommendation 11:* HM Treasury should consider whether Article 4 of MiFID II or section 85 of FSMA should be extended to non-transferable securities.
- (c) *Recommendation 12:* HM Treasury should consider the optimal scope of the FCA's remit.
- (d) *Recommendation 13:* HM Treasury and other relevant Government bodies should work with the FCA to ensure that the legislative framework enables the FCA to intervene promptly and effectively in marketing and sale through technology platforms, and unregulated intermediaries, of speculative illiquid securities and similar retail products.

### **CHAPTER 3: KEY EVENTS IN THE FCA'S REGULATION OF LCF**

#### **1. Introduction**

1.1 This Chapter provides an overview of the key events in the FCA's regulation of LCF that are relevant to the issues within the remit of the Investigation broken down by category. The Investigation Team has prepared two chronologies – which are included as appendices to this Report – to set out and expand on the necessary factual background. The first chronology is set out at **Appendix 7** and covers the key events in LCF's history. This chronology is intended to be a summary and to be used as a quick reference guide. The second chronology, included at **Appendix 8** to this Report, is a more detailed chronology of the events involving LCF that are relevant to the issues being considered by the Investigation. For the avoidance of doubt, this Chapter does not cover background issues which are relevant to the FCA's general resourcing and prioritisation decisions (e.g. significant regulatory changes that occurred during the Relevant Period). Those issues are dealt with in **Chapter 5** (The FCA's finite resources and prioritisation).

1.2 The key events in the FCA's regulation of LCF can be broken down into the following categories:

- (a) *Regulatory transactions*: this covers LCF's applications for authorisation and variation of permission and relevant applications to approve individuals to hold controlled functions (i.e. specific roles within an FCA-regulated firm which required approval from the FCA) at the firm.
- (b) *Financial promotions*: this covers actions taken by the Financial Promotions Team in connection with financial promotions for products offered by LCF.
- (c) *Significant information and intelligence received by the FCA regarding LCF*: this covers significant information and intelligence received by the FCA relevant to its regulation and supervision of LCF during the Relevant Period.

**2. Regulatory transactions**

2.1 LCF had three key regulatory transactions during the Relevant Period, the most significant being the First VOP Application<sup>160</sup> (submitted in October 2016). Throughout each of these regulatory transactions (particularly the First VOP Application), the FCA had sufficient information to identify concerns regarding LCF’s business but failed to do so.

2.2 Further details regarding these three regulatory transactions are:

<p>Initial application for permission following LCF’s transfer from the OFT to the FCA (the “<b>Initial Authorisation Application</b>”).</p>	<p>The FCA became responsible for the regulation of approximately 50,000 consumer credit firms on 1 April 2014.<sup>161</sup> Consumer credit firms wishing to continue to carry out consumer credit activities after 1 April 2014 needed to register for interim permission with the FCA.<sup>162</sup> Given the volume of firms, the FCA required consumer credit firms to apply for full permission in set “<i>application periods</i>”.<sup>163</sup> LCF’s application period started on 1 August 2015 and ended on 31 October 2015.<sup>164</sup></p> <p>LCF submitted its application to the FCA for authorisation under Part 4A of FSMA on 21 October 2015. LCF applied to be authorised for the following regulated activities:</p> <ul style="list-style-type: none"> <li>• credit broking;</li> <li>• entering into regulated credit agreements as lender (excluding high-cost short-term credit, bill of sale agreement, and home collected credit agreement); and</li> <li>• exercising / having right to exercise lender’s rights and duties under a regulated credit agreement (excluding high-cost short-term credit, bill of sale agreement, and</li> </ul>
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<sup>160</sup> LCF’s first Variation of Permission application as defined at paragraph 3.4(c) of **Chapter 1** (Introduction and background).

<sup>161</sup> In February 2014, the FCA explained “[w]e take over the regulation of around 50,000 consumer credit firms from the Office of Fair Trading on 1 April 2014” (see: <https://www.fca.org.uk/publications/policy-statements/ps14-3-final-rules-consumer-credit-firms> (accessed on 22 November 2020)).

<sup>162</sup> Policy Statement PS13/8, *FCA regime for consumer credit: carrying across some Consumer Credit Act secondary legislation into FCA rules*, August 2013, at page 9 (see: <https://www.fca.org.uk/publication/policy/ps13-08.pdf> (accessed on 22 November 2020)).

<sup>163</sup> Policy Statement PS14/3, *Detailed rules for the FCA regime for consumer credit, including feedback on FCA QCP 13/18 and ‘made rules’*, February 2014, at page 17 (see: <https://www.fca.org.uk/publication/policy/ps14-03.pdf> (accessed on 22 November 2020)).

<sup>164</sup> Transcript of a call from LCF to the FCA Contact Centre 1 May 2015, at page 3.

	<p>home collected credit agreement).<sup>165</sup></p> <p>The materials submitted with the Initial Authorisation Application included an application for LCF's CEO to hold the following Controlled Functions: (i) CF1 (Director); and (ii) CF11 (Money Laundering Reporting Officer).<sup>166</sup></p> <p>In February 2016 (prior to the FCA assigning a Case Officer to review the Initial Authorisation Application), LCF asked for the addition of a corporate finance permission to enable it to advise companies on financing and structuring.<sup>167</sup> LCF also submitted an application for its compliance officer to hold the CF10 (Compliance oversight function) role.<sup>168</sup></p> <p>A member of the Credit Authorisations Division was assigned to review the application in March 2016<sup>169</sup> and various discussions took place between the relevant team member and LCF in April and May 2016.<sup>170</sup></p> <p>During these discussions, the relevant team member explained that pursuing the corporate finance permission at this stage would result in delays to the application as another team within the FCA would need to be involved.<sup>171</sup> Accordingly, LCF withdrew its request for corporate finance permissions. LCF also narrowed the scope of its permissions so that it was only seeking credit broking permissions that were secondary to its primary unregulated business.<sup>172</sup> The narrowing of LCF's permissions meant that LCF was considered a 'limited'</p>
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<sup>165</sup> LCF Part 4A Application Form, 21 October 2015, at page 6.

<sup>166</sup> Application Form for LCF's CEO, 21 October 2015, at page 6.

<sup>167</sup> The updated business plan explained that the firm was "*aiming to be active in the corporate finance market, specifically in: (a) advisory, including finance and structuring – specifically, this will include advising firms on their capital structure, financial needs, growth & capital investment; (b) financial promotions – bring about investments into growth companies from corporate institutional and retail investors into equity and debt securities and non-complex derivative such as warrants and options. This would also allow the firm to approve its own documentation (where needed) as it now relies on outside FCA authorized firms to approve its promotional material under Section 21 FSMA*". (see: London Capital & Finance plc, Regulatory Business Plan, 14 February 2016, at page 2).

<sup>168</sup> Email Message Detail 17 February 2016 (Document with Control Number 121832); Application Form for LCF's Compliance Officer, 16 February 2016 (Document with Control Number 121897).

<sup>169</sup> Email from a Manager in the FCA's Credit Authorisations Division to the team, 21 March 2016 at 10.04am (Document with Control Number 214018).

<sup>170</sup> By way of example see Task Detail 8 April 2016 (Document with Control Number 121934).

<sup>171</sup> Email Message Detail 12 April 2016 (Document with Control Number 121846).

<sup>172</sup> Email Message Detail 9 May 2016 (Document with Control Number 121883).



Chapter 3: Key events in the FCA’s regulation of LCF

	<p>permission firm<sup>173</sup> and that LCF would only require a single Approved Person on its staff; an individual in the CF8 (Apportionment and oversight function) role.<sup>174</sup></p> <p>The relevant team member completed the approval process of LCF’s application on 11 May 2016.<sup>175</sup> The FCA informed LCF of the approval of its authorisation application on 7 June 2016 (albeit that the email stated the authorisation took effect from 11 May 2016)<sup>176</sup> and LCF’s CEO was informed on the same day that he had been approved for the CF8 (Apportionment and oversight function) role.<sup>177</sup></p> <p>The FCA’s systems were not updated correctly and, as such, LCF was categorised as a full rather than a limited permission firm. This error does not appear to have had a substantive impact on the FCA’s regulation of LCF.<sup>178</sup></p>
<p>The First VOP Application.</p>	<p>LCF submitted the First VOP Application on 14 October 2016. LCF applied for the addition of the following permissions:</p> <ul style="list-style-type: none"> <li>• making arrangements with a view to transactions in investments;</li> <li>• arranging safeguarding and administration of assets;</li> <li>• arranging (bringing about) deals in investments; and</li> <li>• advising on investments (except on Pension Transfers and Pension Opt Outs).<sup>179</sup></li> </ul> <p>The requested permissions were stated in the application form to be subject to the following standard requirements:</p> <ul style="list-style-type: none"> <li>• may hold/control client money if rebated commission;</li> </ul>

<sup>173</sup> The email from the Case Officer to LCF explained: “your firm is now considered a ‘limited’ permission firm, as the credit broking will be secondary to your firm’s main business”. Email Message Detail 11 May 2016 (Document with Control Number 121907).

<sup>174</sup> Email Message Detail 11 May 2016 (Document with Control Number 121913).

<sup>175</sup> LCF Authorisation Approval, 11 May 2016.

<sup>176</sup> Task Detail 7 June 2016 (Document with Control Number 121977).

<sup>177</sup> Email Message Detail, 7 June 2016 (Document with Control Number 121919).

<sup>178</sup> The FCA’s response to an information request submitted by the Investigation Team stated: “[n]ote: we have checked our systems and LCF was incorrectly categorised on our system between 8 June 2016 and 8 December 2016 – specifically, the Consumer Credit Status reporting type was not set to ‘Limited’ on the firm’s TARDIS record. This meant there was a period where full permissions consumer credit, not limited permission consumer credit data items were scheduled. However, none of these data items fell due before the firm profile was corrected, and the data items were removed from the firm’s schedule. In summary, therefore, none of the full permission returns were in fact due between these dates, and nor were they submitted”. (FCA Response to Information Request LCF\_DEC11/12\_05, at pages 1 and 2).

<sup>179</sup> Variation of Permission Application, 14 October 2016.

	<p>and</p> <ul style="list-style-type: none"><li>• corporate finance business only.<sup>180</sup></li></ul> <p>At the same time as the First VOP Application, LCF also submitted Approved Persons applications for its CEO,<sup>181</sup> Compliance Officer,<sup>182</sup> Operations Manager<sup>183</sup> and one of its directors.<sup>184</sup></p> <p>A member of the Authorisations Division was assigned to review the First VOP Application and various discussions took place between the relevant team member and LCF between December 2016 and June 2017.<sup>185</sup> Separate team members were also assigned to review the Approved Persons applications.<sup>186</sup></p> <p>LCF subsequently submitted Approved Persons applications for an Operations Assistant<sup>187</sup> and another director.<sup>188</sup></p> <p>During the exchanges between the relevant team member reviewing the First VOP Application and LCF, the relevant team member noted that the firm's Regulatory Business Plan did not explain the need for the firm to have permission to hold client money.<sup>189</sup> Following further questions from the relevant team member, LCF dropped the request for client money permissions and the related CF10a Approved Persons application.<sup>190</sup></p>
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<sup>180</sup> *Ibid.*

<sup>181</sup> The application was to hold the following functions: CF1 (Director), CF3 (Chief Executive) and CF30 (Customer). See: FCA Authorisations Approved Persons: SIF Case Assessment, 14 October 2016.

<sup>182</sup> The application was to hold CF2 (Non Executive Director). See: Individual Details Application for LCF's Compliance Officer, 14 October 2016.

<sup>183</sup> The application was to hold CF11 (Money Laundering Reporting Officer). See: Individual Details Application for LCF's Operations Manager, 17 October 2016.

<sup>184</sup> The application was to hold CF2 (Non Executive Director). FCA Authorisations Approved Persons: SIF Case Assessment, 18 October 2016.

<sup>185</sup> By way of example see Email Message Detail 12 December 2016 (Document with Control Number 122640).

<sup>186</sup> Email Message Detail 31 October 2016 (Document with Control Number 122971).

<sup>187</sup> The application was to hold CF10a (CASS Oversight function). Individual Details Application for LCF's Operations Assistant, 23 January 2017.

<sup>188</sup> The application was to hold CF2 (Non Executive Director). Individual Details Application for an LCF director, 19 April 2017. The Compliance Officer's application to hold CF2 (Non Executive Director) was also switched to CF1 (Director) (see: Email from LCF's CEO explaining that the correct application should be for CF1 (Document with Control Number 122899)).

<sup>189</sup> Email Message Detail 12 December 2016 (Document with Control Number 122640).

<sup>190</sup> Email Message Detail 9 June 2017 (Document with Control Number 122787).

Chapter 3: Key events in the FCA’s regulation of LCF

	<p>The relevant team member also queried LCF’s financial information and financial projections, including in relation to its bond business.<sup>191</sup></p> <p>The relevant team member approved the First VOP Application on 13 June 2017 granting LCF permissions to conduct corporate finance activities as an “exempt CAD firm”.<sup>192</sup> At that time, LCF also became a full permission firm and various Approved Persons applications were also approved.<sup>193</sup></p>
<p>The Second VOP Application.<sup>194</sup></p>	<p>LCF submitted the Second VOP Application on 10 September 2018 to remove its “corporate finance only” requirement so that it could offer investment advice generally, including to retail clients.<sup>195</sup> In conjunction with the Second VOP Application, LCF submitted a regulatory business plan which stated: “[p]resently, the Firm receives inbound investments via its bonds of £10m to £15m per calendar month into unregulated business”.<sup>196</sup></p> <p>A team member was assigned to the application in September 2018 and asked questions regarding LCF’s suitability test. On this point, the relevant team member explained: “[b]ecause the firm will be potentially advising retail clients, we need to see and review the firm’s suitability assessment carried out on clients as required by COBS 9A”.<sup>197</sup> At no point did the relevant team member raise any concerns regarding LCF’s business.</p> <p>Ultimately the FCA’s review of the application stalled when the FCA’s Intelligence Team identified adverse intelligence regarding LCF and related individuals in mid-October 2018.</p>

<sup>191</sup> Email Message 23 December 2016 (Document with Control Number 122663).

<sup>192</sup> Email Message Detail 13 June 2017 (Document with Control Number 122816). “Exempt CAD firms” are investment firms which have permission only to provide investment advice or to receive and transmit orders from investors (see: <https://www.handbook.fca.org.uk/handbook/glossary/G1408.html> (accessed on 22 November 2020)). As a result, such firms have limited capital requirements.

<sup>193</sup> The Compliance Officer’s application to hold the CF1 (Director) and CF10 (Compliance oversight) roles (see: Task Detail 14 June 2017 (Document with Control Number 122948)); the CEO’s application to hold the CF1 (Director), CF3 (Chief Executive) and CF30 (Customer) roles (see: Email Message Detail (Document with Control Number 122961); two individuals to hold the CF2 role (see: Email Message 13 June 2017 (Document with Control Number 123001) and Email Message 15 June 2017 (Document with Control Number 123679)); and the Operations Manager’s application to hold the CF11 (Money Laundering Reporting Officer) role (see: Email Message 13 June 2017 (Document with Control Number 122978)).

<sup>194</sup> LCF’s second Variation of Permission application as defined at paragraph 3.23(d) of **Chapter 2** (Executive summary).

<sup>195</sup> Variation of Permission Application, 10 September 2018.

<sup>196</sup> LCF Regulatory Business Plan, 5 September 2018, at page 4 (Document with Control Number 215261).

<sup>197</sup> Email Message 10 October 2018 (Document with Control Number 125245).

	<p>Even when the relevant team member was aware of the issues identified by the Intelligence Team, he was concerned that he did not have sufficient grounds to reject the application. In an email to the Supervision Division, he stated: “[t]he other aspect I wanted to check with you, is that whilst [the Authorisations Division] can definitely appreciate why Supervision do not want [the Second VOP Application] to proceed, is there any information you can provide that can go to the refusal committee/[Regulatory Transactions Committee]? Otherwise, we will not have valid grounds and our refusal will be refused”.<sup>198</sup></p> <p>Following the FCA’s unannounced site visit on 10 December 2018, LCF withdrew the Second VOP Application on 11 December 2018.<sup>199</sup></p>
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### 3. Financial promotions

3.1 During the Relevant Period, there were six interactions between the FCA’s Financial Promotions Team and LCF (or related parties) regarding LCF’s financial promotions. None of these resulted in a detailed review of LCF’s business nor did the FCA request details of LCF’s systems and controls relating to financial promotions.

<p>18 January 2016 – 11 March 2016</p>	<p>A consumer emailed the FCA’s Customer Contact Centre on 13 December 2015 to ask whether LCF had the appropriate permissions for the products it was offering: “I went to the FCA website to confirm that [LCF] is authorised to offer savings account as they are advertising up to 8% AER for a 3 year bond agreement. All I can see is that they have permission to act as a lender, however I am not sure this means that they can also borrow and pay dividends (on a savings program)”.<sup>200</sup></p> <p>The Customer Contact Centre referred the case to relevant teams within the Supervision Division, including the Financial Promotions Team.<sup>201</sup> A member of the Financial Promotions Team reviewed LCF’s website and filled in a “new cases</p>
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<sup>198</sup> Email from an Associate in the Authorisations Department to an Associate in the Supervision Division, 20 November 2018 at 9:45am (Document with Control Number 215325).

<sup>199</sup> Email Message, 11 December 2018 (Document with Control Number 125299).

<sup>200</sup> Email Message 13 December 2015 (Document with Control Number 121481).

<sup>201</sup> Case Detail (Document with Control Number 121491).

	<p>form”<sup>202</sup> which set out the team member’s assessment of whether the website was in breach of the applicable financial promotions rules.<sup>203</sup> The completed new cases form noted that the website was promoting a bond and it was not compliant with the applicable rules as there were “<i>no standard risk disclosures</i>”. The form also explained that LCF’s website stated that the promotional materials for the firm’s bonds had been approved by Sentient Capital London Limited (“<b>Sentient Capital</b>”) but it was unclear who had approved the website.<sup>204</sup></p> <p>The Financial Promotions Team subsequently wrote to LCF on 18 January 2016 as a result of the concerns identified by the December 2015 review of LCF’s website. The letter identified the following issues with respect to LCF’s website:</p> <ul style="list-style-type: none"><li>• The website did not include a warning that the customer’s capital was at risk. The letter from the Financial Promotions Team to LCF stated that this was a breach of COBS 4.2.1R and it was also “<i>not in line with COBS 4.2.4G(1)</i>”.</li><li>• The statement “<i>Protection 100%</i>” (which the letter noted was used in relation to each bond) was misleading since the customer’s capital was at risk. The letter explained that this statement was, therefore, misleading and in breach of COBS 4.2.1R.</li><li>• Whilst the website referred to various information memoranda being approved by Sentient Capital, it was unclear whether an authorised firm had approved the website as a promotion.<sup>205</sup></li></ul> <p>A telephone conversation took place on 19 January 2016 between a member of the Financial Promotions Team and LCF’s senior management. The FCA’s note of that call highlighted that LCF’s senior management had stated that the firm had received legal advice regarding the issues raised by the Financial Promotions Team and that the firm agreed with the FCA’s position. The FCA’s note also stated: “[i]n particular, [LCF’s senior management] stated that</p>
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<sup>202</sup> A “new cases form” refers to the form completed by a Case Officer on the opening of a new case.

<sup>203</sup> Financial Promotions New Cases Form, 15 December 2015, at page 1. The Investigation has not been able to review LCF’s website as at the date the Financial Promotions Team conducted its review in December 2015. However, enclosed with the New Cases Form were print outs from LCF’s website which support the Financial Promotion Team’s analysis.

<sup>204</sup> *Ibid.*, at page 1.

<sup>205</sup> Letter from the Financial Promotions Team to LCF’s CEO dated 18 January 2016 (Document with Control Number 096361).

Chapter 3: Key events in the FCA’s regulation of LCF

	<p>[management] now appreciates that, in a worst case scenario, client’s loans would not be 100% protected. [Management] went on to say that [it] would be appointing a compliance officer shortly and will also be obtaining further legal advice, and will subsequently be providing [the FCA] with a formal response highlighting the steps [management] will be taking to address our concerns.”<sup>206</sup></p> <p>LCF sent the FCA a letter dated 29 January 2016 which detailed the steps the firm had taken to address the FCA’s concerns. Among other steps, the letter noted “[t]he term “Protection 100%” has been removed and replaced with “Assets secured” which is 100% accurate”.<sup>207</sup> The covering email which attached the letter, also dated 29 January 2016, noted that LCF had taken advice from a law firm and Sentient Capital in making the changes noted in the letter.<sup>208</sup></p> <p>The FCA replied by email dated 15 February 2016 to the effect that it remained concerned that the prominence of the capital at risk warning that LCF added to its homepage was not adequately displayed.<sup>209</sup> By letter dated 7 March 2016, LCF set out the steps it had taken to address this concern.<sup>210</sup> By email dated 10 March 2016, the FCA confirmed that in the light of the additional actions taken by LCF it had closed its file.<sup>211</sup></p>
<p>2 September 2016 – 3 October 2016</p>	<p>A consumer called the Customer Contact Centre on 15 July 2016 to raise concerns regarding LCF’s business, including that it could be a “pyramid scam”.<sup>212</sup> The Customer Contact Centre reviewed LCF’s website and escalated concerns to the</p>

<sup>206</sup> Note of telephone conversation, 19 January 2016 (Document with Control Number 108457).

<sup>207</sup> Letter from LCF to the Financial Promotions Team, 29 January 2016 (Document with Control Number 214221).

<sup>208</sup> Email from LCF’s CEO to an Associate in the Financial Promotions Team, 29 January 2016, at 5:08pm (Document with Control Number 214260).

<sup>209</sup> Email from an Associate in the Financial Promotions Team to LCF’s CEO, 15 February 2016, at 5:12pm (Document with Control Number 214275).

<sup>210</sup> Letter from LCF to an Associate in the Financial Promotions Team, 7 March 2016 (Document with Control Number 214203).

<sup>211</sup> Email from an Associate in the Financial Promotions Team to LCF’s CEO, 10 March 2016, at 4:58pm (Document with Control Number 214249).

<sup>212</sup> The transcript of the call shows that the consumer raised concerns regarding the financial viability of LCF’s business: “I mean, they seem very nice people, they’re very open, they explain things but they haven’t been able to answer my queries why they’ve only got £8 in the bank and why they’ve only lent out £140,000 last year when they’ve lent out millions this year. They just can’t answer these questions”. The Investigation Team understands the consumer was the individual referred to in Section 4 of this Chapter as “Individual A” (see: Transcript of the first call from Individual A to the Customer Contact Centre, 15 July 2016).

	<p>Consumer Credit Triage Team within the Supervision Division regarding whether LCF had the correct permissions and the lack of clarity as to the role of Sentient Capital.<sup>213</sup> The escalation to the Consumer Credit Triage Team did not refer to the consumer's concerns regarding how LCF was operating its business and the possibility that it could be a "pyramid scam".</p> <p>The Consumer Credit Triage Team referred the case to the Financial Promotions Team as the concerns regarded LCF's website.<sup>214</sup> A member of the Financial Promotions Team reviewed LCF's website in mid-July 2016 and filled in a new cases form which set out the relevant team member's assessment of whether the website was in breach of the applicable financial promotions rules. The completed form made two initial comments regarding LCF's website:</p> <ul style="list-style-type: none"><li>• "Regulatory disclosure does not make it clear [LCF] are not regulated for the purposes of issuing mini bond".</li><li>• "Capital at risk not sufficiently prominent compared to prominence of benefits".<sup>215</sup></li></ul> <p>It is unclear what happened between mid-July and early September 2016 but the Financial Promotions Team only sent a letter on 2 September 2016 in connection with the issues identified in the completed new cases form (which was dated 15 July 2016). The letter was sent by the Financial Promotions Team to Sentient Capital (as approver of LCF's financial promotions pursuant to section 21 of FSMA) and was copied to LCF.<sup>216</sup></p> <p>The letter set out various concerns including:</p> <ul style="list-style-type: none"><li>• The statement at the top of the home page of LCF's website which read "[a]uthorised and regulated by the Financial Conduct Authority" was misleading because "[LCF] is not authorised and regulated by the FCA for</li></ul>
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<sup>213</sup> Case Detail

<sup>214</sup> *Ibid.*

<sup>215</sup> Financial Promotions New Cases Form, 15 July 2016 (Document with Control Number 083892). The Investigation has not been able to review LCF's website as at the exact date the Financial Promotions Team conducted its review in July 2016. However, enclosed with the New Cases Form were print outs from LCF's website.

<sup>216</sup> Letter from the Financial Promotions Team to Sentient Capital London Limited, 2 September 2016 (Document with Control Number 100156).

	<p><i>the purposes of issuing the [LCF] bond” but only for consumer credit lending.<sup>217</sup></i></p> <ul style="list-style-type: none"> <li>• The regulatory statement was “<i>being used in a promotional manner as it is the first bullet point in the financial promotion and is highlighted in bold font. In our view it is not acceptable to use a firm’s regulatory status in a promotional manner, especially when this is misleading</i>”.</li> <li>• The risk warnings in respect of consumer’s capital being at risk and that FSCS protection was unavailable were not displayed sufficiently prominently.</li> <li>• The letter also asked for further details regarding the “<i>100% track record</i>” statement on LCF’s website.<sup>218</sup></li> </ul> <p>Sentient Capital replied by letter dated 6 September 2016. The letter was signed by Sentient Capital’s CEO and Compliance Officer. The Financial Promotions Team did not identify that Sentient Capital’s Compliance Officer was also LCF’s Compliance Officer. The letter stated:</p> <ul style="list-style-type: none"> <li>• FCA-authorisation “<i>is not necessary for a firm to issue its own bonds</i>”. However, Sentient Capital accepted that the letter could be interpreted as the FCA had suggested and, as such, LCF agreed to amend its website to read “[a]uthorised and regulated by the [FCA] for the purpose of consumer credit lending”.</li> <li>• Sentient Capital was “<i>confident it was not the intention to utilise authorisation for promotional purposes</i>”. Again, Sentient Capital accepted the FCA’s concern and explained that LCF would make the regulatory statement less prominent.</li> <li>• “<i>The statement “100% track record” relates to [LCF] fully repaying investor capital, when due. [LCF] has now changed the statement to be precise to “100% track record in repaying investor capital”. We have requested proof of this and [LCF] has provided it, so Sentient is satisfied that this statement is not misleading</i>”.</li> </ul>
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<sup>217</sup> *Ibid.*, at page 1. The letter explained: “*GEN 4.5.3 [of the FCA Handbook] states “A firm must not indicate or imply that it is authorised by the FCA in respect of business for which it is not authorised.” In our opinion the reference to an FCA regulated firm as a promotional bullet points relating to the bond may give consumers the possible indication their investment benefits from the protections of the regulatory regime, which is not the case and is therefore misleading.*”

<sup>218</sup> *Ibid.*



	<ul style="list-style-type: none"><li>• Risk warnings regarding the consumers' capital being at risk and a lack of FSCS protection had been added and/or made more prominent.<sup>219</sup></li></ul> <p>The Financial Promotions Team raised further concerns by a letter to Sentient Capital on 8 September 2016 that stated:</p> <ul style="list-style-type: none"><li>• <i>“We note that you have amended the text in the box to say “Authorised and regulated by the Financial Conduct Authority for the purpose of consumer credit lending” and have made it less prominent by moving it further down and removing the bold font. It is important to make it clear to consumers what [LCF] is regulated for, but it is equally as important to be clear what they are not regulated for. In our opinion it is still not clear to consumers that [LCF] is not regulated by the FCA for the purposes of the bond, especially as the regulatory statement is contained with other promotional information about the bond investment. It is important consumers understand the investment does not receive any of the protections associated with a regulated firm. Please make this clearer on the website”.</i></li><li>• <i>“The statement “Authorised and regulated by the [FCA] for the purpose of consumer credit lending” is also incorrect. [LCF] is only regulated by the FCA for credit broking... Please amend this statement accordingly”.</i></li><li>• <i>“You have confirmed that the statement “100% track record” relates to [LCF] fully repaying investor capital in the past when due. In our opinion this triggers the past performance requirements in COBS 4.6R but the promotion does not contain this information. COBS 4.6.2R states a firm must ensure that information that contains an indication of past performance of relevant business, a relevant investment or a financial index, satisfies the conditions set out in COBS 4.6.2R(1-6).”<sup>220</sup></i></li></ul> <p>Sentient Capital responded by letter dated 15 September 2016 and stated that LCF:</p>
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<sup>219</sup> Letter from Sentient Capital to the Financial Promotions Team, 6 September 2016 (Document with Control Number 100189).

<sup>220</sup> Letter from the Financial Promotions Team to Sentient Capital, 8 September 2016 (Document with Control Number 100189).

Chapter 3: Key events in the FCA’s regulation of LCF

	<ul style="list-style-type: none"> <li>• would remove the sentence “[a]uthorised and regulated by the [FCA] for the purpose of consumer credit lending”;</li> <li>• used the phrase “[LCF] is regulated by the FCA for credit broking activities”; and</li> <li>• disputed that the 100% track record statement engaged the FCA’s past performance requirements (i.e. the provisions of COBS 4.6R).<sup>221</sup></li> </ul> <p>By letter dated 16 September 2016, the Financial Promotions Team wrote to Sentient Capital again to reiterate its view that the 100% track record statement triggered the past performance rules.<sup>222</sup> Sentient Capital responded by letter dated 19 September 2016 stating that LCF had amended the 100% track record statement to include a warning that past performance was not an indicator of future performance.<sup>223</sup></p> <p>By further letter of 21 September 2016, the Financial Promotions Team raised the new issue that “<i>the risk of illiquidity of the bond lacks prominence</i>”<sup>224</sup> to which Sentient Capital responded noting “[t]he phrase ‘Bond Series 3 to 7 are non-transferable’ has been added.”<sup>225</sup> By email dated 3 October 2016, the FCA confirmed to Sentient Capital that it had closed the case.<sup>226</sup></p>
5 April 2017 – 6 April 2017	<p>There were two escalations to the Financial Promotions Team in March 2017 which appear to have triggered further activity by that team in relation to LCF’s financial promotions. Taking each escalation in turn:</p> <ul style="list-style-type: none"> <li>• A member of the public submitted a report of a misleading financial promotion to the Financial Promotions Team (via an online form that was sent to a general mailbox accessed by the Financial</li> </ul>

<sup>221</sup> Letter from Sentient Capital to the Financial Promotions Team, 15 September 2016 (Document with Control Number 099491).

<sup>222</sup> Letter from the Financial Promotions Team to Sentient Capital, 16 September 2016 (Document with Control Number 099490).

<sup>223</sup> Letter from Sentient Capital to the Financial Promotions Team, 19 September 2016.

<sup>224</sup> Letter from the Financial Promotions Team to Sentient Capital, 21 September 2016 (Document with Control Number 099647).

<sup>225</sup> Letter from Sentient Capital to the Financial Promotions Team, 27 September 2016 (Document with Control Number 099713).

<sup>226</sup> Email from an Associate in the Financial Promotions Team to Sentient Capital’s Compliance Officer, 3 October 2016, at 1:43pm (Document with Control Number 099714).

	<p>Promotions Team) on 20 March 2017. The individual had seen an online advert for LCF's products. In response to a question on the online form regarding the reason for the complaint, the individual wrote: "[LCF] is claiming to charge small businesses 10-20% interest on loans, and offers up to 8% interest for 3 year bonds of a minimum of £5000. <b>I feel that this has to be a scam. I checked the FCA register and the company has been registered since July last year - a big red flag in my opinion that they are such a new company. They are not covered by the FSCS and do not adhere to anti-money laundering regulations. They claim to offer asset backed securities that will give people the impression that the 'bonds' they are buying are safe investments, yet a quick look at the risks they state at the bottom of their page reveal these are highly risky investments with no guarantees, no assets (or at least quality ones) to back them up so far as I can tell. My guess is that they will take peoples money and will go out of business before the bonds are redeemable. In addition, they also claim to have a 'withholding tax' on the interest paid of 20%, which also speaks for itself. There are red flags all over their literature</b>"<sup>227</sup> (emphasis added).</p> <ul style="list-style-type: none"><li>• A consumer submitted a report to the ASA on 28 March 2017 with the following complaint: "[t]he advert has no mention that capital is at risk and makes it seem like this is a deposit account. It isn't, it's a loan to the company when the investor could lose all their money. There is nothing to indicate that to the viewer".<sup>228</sup> The ASA emailed this complaint to the Financial Promotions Team on 31 March 2017.<sup>229</sup></li></ul> <p>The extent of the subsequent review of LCF's website by the Financial Promotions Team in the light of these two escalations is unclear. However, in the course of the review, the Financial Promotions Team noticed that the changes implemented to rectify the breaches identified in September 2016 were no longer present on the website and the website was once again in breach of the FCA's financial promotion</p>
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<sup>227</sup> Email Message, 20 March 2017 (Document with Control Number 123602).

<sup>228</sup> ASA Web Complaint Form, 28 March 2017.

<sup>229</sup> Email from a Senior Complaints Executive at the ASA to the Financial Promotions Team, 31 March 2017 at 1:17pm.

	<p>rules. Accordingly, the Financial Promotions Team sent a letter dated 5 April 2017 to LCF which covered two points:</p> <ul style="list-style-type: none"><li>• The letter noted that the FCA had already written to Sentient Capital and LCF several times in September 2016 “regarding concerns about the [LCF] website, such as the “authorised and regulated” statement... the past performance trigger “100% track record” and the absence of an illiquidity warning. The capital at risk warning that was contained in the second box on the home page... is also no longer there. We are very disappointed to see that the changes made to the website to address these concerns are no longer in place. We have enclosed copies of our previous correspondence to remind you of our concerns”.</li><li>• The letter also questioned who was approving LCF’s website as a financial promotion.<sup>230</sup></li></ul> <p>By email of the same day, LCF’s Compliance Officer wrote to the Financial Promotions Team and stated LCF “<i>didn’t notice the change and have contacted the technical providers. They had apologised and promised to investigate on how the version you saw was uploaded.</i>” LCF also explained that it did not need approval from Sentient Capital given LCF was “<i>authorised and regulated by the FCA (albeit with limited permission)</i>” and that LCF had had telephone calls with the FCA to this effect.<sup>231</sup></p> <p>By email dated 6 April 2017 the FCA noted that “<i>technical providers have re-instated the latest version of the website and you were unaware it had changed. We also note that you approved your own website in your capacity as an authorised firm. We confirm that we have now closed our file.</i>”<sup>232</sup></p> <p>The Financial Promotions Team considered this breach to be relatively unimportant. For example, three members of the Financial Promotions Team exchanged emails on 11 April 2017 expressing their collective view that the case was not of sufficient significance to be mentioned in the team’s weekly report. One team member involved in the case expressed the view as follows: “<i>I’m not sure my closed case is worthy of mention. I wrote to [LCF] because all the changes they had made to their website last year when I wrote to them had</i></p>
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<sup>230</sup> Letter from the Financial Promotions Team to LCF, 5 April 2017 (Document with Control Number 112309).

<sup>231</sup> Email from LCF’s Compliance Officer to an Associate in the Financial Promotions Team, 5 April 2017, at 3:50pm.

<sup>232</sup> Email from an Associate in the Financial Promotions Team to LCF’s Compliance Officer, 6 April 2017, at 10:17am.

Chapter 3: Key events in the FCA’s regulation of LCF

	<p><i>disappeared and the old non-compliant version was up. I wrote to them and it was a technical error – at the flick of a switch the compliant version was back again.</i><sup>233</sup></p> <p>It does not appear that the Financial Promotions Team escalated or investigated the consumer’s concern in the report of 20 March 2017 that “<i>this</i> [i.e. a promotion for LCF’s products] <i>has to be a scam</i>”. Importantly, the Financial Promotions Team does not appear to have escalated these concerns to the Authorisations Division which was, at that time, reviewing the First VOP Application.<sup>234</sup></p>
<p>1 June 2017</p>	<p>In addition to handling complaints regarding financial promotions escalated by other teams within the FCA, consumers and other external parties (e.g. the ASA), the Financial Promotions Team also conducted its own proactive monitoring using a tool from a company called Ebiquity which provided, among other things, reports focused on adverts for financial products.<sup>235</sup> An Ebiquity report from early May 2017 identified a press promotion for LCF’s products.<sup>236</sup> It appears that the Financial Promotions Team opened a case in connection with this press promotion, which was an advert that appeared in <i>The Times</i> on 3 May 2017.<sup>237</sup> The Financial Promotions Team sent a letter to LCF on 1 June 2017 which stated:</p> <p><i>“[w]e consider that this promotion does not comply with our rules and is not in line with our guidance because we consider that the statement “Authorised and regulated by the [FCA] for credit purposes” could be misleading in the context of the financial promotion. As the promotion is for investment activity that is not regulated by the FCA, including a statement regarding your regulatory status could be misleading for consumers. In our opinion the reference to an FCA regulated firm may give consumers the possible indication that their investment benefits from the protections of the regulatory regime, which is not the case”.</i><sup>238</sup></p>

<sup>233</sup> Email chain between three members of the Financial Promotions Team, 11 April 2017, at 8:04am (Document with Control Number 214295).

<sup>234</sup> See Section 2 of this **Chapter 3** for further details regarding LCF’s first Variation of Permission application.

<sup>235</sup> Interview Transcript T, at pages 8 to 10.

<sup>236</sup> New Weekly Monitoring Report, 8 May 2017, at page 16 (Document with Control Number 080824).

<sup>237</sup> Case Detail (Document with Control Number 123710).

<sup>238</sup> Letter from the Financial Promotions Team to LCF’s CEO, 1 June 2017 (Document with Control Number 109858).

Chapter 3: Key events in the FCA’s regulation of LCF

	<p>LCF responded the same day to say that it had made changes to the advert (albeit noting that LCF considered it a general advert that did not promote any specific investment and was, therefore, outside the scope of the financial promotions rules).<sup>239</sup> The Financial Promotions Team emailed to confirm that they were closing the case but disagreeing with LCF’s assertion that the advert fell outside the financial promotions rules.<sup>240</sup></p> <p>It appears that there was no other action or review undertaken by the Financial Promotions Team. Further, the Financial Promotions Team does not appear to have discussed the case with the Authorisations Division which was, at that time, still reviewing the First VOP Application.<sup>241</sup></p>
<p>12 June 2017 – 13 June 2017</p>	<p>Following the escalation of a consumer complaint by the ASA to the Financial Promotions Team on 8 June 2017 regarding a promotion for LCF’s products that appeared in the <i>Daily Telegraph</i> in May 2017,<sup>242</sup> the Financial Promotions Team wrote to LCF on 12 June 2017 to raise similar concerns regarding the promotion in <i>The Times</i>.<sup>243</sup></p> <p>The promotion contained the warning “[a]s with any investments, your capital may be at risk”. The email from the Financial Promotions Team noted that “[w]ith a mini bond a consumer’s capital is at risk”. As a result, the Financial Promotions Team explained that the promotion was in breach of the fair, clear and not misleading requirement in COBS 4.2.1R.<sup>244</sup></p>

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<sup>239</sup> Email from LCF’s Compliance Officer to the Financial Promotions Team, 1 June 2017 at 12:29pm (Document with Control Number 219497).

<sup>240</sup> Email from the Financial Promotions Team to LCF’s Compliance Officer, 1 June 2017 at 2:11pm (Document with Control Number 219497).

<sup>241</sup> See Section 2 of this **Chapter 3** for further details regarding the First VOP Application.

<sup>242</sup> Email from a Complaints Executive at the ASA to the Financial Promotions Team, 8 June 2017 at 12:54pm (Document with Control Number 123757).

<sup>243</sup> Email from the Financial Promotions Team to LCF’s CEO and Compliance Officer, 12 June 2017 at 4:03pm (Document with Control Number 100193).

<sup>244</sup> *Ibid.*

Chapter 3: Key events in the FCA’s regulation of LCF

	<p>LCF responded the next day to say the promotion would be “<i>amended immediately</i>” and that “[i]nternal disciplinary procedure to run”.<sup>245</sup></p> <p>It appears that there was no other action or review undertaken by the Financial Promotions Team. Further, the Financial Promotions Team does not appear to have discussed the case with the relevant Case Officer in the Authorisations Department who was, at that time, in the process of approving the First VOP Application.<sup>246</sup></p>
<p>18 August 2017 – 4 September 2017</p>	<p>A member of the public submitted an online report of a misleading financial promotion in connection with LCF’s website on 11 August 2017. The complaint stated: “[LCF’s website] <i>fails to warn that the capital is at risk – it flaunts its FCA membership and misleads consumers that their deposit is protected under the FSCS</i>”.<sup>247</sup> The Financial Promotions Team reviewed this report and sent a letter to LCF on 18 August 2017.<sup>248</sup></p> <p>The Financial Promotions Team’s letter identified the following issues in respect of LCF’s website and a sponsored <i>Google</i> promotion:</p> <ul style="list-style-type: none"> <li>• The website displayed the statement “<i>we are authorised and regulated by the Financial Conduct Authority, FRN 722603</i>” which raised the same concerns detailed in the Financial Promotions Team’s letter of 2 September 2016 (i.e. the statement was misleading as it was used in relation to investment activity that was not regulated by the FCA). This was stated to be in breach of COBS 4.2.4G(4).</li> <li>• The firm was using its regulatory status in a promotional manner.</li> <li>• A sponsored <i>Google</i> promotion for LCF failed to contain a “<i>capital at risk</i>” warning, which was stated to be a breach of COBS 4.2.4R(1).</li> </ul>

<sup>245</sup> Email from LCF’s Compliance Officer to the Financial Promotions Team, 13 June 2017 at 10:23am (Document with Control Number 100193).

<sup>246</sup> See Section 2 of this **Chapter 3** for further details regarding the First VOP Application.

<sup>247</sup> Email Message Detail, 11 August 2017 (Document with Control Number 124046).

<sup>248</sup> Letter from the Financial Promotions Team to LCF’s CEO, 18 August 2017 (Document with Control Number 108068).

	<ul style="list-style-type: none"><li>• The sponsored <i>Google</i> promotion also contained the statement “100% track record” which triggered the past performance requirements in COBS 4.6.2R.<sup>249</sup></li></ul> <p>The letter from the Financial Promotions Team noted that they had written to LCF “on three other occasions concerning deficiencies in [LCF’s] promotions”. The letter explained that a further breach would result in the team seeking “a formal attestation by an approved person conducting a significant influence function from within [LCF] that there are adequate systems and controls in place for the approval of compliant financial promotions”.<sup>250</sup></p> <p>LCF responded on 31 August 2017 and explained the changes they had made to their website and the <i>Google</i> promotion. The response stated that LCF “had no intention of utilising its regulatory status as a marketing tool” and in respect of the threatened attestation: “[p]lease note that our promotional material undergoes a full approval process at all times, marked to COBS and other aspects we consider”.<sup>251</sup></p> <p>In the light of the amendments made by LCF, the Financial Promotions Team closed the case without any further action.<sup>252</sup> It does not appear that the Financial Promotions Team (or any other team within the FCA) took any steps to verify LCF’s assertion that its “promotional material undergoes a full approval process at all times”. In addition, even though the FCA had identified multiple breaches of the financial promotions rules by LCF, there was no ongoing targeted monitoring of LCF’s financial promotions. The Financial Promotions Team was reliant on complaints from consumers or the Ebiquity tool to identify any future issues with LCF’s financial promotions.</p>
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3.2 The FCA’s intervention at LCF in December 2018, which arose from adverse intelligence identified on a non-public external database accessible by the FCA’s Intelligence Team,<sup>253</sup>

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<sup>249</sup> *Ibid.*

<sup>250</sup> *Ibid.*

<sup>251</sup> Letter from LCF’s Compliance Officer to the Financial Promotions Team, 31 August 2017 (Document with Control Number 100389).

<sup>252</sup> Email from the Financial Promotions Team to LCF’s Compliance Officer, 4 September 2017 at 3:58pm (Document with Control Number 100387).

<sup>253</sup> See Section 4 of this **Chapter 3** and **Chapter 13** (Other matters of importance to the Investigation) of this Report.



was not led by the Financial Promotions Team but the action taken by the FCA was focused on LCF's financial promotions. As part of the FCA's unannounced visit to LCF's premises on 10 December 2018, the team served LCF with a supervisory notice pursuant to the financial promotions "banning power" under section 137S of FSMA<sup>254</sup> (the first time the FCA had used such a power)<sup>255</sup> which required the firm to take the following steps immediately:

- (a) "[w]ithdraw from its website ([www.londoncapitalandfinance.co.uk](http://www.londoncapitalandfinance.co.uk)) all communications relating to its 'Fixed Rate ISA or Bond'";
- (b) "[w]ithdraw all other communications that relate to its 'Fixed Rate ISA or Bond', whether those communications appear on Facebook, Youtube, [www.top-isa.rates.co.uk](http://www.top-isa.rates.co.uk), [www.best-savings-rate.co.uk](http://www.best-savings-rate.co.uk), as a result of Google searches or any other platform or advertising medium";
- (c) "[r]efrain from making any communications that in substance replicated the claims made on the firm's website about the 'Fixed Rate ISA or Bond'"; and
- (d) "[p]ublish on its website the following statement prominently at the top of the homepage 'The [FCA] has directed [LCF] to withdraw all of its existing marketing materials in relation to LCF's Fixed ISA or Bond'".<sup>256</sup>

3.3 Following further discussions between the FCA and LCF after the unannounced visit, LCF voluntarily applied for the imposition of requirements (also known as a "VREQ")<sup>257</sup> on 13

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<sup>254</sup> Section 137S(1) of FSMA states: "[t]he FCA may give a direction under this section if (a) an authorised person has made, or proposes to make, a communication or has approved, or proposes to approve, another person's communication, and (b) the FCA considers that there has been, or is likely to be, a contravention of financial promotion rules in respect of the communication or approval". Section 137S(2) of FSMA states: "[a] direction under this section may require the authorised person (a) to withdraw the communication or approval; (b) to refrain from making the communication or giving the approval (whether or not it has previously been made or given); (c) to publish details of the direction; (d) to do anything else specified in the direction in relation to the communication or approval".

<sup>255</sup> FCA Use of Banning Power (see: FCA response to Information Request LCF\_DEC11/12\_03).

<sup>256</sup> Second Supervisory Notice from the FCA to LCF, 17 January 2019, at paragraph 1 (see: <https://www.fca.org.uk/publication/supervisory-notices/second-supervisory-notice-london-capital-and-finance-plc-2019.pdf> (accessed on 22 November 2020)).

<sup>257</sup> The FCA's summary of its approach to enforcement explains the use of VREQs as follows: "[w]e will seek to use our VREQ...powers where we suspect serious misconduct may have occurred and harm needs to be prevented immediately" (FCA Mission: Our Approach to Enforcement, March 2018, at page 10, see:

December 2018 such that LCF could “*not communicate or approve any invitation or inducement to engage in investment activity (i.e. financial promotion)*”.<sup>258</sup>

3.4 The issues with LCF’s financial promotions which were the basis for the intervention in December 2018 were similar to those identified in the previous interventions:

- (a) “[u]ndue prominence given to the firm’s FCA authorisation despite the bonds not being regulated or having FSCS protection”;<sup>259</sup>
- (b) “[p]ast performance warning insufficiently prominent”;<sup>260</sup> and
- (c) “[i]nappropriate comparison with cash savings”.<sup>261</sup>

3.5 There was one additional issue with LCF’s financial promotions that had not been identified by the Financial Promotions Team prior to the intervention in late 2018: “[t]he LCF Bonds are not ISA qualifying investments”.<sup>262</sup>

#### 4. Significant information and intelligence

4.1 The FCA received various adverse information and intelligence regarding LCF from a variety of sources during the Relevant Period. The table below summarises the key pieces of information and intelligence received by the FCA regarding LCF:

A letter received by the FCA in January 2017 from an anonymous source (the “ <b>Anonymous Letter</b> ”).	The FCA’s Unauthorised Business Department received by post an undated letter from an anonymous source in January 2017. The letter was addressed to a Detective Constable in the “Fraud Squad” at Metropolitan Police Headquarters in London. The
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<https://www.fca.org.uk/publication/corporate/our-approach-enforcement.pdf?mod=djemRiskCompliance> (accessed on 22 November 2020)).

<sup>258</sup> Second Supervisory Notice from the FCA to LCF, 17 January 2019, at paragraph 3.

<sup>259</sup> *Ibid.*, at paragraph 9.

<sup>260</sup> *Ibid.*, at paragraphs 10 and 11.

<sup>261</sup> *Ibid.*, at paragraphs 12 and 13.

<sup>262</sup> *Ibid.*, at paragraphs 7 and 8. LCF’s ISA products are considered in more detail in **Chapter 13** (Other Matters of Importance to the Investigation) of this Report. For the avoidance of doubt, the Investigation is not suggesting that the Financial Promotions Team should have identified the ISA issue prior to the intervention in 2018. As noted above, LCF became an authorised ISA manager in November 2017 and the Financial Promotions Team’s last interaction with LCF was in September 2017.

	<p>letter was copied to an individual in the FCA's Unauthorised Business Department.<sup>263</sup></p> <p>The content of the letter was:</p> <p><i>“Re.London Capital and Finance Group</i></p> <p><i>I wrote a few back regarding the above company. Just by way of an update. They have raised £30m now and as far as I can see they have just “lent” the money to related companies controlled by the main players... [the letter then lists two individuals, neither of whom were obviously connected to LCF (i.e. they were not LCF's Approved Persons)].</i></p> <p>[The letter then includes a sentence alleging that one of the individuals had been making lavish purchases.]</p> <p><i>They trade on the fact that they are FCA regulated well they have a consumer credit license, they are not authorised for investment purposes or dealing with the general public re investment... the product is being heavily mis sold [...]</i></p> <p><i>It crazy...</i></p> <p><i>I have copied in [an FCA employee in the Unauthorised Business Department] at the FCA too... hopefully between you things will happen.”<sup>264</sup></i></p> <p>The letter had been stamped by the FCA Enforcement Team as being received on 27 January 2016. The contemporaneous documentary evidence and information obtained from interviews with FCA personnel appear to show that the letter was actually received on or about 27 January 2017.<sup>265</sup></p> <p>On 30 January 2017, the letter was sent to the Consumer Credit Team within the Supervision Division with a copy to the FCA's Intelligence Team. An email on 31 January 2017 confirmed that a case was opened (referred to as a “<i>risk event</i>”) by the Consumer Credit Team in connection with the letter.<sup>266</sup> That email also copied the relevant team member in the Authorisations Division who was considering the First VOP Application, and the Consumer Credit Team made the following request: “[i]n light</p>
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<sup>263</sup> Anonymous and undated letter addressed to a Detective Constable in the Metropolitan Police (Document with Control Number 217589).

<sup>264</sup> Anonymous letter addressed to a Detective Constable in the Metropolitan Police, undated.

<sup>265</sup> Email from an Associate in the Consumer Credit Department within the Supervision Division to a Manager in the same team, 30 January 2017 at 3:07pm (Document with Control Number 217588).

<sup>266</sup> Email from an Associate in the Consumer Credit Department within the Supervision Division to an Associate in the Intelligence Team, 31 January 2017 at 10:53am (Document with Control Number 217561).

Chapter 3: Key events in the FCA’s regulation of LCF

	<p><i>of [the allegations in the letter] please do not seek to authorise these permissions until our investigation is complete...”</i></p> <p>Following contact between the FCA and the Detective Constable at the Metropolitan Police to whom the letter was addressed, the FCA closed the risk event on the basis the FCA did not believe that the entity referred to in the letter – “<i>London Capital and Finance Group</i>” – was the same entity as LCF and that the names and addresses of the individuals referred to in the letter did not match with those connected with LCF.<sup>267</sup> The FCA was unable to produce evidence to the Investigation of exactly what the Detective Constable at the Metropolitan Police told the individual in the Intelligence Team regarding the contents of this letter.<sup>268</sup> This is a failure as the FCA should be able to evidence key decisions taken in response to allegations of fraud.</p> <p>No further action was taken by the FCA in relation to the Anonymous Letter.<sup>269</sup></p> <p>The relevant team member reviewing LCF’s First VOP Application referenced the Anonymous Letter in the form approving the application but it did not result in any further investigation or analysis by the Case Officer.<sup>270</sup></p>
<p>Repeat calls to the FCA’s Customer Contact Centre from an individual (“<b>Individual</b></p>	<p>There were at least 15 calls to the FCA’s Customer Contact Centre from Individual A between 15 July 2016 and 22 February 2018.<sup>271</sup></p>

<sup>267</sup> Case Detail (Document with Control Number 123434).

<sup>268</sup> Email from the FCA Investigation Liaison Team to the Investigation Team, 16 July 2020 at 10:19pm.

<sup>269</sup> Further details of how the Investigation considers the Anonymous Letter should have been handled are set out in **Chapter 10** (Adequacy of the FCA’s supervision of LCF) and **Chapter 12** (Information provided by third parties).

<sup>270</sup> The completed form stated: “[d]uring the application a concern was raised regarding intelligence received that a similarly named entity was raising funds and misappropriating them...The case was closed due to confirmation from police contact that there was no reason to believe entities were the same as name, address and dates of birth did not match. As the applicant has withdrawn the request for client money permissions...there are no further concerns with this” (FCA Variation of Permission: Recommendation, 13 June 2017, at page 3).

<sup>271</sup> Further details of these calls are in **Appendix 6**. Transcript of the first call from Individual A to the Customer Contact Centre, 15 July 2016; Transcript of the second call from Individual A to the Customer Contact Centre 15 July 2016; Transcript of a call from Individual A to the Customer Contact Centre 18 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 3 November 2016; Transcript of a call from Individual A to the FCA Contact Centre 5 June 2017; Transcript of a call from Individual A to the FCA Contact Centre 16 June 2017; Transcript of a call from Individual A to the FCA Contact Centre 19 June 2017; Transcript of a call from Individual A to the FCA Contact Centre 21 June 2017; Transcript of a call from Individual A to the FCA Contact Centre, 7 July 2017; Transcript of a call from Individual A to the FCA Contact Centre 10 July 2017; Transcript of a call from Individual A to the FCA Contact Centre 11 July 2017; Transcript of a call from Individual A to the FCA Contact Centre 19 February 2018.

<p>A”) during the period 15 July 2016 – 19 February 2018.</p>	<p>Individual A made at least seven calls to the Customer Contact Centre in 2016.<sup>272</sup> Broadly, those calls highlighted the following issues:</p> <ul style="list-style-type: none"> <li>• Concerns that LCF was operating a “<i>pyramid scam</i>”.<sup>273</sup></li> <li>• Concerns about LCF’s business model and apparent rapid growth in the light of accounting information filed at Companies House at the time which showed that LCF appeared to have loaned money to one main entity (which had connections to LCF) and had income of £14,000 against statements by LCF that it had loaned money to 160 companies and that they had invested funds of £30 million.<sup>274</sup></li> <li>• The truthfulness of LCF’s financial promotions.<sup>275</sup></li> <li>• Whether LCF had the relevant permissions for the activities it was conducting.<sup>276</sup></li> <li>• A lack of clarity regarding companies connected to LCF, their roles and when they were incorporated. In particular that information provided about LCF’s security trustee appeared to be incorrect.<sup>277</sup></li> <li>• Potential conflicts of interest between LCF and connected companies.<sup>278</sup></li> </ul> <p>Two of the five calls in 2016 to the Customer Centre were escalated to the Consumer Credit Team in the Supervision Division but only in relation to the necessary permissions required by LCF:</p>
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<sup>272</sup> Transcript of the first call from Individual A to the Customer Contact Centre 15 July 2016; Transcript of the second call from Individual A to the Customer Contact Centre 15 July 2016; Transcript of a call from Individual A to the Customer Contact Centre 18 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016; Transcript of a call from Individual A to the FCA Contact Centre 3 November 2016.

<sup>273</sup> Transcript of the first call from Individual A to the Customer Contact Centre, 15 July 2016, at pages 5 to 11; Transcript of the second call from Individual A to the Customer Contact Centre 15 July 2016, at page 8.

<sup>274</sup> Transcript of a call from Individual A to the FCA Contact 18 July 2016, at pages 5 and 14; Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016, at page 11.

<sup>275</sup> Transcript of a call from Individual A to the FCA Contact Centre 18 July 2016, pages 7 and 12.

<sup>276</sup> Transcript of a call from Individual A to the FCA Contact Centre 18 July 2016, at pages 3 and 6; Transcript of a call from Individual A to the FCA Contact Centre 3 November 2016, at page 14.

<sup>277</sup> Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016, at page 7.

<sup>278</sup> Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016, at page 14.

	<ul style="list-style-type: none"><li>• One of these calls was referred by the Consumer Credit Team to the Financial Promotions Team given the Associate in the Contact Centre had expressed concerns regarding LCF’s website. As noted in Section 3 of this Chapter, this resulted in the Financial Promotions Team sending a letter to Sentient Capital (as approver of LCF’s website pursuant to section 21 of FSMA) on 2 September 2016. Individual A’s concerns that LCF was operating a “pyramid scam” were not investigated by any team within the FCA.</li><li>• The Consumer Credit Team closed the second of the cases arising from Individual A’s calls to the Contact Centre in 2016 after conducting a risk-scoring exercise and deciding that it was below the tolerance level for any action to be taken.<sup>279</sup></li></ul> <p>Individual A made seven calls to the Customer Contact Centre in 2017 and a further call in 2018.<sup>280</sup> Broadly, those calls highlighted the following issues:</p> <ul style="list-style-type: none"><li>• Concerns that interest payments to Bondholders were being funded by capital contributions.<sup>281</sup></li><li>• LCF had no assets to provide security for the bonds it was offering since all of its assets were already mortgaged.<sup>282</sup></li><li>• Repeated concerns about the security trustee of LCF’s bonds including potential conflicts of interest.<sup>283</sup></li><li>• Concerns about the use of Bondholder funds and the inability to access financial information from LCF.<sup>284</sup></li></ul>
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<sup>279</sup> Case Detail (Document with Control Number 122276).

<sup>280</sup> Transcript of a call from Individual A to the FCA Contact Centre 5 June 2017; Transcript of a call from Individual A to the FCA Contact Centre 16 June 2016; Transcript of a call from Individual A to the FCA Contact Centre 19 June 2017; Transcript of a call from Individual A to the FCA Contact Centre 21 June 2017; Transcript of a call from Individual A to the FCA Contact Centre 7 July 2017; Transcript of a call from Individual A to the FCA Contact Centre 10 July 2017; Transcript of a call from Individual A to the FCA Contact Centre 11 July 2017; Transcript of a call from Individual A to the FCA Contact Centre 19 February 2018.

<sup>281</sup> Case Detail 16 June 2017 (Document with Control Number 123772); Transcript of a call from Individual A to the FCA Contact Centre, 16 June 2016, at page 7.

<sup>282</sup> Case Detail 21 June 2017 (Document with Control Number 123786); Transcript of a call from Individual A to the FCA Contact Centre 21 June 2017, at pages 10 and 11.

<sup>283</sup> Case Detail 10 July 2017 (Document with Control Number 123886); Transcript of a call from Individual A to the FCA Contact Centre 10 July 2017, at page 17.

<sup>284</sup> Transcript of a call from Individual A to the FCA Contact Centre, 16 June 2016, at pages 4 and 5; Transcript of a call from Individual A to the FCA Contact Centre 19 June 2017, at page 8; Transcript of a call from Individual A to the FCA Contact Centre 19 February 2018, at page 4.

Chapter 3: Key events in the FCA’s regulation of LCF

	<ul style="list-style-type: none"> <li>• Concerns about the retail nature of the marketing of mini-bonds.<sup>285</sup></li> <li>• Conflicts of interest arising out of the LCF team being made up on employees of the marketing company who marketed the bonds.<sup>286</sup></li> <li>• A lack of clarity about the process by which LCF identified SMEs for lending purposes since there was no public interface inviting SMEs to apply for loans.<sup>287</sup></li> <li>• Repeated concerns about LCF’s business model, apparent rapid growth and the sustainability of the company structure.<sup>288</sup></li> </ul> <p>One of the eight calls in 2017/2018 was escalated by the Customer Contact Centre to the Consumer Credit Event Supervision Team. The risk event was closed without any further action.<sup>289</sup></p> <p>No proactive review of LCF’s business was conducted by the FCA despite repeated warnings from Individual A.<sup>290</sup></p>
<p>Concerns raised by individuals within the FCA’s Listing Transactions Team in August/September 2018.</p>	<p>In early August 2018, LCF submitted to the FCA’s Listing Transactions Team a draft prospectus in connection with a proposed £250 million fixed interest bond programme<sup>291</sup> and that prospectus was allocated to individuals in that team for review.<sup>292</sup> One member of the Listing Transactions Team emailed the Consumer Credit Team within the Supervision</p>

<sup>285</sup> Case Detail 21 June 2017 (Document with Control Number 123786); Transcript of a call from Individual A to the FCA Contact Centre 21 June 2017, at page 2; Transcript of a call from Individual A to the FCA Contact Centre 10 July 2017, at page 9; Transcript of a call from Individual A to the FCA Contact Centre 19 February 2018, at page 2.

<sup>286</sup> Transcript of a call from Individual A to the FCA Contact Centre 16 June 2016, at page 8; Transcript of a call from Individual A to the FCA Contact Centre 21 June 2017, at page 7; Transcript of a call from Individual A to the FCA Contact Centre 19 February 2018, at page 6.

<sup>287</sup> Transcript of a call from Individual A to the FCA Contact Centre 21 June 2017, at page 9; Transcript of a call from Individual A to the FCA Contact Centre 10 July 2017, at page 24.

<sup>288</sup> Transcript of a call from Individual A to the FCA Contact Centre 16 June 2016, at pages 6 and 14; Transcript of a call from Individual A to the FCA Contact Centre 10 July 2017, at page 13.

<sup>289</sup> Case Detail (Document with Control Number 123786).

<sup>290</sup> Further details of the Investigation’s criticisms of how the calls from Individual A were handled are set out in **Chapter 12** (Information provided by third parties).

<sup>291</sup> Letter from Lewis Silkin LLP to the FCA dated 2 August 2018.

<sup>292</sup> Email between members of the Listing Transactions Team, 2 August 2018, at 4:29pm (Document with Control Number 217342).

	<p>Division to ask whether there were any supervisory concerns in relation to LCF.</p> <p>The email was sent to the Consumer Credit Team within the Supervision Division because LCF was still assigned to that team on the FCA's IT systems. However, the FCA confirmed in response to an information request from the Investigation Team that LCF should have been assigned to the team within the Supervision Division responsible for corporate finance firms (known at the time as the Overseas Wholesale Banks Department) on approval of the First VOP Application in June 2017 and that the transfer did not actually occur until June 2018 but the FCA's systems did not reflect this transfer until some time between 8 August 2018 and late January 2019.<sup>293</sup></p> <p>The Consumer Credit Team replied to the email from the Listing Transactions Team on 8 August 2018:</p> <p><i>"I have checked the firms regulatory history and identified no open risk events or on-going concerns with the firm. The [case history on the FCA's case management system] does not suggest any enforcement action and the firm are not part of any thematic reviews".</i><sup>294</sup></p> <p>LCF submitted a revised version of the prospectus at the end of August 2018.<sup>295</sup> The individuals in the Listing Transactions Team who reviewed the revised prospectus raised the following concerns with the Supervision Division in September 2018:</p> <ul style="list-style-type: none"><li>• The rapid growth of LCF and its loan book. In particular the loan book had grown from £10 million of loans in 2016 to £50 million of loans in 2017 and was to further increase to £130 million of loans by the end of the accounting year for 2018.</li><li>• LCF had only one bank account into which both the proceeds of the loans were paid and from which the loans were made.</li></ul>
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<sup>293</sup> Request 80 – FCA Clarification to earlier Response to Information Request LCF\_JUL\_005; FCA Response to Information Request LCF\_DEC11/12\_16.

<sup>294</sup> Email from an Associate in the Consumer Credit Supervision Team to the Listing Transactions Team, 8 August 2018, at 12:23pm (Document with Control Number 217308).

<sup>295</sup> Email between members of the Listing Transactions Team, 30 August 2018, at 8:48am (Document with Control Number 217283).



Chapter 3: Key events in the FCA’s regulation of LCF

	<ul style="list-style-type: none"> <li>• There was a lack of any procedures for liquidity management.</li> <li>• LCF had no impairment provisions in its accounts against its loan book and no “<i>bad debt</i>” write offs in 2016 and 2017. The Listing Transactions Team said this did not make any sense given the “<i>high risk</i>” nature of its loan book.</li> <li>• Bonds were being promoted to unsophisticated investors.<sup>296</sup></li> </ul> <p>As a result of the above, the individuals in the Listing Transactions Team expressed two specific concerns:</p> <ul style="list-style-type: none"> <li>• LCF was at risk of not being able to meet its obligations to retail Bondholders; and</li> <li>• LCF was promoting high risk bonds to unsophisticated retail investors in breach of the COBS rules.<sup>297</sup></li> </ul> <p>The Listing Transactions Team raised these concerns with the Supervision Division and highlighted that this case was considered “<i>high risk</i>” from a listing transactions perspective and that LCF may pose significant risks to the FCA as a whole.<sup>298</sup> A risk event was opened by the Supervision Division in September 2018 but no action had been taken to progress the case by the relevant individual in the Supervision Division before the Intelligence Team identified significant adverse intelligence regarding LCF in mid-October 2018 (see below).<sup>299</sup></p>
Intelligence identified by the FCA’s Intelligence Team in October 2018.	As part of a review conducted on a non-public database external to the FCA <sup>300</sup> in relation to another firm in October 2018, a member of the FCA’s Intelligence Team identified significant adverse intelligence in relation to LCF and related individuals and entities. The significant adverse intelligence showed

<sup>296</sup> Email from a Senior Associate in the Listings Transaction Team to an Associate in the Retail Lending Evaluation Team within the Supervision Division, 11 September 2018 at 10:50am (Document with Control Number 217291).

<sup>297</sup> *Ibid.*

<sup>298</sup> *Ibid.*, at 3:42pm.

<sup>299</sup> FCA Response to Information Request LCF\_JUN\_13.

<sup>300</sup> The external database is accessible to only a limited number of the FCA’s Intelligence Team and access is subject to strict conditions.

Chapter 3: Key events in the FCA’s regulation of LCF

	potential conflicts of interest, potential criminality and concerns regarding the way in which LCF was running its business. <sup>301</sup>
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4.2 The table above does not refer to the letter sent by the independent financial adviser, Mr Neil Liversidge, to the FCA in November 2015 (the “**Liversidge Letter**”) which has received attention from Bondholders and the media in the wake of the collapse of LCF.<sup>302</sup> This is because the searches conducted by the FCA were unable to establish, one way or another, whether the FCA had, or had not, received the Liversidge Letter during the Relevant Period.

4.3 The Investigation is unable to reach a definitive conclusion as to whether the FCA received the Liversidge Letter during the Relevant Period. However, the Investigation considers that it is, in any event, largely irrelevant whether the FCA did, or did not, receive the Liversidge Letter for two reasons:

- (a) First, as discussed elsewhere in this Report, the FCA’s approach to handling concerns from third parties regarding LCF’s conduct (e.g. the Anonymous Letter and the concerns raised by Individual A) was such that, even if the Liversidge Letter had been received by the FCA in 2015 (or any time during the Relevant Period), it is unlikely that it would have resulted in any, or any substantive, action or re-action by the FCA.<sup>303</sup>
- (b) Second, the (obvious) concerns identified by Mr Liversidge should, in any event, have been identified by one or more of the teams within the FCA who were

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<sup>301</sup> Email from an Associate in the Intelligence Team to various individuals in other teams within the FCA (including the Supervision Division and the Listing Transactions Team), 22 October 2018 at 11:30am (Document with Control Number 222310). See further details regarding this point in **Chapter 13** (Other matters of importance to the Investigation) in this Report.

<sup>302</sup> By way of example, see: <https://www.theguardian.com/business/2019/mar/29/one-of-the-biggest-financial-scandals-around-fca-criticised-over-lcf> (accessed on 22 November 2020).

<sup>303</sup> In its representations, the FCA suggested this was an “*unwarranted*”, “*un-evidenced*” and “*speculative*” conclusion. The Investigation disagrees. As explained in paragraph 6.1 of **Chapter 1** (Introduction and background) of this Report, the Investigation has drawn inferences where the evidence suggests that it is more likely than not for an event/action to have taken place. The Investigation infers that, even if the FCA had received the Liversidge Letter, it would not have resulted in any substantive action by the FCA. This inference is based on the FCA’s failure to respond appropriately to: (a) the Anonymous Letter, which provided allegations about LCF (see the table above); and (b) 15 calls from Individual A to the FCA between 15 January 2016 and 22 February 2018 raising detailed allegations that LCF may have engaged in fraud or irregularity (see Section 3 of **Appendix 6**).

reviewing LCF's financial information during the Relevant Period (e.g. someone in the Authorisations Division with responsibility for reviewing the First VOP Application).

4.4 According to Mr Liversidge, the Liversidge Letter was addressed to the FCA's Enforcement Division and was sent by post. The Investigation accepts, on the basis of his evidence, that Mr Liversidge did in fact post the letter in November 2015.

4.5 The content of the Liversidge Letter focused on concerns regarding LCF marketing its products to an unsophisticated investor client of Mr Liversidge. It included the following passage:

*"If [LCF] can reach [Mr Liversidge's unsophisticated retail investor client] then they can reach a lot more and from what I see, I would not class this as a suitable investment for the unsophisticated retail market. Additionally, the obviously unprofessional character of this promotion gives me cause for concern as to how safe or otherwise will be any funds clients place with them".*<sup>304</sup>

4.6 According to Mr Liversidge, the Liversidge Letter enclosed a redacted email exchange between Mr Liversidge and his client and the LCF accounts for the financial year ending 30 April 2015 which he had obtained from Companies House.<sup>305</sup> The redacted email exchange includes the following analysis of LCF's business by Mr Liversidge:

*"According to the last full set of accounts [LCF] only has 1 customer to whom it is lending everything... You'd be lending money via [LCF] to [Company A]... They've also been lenders to [Company B]— who are worth the square root of bugger all... You're getting 8% according to their website, not 8.5%. LCF lends the money out at 15%. What do you know about the business they're lending to? What do you know about the 'assets' it's supposedly secured on? If a business has to pay 15% - so much over the odds for capital, there's a reason why... This looks like some dodgy foreign property development outfit. No wonder banks won't lend on it... The owners don't have much at risk per the accounts and [a member of*

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<sup>304</sup> Letter from Mr Liversidge at West Riding Personal Financial Solutions Ltd to the FCA Enforcement Division, 29 November 2015, at page 1.

<sup>305</sup> *Ibid.*, at pages 2 to 21.

LCF's senior management] *has been a director of [LCF] and [[Company A]]. Conflict of interest?...*<sup>306</sup>

4.7 In response to a request from the Investigation submitted in October 2019, the FCA stated that it had been unable to find a copy of the Liversidge Letter that had been received by the FCA during the Relevant Period.<sup>307</sup> The FCA confirmed that it had, however, received a copy of the Liversidge Letter on 14 March 2019 after contacting Mr Liversidge directly.<sup>308</sup>

4.8 The Investigation subsequently asked the FCA for a detailed explanation of the steps that had been taken to confirm whether the Liversidge Letter had been received by the Enforcement Division or any other team within the FCA. The response explained that the FCA had taken the following steps:

- (a) The FCA Investigation Liaison Team reviewed all cases logged against LCF in the FCA's case management system during the period 29 November 2015 to 31 December 2015. This review identified no cases relating to the Liversidge Letter.<sup>309</sup>
- (b) The FCA Investigation Liaison Team also reviewed cases relating to Mr Liversidge in the FCA's case management system. This review identified a call from Mr Liversidge in December 2015 which appears to have been about a letter sent by Mr Liversidge in respect of a different firm on 27 November 2019.<sup>310</sup>
- (c) The FCA Investigation Liaison Team ran a search for the term 'Liversidge' across the FCA's document management system. The responses were reviewed by the FCA Investigation Liaison Team and no evidence of the Liversidge Letter being received by the FCA during the Relevant Period was identified.<sup>311</sup>

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<sup>306</sup> *Ibid.*, at page 2.

<sup>307</sup> Email from the FCA Investigation Liaison Team to the Investigation Team, 29 November 2019 at 10.51pm.

<sup>308</sup> *Ibid.*

<sup>309</sup> FCA Response to Information Request LCF 20200427\_02, at pages 1 to 3.

<sup>310</sup> *Ibid.*, at page 4.

<sup>311</sup> *Ibid.*, at page 6.

(d) The FCA's Enforcement Division also ran a number of searches across its systems, archived emails and correspondence logs for the Liversidge Letter. These searches did not locate evidence that the Liversidge Letter was received by the FCA during the Relevant Period.<sup>312</sup>

4.9 The Investigation Team has also run targeted searches for the Liversidge Letter (or references to it) across the various documents received from the FCA. These searches did not locate evidence to suggest that the Liversidge Letter was received by the FCA during the Relevant Period.

4.10 The Investigation does not rule out the possibility that the Liversidge Letter was received by the FCA and then somehow lost through inadvertent human error before it was recorded and passed to the Enforcement and/or Supervision Divisions. Indeed, Mr Bailey noted that these events pre-dated his tenure as the FCA's CEO but commented:

*"...what I can tell you is the process[es] of the FCA were not very robust going back in time. So I have to be frank, I think if I had to predict it I would say [the Liversidge Letter] probably did come and for some reason never got recorded but I can't give you chapter and verse on that".*<sup>313</sup>

4.11 In the light of Mr Bailey's comment, if it had been incumbent on the Investigation to have reached a decision on this point, it would have concluded on the balance of probabilities that the Liversidge Letter was received by the FCA.<sup>314</sup>

## 5. Conclusion

5.1 As noted at the outset of this Chapter, **Appendix 8** sets out a more detailed chronology of events relevant to the FCA's regulation of LCF during the Relevant Period. The key issues identified in this Chapter are also analysed further in the following Chapters:

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<sup>312</sup> *Ibid.*, at pages 6 to 8.

<sup>313</sup> Interview with A. Bailey, 17 June 2020, at page 26.

<sup>314</sup> However, it is fair to say that the Investigation has not conducted a mini-trial of this issue. This would have involved an interrogation of the FCA's post-room and communication procedures and examination of the relevant personnel in place in the post-room and Enforcement Division at the time. The Investigation did not consider that it would have been a proportionate use of its time and resources to have done so, given its views as set out at paragraph 4.3 above. There was nothing in the information available to the Investigation to suggest that there had been any deliberate suppression or withholding of the letter on the part of the FCA.

*Chapter 3: Key events in the FCA's regulation of LCF*

- (a) LCF's regulatory transactions are covered in **Chapter 9** (Appropriateness of LCF's permissions) and **Appendix 5** of this Report.
- (b) An analysis of how the FCA handled LCF's financial promotions is set out in **Chapter 11** (FCA rules and policies relating to LCF's financial promotions) of this Report.
- (c) An analysis of how the FCA handled significant information and intelligence regarding LCF is set out in **Chapter 12** (Information provided by third parties) and **Appendix 6** of this Report.

## **PART B: PRELIMINARY ISSUES**

### **CHAPTER 4: INTRODUCTION TO THE PRELIMINARY ISSUES**

#### **1. Overview of the preliminary issues**

1.1 Part B of this Report deals with certain preliminary matters which provide necessary and important context for the Investigation's analysis of the issues set out in the Direction.<sup>315</sup>

1.2 **Chapter 5** (The FCA's finite resources and prioritisation) of this Report provides an overview of the broad scope of the FCA's regulatory remit and its limited resource. The Chapter acknowledges that the FCA could not address every risk that it identified, nor could it prevent every harm from occurring. The Chapter also explains that the FCA inevitably had to make prioritisation decisions based on the available information and considers whether this contextual information explains or mitigates the weaknesses and deficiencies described elsewhere in this Report.

1.3 **Chapter 6** (The FCA's approach to the Perimeter) of this Report describes how the FCA approached the Perimeter and, in particular, the circumstances in which the FCA would take action in relation to conduct outside the Perimeter in a case such as LCF. This issue is important in the light of the Investigation's conclusion that LCF's bond issues did not constitute "regulated activity" and, therefore, LCF's primary business was outside the Perimeter.<sup>316</sup> The FCA was nonetheless responsible for regulating LCF (given LCF was an authorised firm) and was also aware of the risk that firms might use their FCA-authorised status improperly in order to promote their unregulated business as LCF did.<sup>317</sup>

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<sup>315</sup> Part C of this Report sets out an analysis of the issues on which the Investigation must focus pursuant to paragraph 3 of the Direction.

<sup>316</sup> See **Chapter 6** (The FCA's approach to the Perimeter) and **Appendix 5** of this Report for further explanation of the Investigation's conclusion on this point.

<sup>317</sup> See also Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report which explains that the Financial Promotions Team raised concerns in correspondence with LCF that the firm was using its regulatory status as a promotional tool and was not being clear with Bondholders that LCF's products were not regulated.

- 1.4 **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks) of this Report provides an overview of the FCA’s knowledge and awareness of mini-bonds<sup>318</sup> and the related risks both prior to and during the Relevant Period. Based on documents provided to the Investigation by the FCA, it is clear that the FCA identified before and during the Relevant Period that mini-bonds carried particular risks for consumers. The FCA’s institutional knowledge of mini-bonds provides necessary context when considering whether the FCA scrutinised LCF’s business sufficiently, particularly in the light of the repeated financial promotions infractions.
- 1.5 **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes) of this Report describes how the FCA’s approach to supervising smaller firms – such as LCF – evolved over the course of the Relevant Period. In particular, in about mid-2016, members of the FCA’s executive management team – who had recently joined the FCA – identified significant deficiencies regarding the effectiveness of the model used to supervise smaller firms. Accordingly, management led the design and delivery of a programme to overhaul the FCA’s approach to supervision, DES.<sup>319</sup> At around the same time the FCA also introduced a programme to overhaul the authorisations process, Delivering Effective Authorisations (“**DEA**”). An understanding of these issues is important context for assessing the FCA’s approach to the supervision and authorisation of LCF throughout the Relevant Period and whether there were any noticeable changes in that approach given the concerns that management had identified. The Investigation has not conducted a broader assessment of the effectiveness of the FCA’s Supervision and Authorisations Divisions as a whole nor has it considered whether the implementation of the DEA and DES programmes has been successful.

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<sup>318</sup> As stated in **Chapter 1** (Introduction and background) of this Report, the term “mini-bond” is controversial and does not have a legal definition and, as such, is not generally used in this Report. The term is used in relevant sections of this Part B for ease of exposition, given it was used in contemporaneous documentation.

<sup>319</sup> The FCA’s Delivering Effective Supervision programme as defined at paragraph 5.3(h) of **Chapter 2** (Executive summary).



## **CHAPTER 5: THE FCA'S FINITE RESOURCES AND PRIORITISATION**

### **1. Introduction**

- 1.1 During the representations process, the FCA emphasised the broad scope of its regulatory remit and its limited resources.<sup>320</sup> In the light of these factors, the FCA submitted that it was necessary for the FCA to prioritise which actual or potential harms it would address during the Relevant Period.<sup>321</sup>
- 1.2 The Investigation accepts that: (i) the FCA had finite resources during the Relevant Period; and (ii) its regulatory remit was broad. The Investigation also accepts, in the light of those factors, that it was necessary for the FCA to prioritise which forms of actual or potential harm it would respond to. Moreover, the Investigation accepts that the FCA took steps to undertake such prioritisation during the Relevant Period. Relatedly, the Investigation accepts it would not have been possible for the FCA to address every issue or prevent all forms of harm, even in sectors where the FCA had identified particular risks.<sup>322</sup> Nor, for the avoidance of doubt, was the FCA required to do so.
- 1.3 However, while the Investigation accepts that prioritisation was necessary, the Investigation has not sought to consider whether the FCA's decisions on prioritisation were appropriate and makes no findings in this regard. To do so would require a broad review of the totality of the FCA's activities and resources during the Relevant Period. Such a broad review would be outside the Investigation's remit in circumstances where the Direction requires that the Investigation focus on the FCA's discharge of its functions in respect of LCF as opposed to the totality of the FCA's activities.<sup>323</sup> Furthermore, such a review would plainly be excessive in time and cost.
- 1.4 Nor has the Investigation considered whether the totality of the FCA's regulatory responsibilities was unduly burdensome in the light of its finite resources. Again the

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<sup>320</sup> Similar representations were also made by other participants in the representations process.

<sup>321</sup> FCA Representations, paragraph 2.2(c).

<sup>322</sup> This is particularly so in circumstances where regulation is not (and during the Relevant Period, was not) cost-free; direct and indirect regulatory costs may well be passed on to individuals and business through higher prices.

<sup>323</sup> Paragraph 3(1) of the Direction.

Investigation is not appropriately placed to make such a broad assessment of the sufficiency or otherwise of the FCA's resources. That being said, the Investigation is aware that the FCA had significant resources during the Relevant Period (see paragraph 3.2 below).

1.5 In order to provide relevant context, and in deference to the FCA's representations, this Report sets out in Section 2 below some of the issues with which the FCA had to deal during the Relevant Period. Sections 3 and 4 below also provide a high-level summary in respect of the FCA's resources and prioritisation decisions during the Relevant Period.

1.6 The question then arises, however, whether the FCA's regulatory failures in respect of LCF (as described in later sections of the Report) are excused or mitigated by the FCA's finite resources and its need to prioritise. For the reasons explained in Section 5 below, the Investigation considers that the FCA's failures are not so excused or mitigated. LCF was an extreme case where the FCA was aware of multiple red flags during the Relevant Period. For instance, the FCA received multiple allegations of fraud by LCF over the Relevant Period. However, the FCA nonetheless repeatedly failed to investigate whether LCF was in fact engaged in such alleged fraud before late 2018 / early 2019. The Investigation considers that these and other failures by the FCA cannot be excused or mitigated by reference to the FCA's finite resources and the need to prioritise.

## **2. Broader issues with which the FCA had to deal during the Relevant Period**

2.1 The FCA has, during the representations process, emphasised that the FCA's regulatory remit was broad and that it had to deal with numerous other issues besides LCF during the Relevant Period. As already explained, the Investigation has not conducted a detailed review of these other issues which would be outside the Investigation's remit and excessive in time and cost. However, the Investigation summarises certain of those other issues below.

2.2 First, according to the FCA, it had to deal with a number of other regulatory issues during the Relevant Period. Many of these regulatory issues were plainly substantial and would have involved significant resource including in terms of senior management time. Issues highlighted to the Investigation by the FCA and others included:

- (a) Brexit, which the FCA has stated involved "onshoring" over fifty pieces of EU legislation, putting in place transitional regimes to address the loss of

“passporting” and numerous measures to mitigate potential risks to consumers and market integrity;<sup>324</sup>

- (b) the implementation and embedding of two major EU Directives: the second Payment Services Directive (“**PSD2**”)<sup>325</sup> and the second Markets in Financial Instruments Directive (“**MiFID II**”),<sup>326</sup> the FCA has told the Investigation that “[b]oth required significant FCA resource to implement the relevant legislation and to support firms to comply with the new requirements;”<sup>327</sup>
- (c) carrying out market investigations and implementing new legislation during the Relevant Period.<sup>328</sup> The FCA and individual participant representations referred the Investigation to a number of significant work programmes that were underway during the Relevant Period. These included: (i) tackling abuses of high cost consumer credit;<sup>329</sup> (ii) pension mis-selling;<sup>330</sup> (iii) implementation of the Senior Managers Regime for banks (introduced in March 2016) and dual-regulated insurers (introduced in December 2018);<sup>331</sup> (iv) Payment Protection Insurance

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<sup>324</sup> FCA Representations, paragraph 3.41.

<sup>325</sup> Directive (EU) 2015/2366.

<sup>326</sup> Directive 2014/65/EU.

<sup>327</sup> FCA Representations, paragraph 3.42.

<sup>328</sup> FCA Representations, paragraph 3.43. The FCA stated: “...a number of significant market investigations were carried out, and new legislation was implemented, in the Relevant Period, including the Mortgage Market Review (“**MMR**”) and Packaged Retail Insurance Based Investment Products (“**PRIIPs**”) Regulations. The FCA’s remit was also expanded either during or shortly after the Relevant Period (necessitating preparing in the period), in relation to its assumption of Claims Management Companies (“**CMCs**”) and the formation of the Office of Professional Bodies Anti-Money Laundering Supervision (“**OPBAS**”), aimed at improving the consistency of anti-money laundering supervision across the accountancy and legal sectors”.

<sup>329</sup> Including the publication in May 2018 of proposals to tackle problems in overdrafts, home-collected credit, catalogue credit and store cards (CP 18/12) and in November 2018 proposing a price cap in the “rent-to-own” market (CP 18/35).

<sup>330</sup> See, for example, the new rules and guidance on advising on pension transfers (PS18/6, March 2018) (see: <https://www.fca.org.uk/publication/policy/ps18-06.pdf> (accessed on 22 November 2020)) and PS18/20 (October 2018) (see: <https://www.fca.org.uk/publication/policy/ps18-20.pdf> (accessed on 22 November 2020)).

<sup>331</sup> See: <https://www.fca.org.uk/firms/senior-managers-certification-regime/dual-regulated-firms> (accessed on 22 November 2020).

complaints;<sup>332</sup> (v) work on asset management governance;<sup>333</sup> (vi) preparing to take over the regulation of claims management companies in April 2019 pursuant to the Financial Guidance and Claims Act 2018; (vii) the launch of a market study into general insurance pricing practices;<sup>334</sup> and (viii) issues pertaining to small firm lending.<sup>335</sup>

2.3 Second, the FCA has emphasised that there were a number of internal factors with which the FCA had to deal during the Relevant Period. These included the fact that the FCA had been established about a year before the Relevant Period, on 1 April 2013. Furthermore, during the Relevant Period there were structural and operational changes to the organisation such as the merging of the Authorisations and Supervision Division, the appointment of a new Chief Executive and the DES Programme.<sup>336</sup>

### 3. The FCA's finite resources

3.1 The FCA has also emphasised that it had finite resources with which to pursue its regulatory remit. The following table was provided to the Investigation by the FCA<sup>337</sup> and illustrates an escalating number of tasks over the Relevant Period for which the FCA was responsible against the FCA total staff numbers (which also increased during the Relevant Period).

Activity	2012	2013	2014	2015	2016	2017	2018	2019
Number of Authorised firms	N/A	N/A	26,000	73,000	56,000	56,000	58,000	59,000

<sup>332</sup> See, for example, the FCA's rules on PPI complaints (PS17/3, March 2017) (see: <https://www.fca.org.uk/publication/policy/ps17-03.pdf> (accessed on 22 November 2020)).

<sup>333</sup> See, for example, the FCA's Asset Management Market Study remedies and changes to the handbook (PS18/8, April 2018) (see: <https://www.fca.org.uk/publication/policy/ps18-08.pdf> (accessed on 22 November 2020)) and the FCA's consultation on further studies regarding asset management market study (CP18/9, April 2018) (see: <https://www.fca.org.uk/publication/consultation/cp18-09.pdf> (accessed on 22 November 2020)).

<sup>334</sup> See, for example, the FCA's General Insurance Pricing Practices, (MS 18/1.1, October 2018) (see: <https://www.fca.org.uk/publication/market-studies/ms18-1-1.pdf> (accessed on 22 November 2020)); the FCA's Fair Pricing in Financial Services (DP 18/9, October 2018) (see: <https://www.fca.org.uk/publication/discussion/dp18-09.pdf> (accessed on 22 November 2020)).

<sup>335</sup> Interview with A. Bailey, 4 August 2020, at page 24.

<sup>336</sup> These issues are dealt with further in **Chapter 8** (The "Delivering Effective Supervision" and "Delivering Effective Authorisations" programmes).

<sup>337</sup> The Investigation has not attempted independently to verify the figures given.

Chapter 5: The FCA's finite resources and prioritisation

Number of Authorisation applications	1,111	1,026	7,781	19,966	7,704	4,534	4,177	4,223
Number of Approved Persons applications	N/A	N/A	6,387	31,098	25,442	24,648	25,360	28,944
Number of Approved Person cases	54,480	87,456	77,476	97,776	82,246	69,737	73,665	77,360
Variation of Permissions applications	1,517	2,120	3,653	7,442	3,544	2,643	2,343	2,646
Reactive cases opened (rounded to nearest 500)	N/A	N/A	16,500	23,000	24,500	29,000	32,500	36,000
Consumer calls to Contact Centre (to nearest 500)	N/A	N/A	120,500	126,500	106,500	100,500	96,000	99,000
Total number of FCA employees	N/A	N/A	2,580	3,000	2,323	3,363	3,496	3,655

3.2 However, the Investigation considers it important to remember that the FCA had significant – albeit finite – resources during the Relevant Period. The table above provides the number of FCA employees which was substantial and which escalated. FCA accounts also reveal significant resources at the FCA's disposal. For example:

- (a) FCA fee income for the year ending 31 March 2015 was £451.2 million (with a “net costs for the year” figure of £487.6 million).<sup>338</sup> The FCA Business Plan

<sup>338</sup> FCA Annual Report and Accounts 2014/15 (for the year ended 31 March 2015), at page 106, see: <https://www.fca.org.uk/publication/corporate/annual-report-2014-15.pdf> (accessed on 22 November 2020).

2014/15 stated that the FCA's ongoing regulatory activity ("ORA") budget for that year was £445.7 million.<sup>339</sup>

- (b) Total group fee income for the year ending 31 March 2016 was £522.4 million (against total group operating costs of £552.2 million).<sup>340</sup> The FCA Business Plan 2015/16 stated that the FCA's ORA budget for that year was £479 million.<sup>341</sup>
- (c) The 2017 accounts gave a "total income" figure of £566.3 million and indicated the group operated at a loss of £9.2 million.<sup>342</sup> The FCA's Business Plan stated that the FCA's ORA budget for that year was £502.9 million.<sup>343</sup>
- (d) The total group income figure for 2017/18 was £600.3 million (against total group operating costs of £547.2 million).<sup>344</sup> The FCA Business Plan 2017/18 stated that the FCA's ORA budget for that year was £508 million.<sup>345</sup>
- (e) Total group income for 2018/19 was £614.3 million (against total group operating costs of £588.9 million).<sup>346</sup> The FCA Business Plan 2018/19 stated that the FCA's ORA budget for that year was £527.2 million.<sup>347</sup>

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<sup>339</sup> FCA Business Plan 2014/15, at page 40 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2014-2015.pdf> (accessed on 22 November 2020)).

<sup>340</sup> FCA Annual Report 2015/16, at pages 70 and 73 (see: <https://www.fca.org.uk/publication/corporate/annual-report-2015-16.pdf> (accessed on 22 November 2020)).

<sup>341</sup> FCA Business Plan 2015/16, at page 73 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2015-16.pdf> (accessed on 22 November 2020)).

<sup>342</sup> FCA Annual Report 2016/17, at page 74 (see: <https://www.fca.org.uk/publication/annual-reports/annual-report-2016-17.pdf> (accessed on 22 November 2020)).

<sup>343</sup> FCA Business Plan 2016/17, at page 44 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2016-17.pdf> (accessed on 22 November 2020)).

<sup>344</sup> FCA Annual Report 2017/18, at page 75 (see: <https://www.fca.org.uk/publication/annual-reports/annual-report-2017-18.pdf> (accessed on 22 November 2020)).

<sup>345</sup> FCA Business Plan 2017/18, at page 87 (see: <https://www.fca.org.uk/publication/business-plans/business-plan-2017-18.pdf> (accessed on 22 November 2020)).

<sup>346</sup> FCA Annual Report 2018/19, at pages 83 to 84 (see: <https://www.fca.org.uk/publication/annual-reports/annual-report-2018-19.pdf> (accessed on 22 November 2020)).

<sup>347</sup> FCA Business Plan 2018/19, at page 53 (see: <https://www.fca.org.uk/publication/business-plans/business-plan-2018-19.pdf> (accessed on 22 November 2020)).

#### 4. The Investigation accepts that the FCA did have to prioritise and that it did so

- 4.1 The Investigation accepts that in principle the FCA did have to prioritise in respect of its finite resources. Furthermore, the Investigation accepts that the FCA did prioritise risks during the Relevant Period.
- 4.2 For instance, the FCA's Business Plans consistently listed the FCA's "key priorities". The 2015/16 Business Plan stated that the "key priorities" were to "secure an appropriate degree of protection for consumers"; "protect and enhance the integrity of the UK financial system" and "[promoting] effective competition in the interests of consumers."<sup>348</sup> Similar statements as to priorities appeared in the 2016/17 Business Plan,<sup>349</sup> the 2017/18 Business Plan<sup>350</sup> and the 2018/19 Business Plan.<sup>351</sup>
- 4.3 For its part, the FCA has emphasised in the representations process its work on consumer credit,<sup>352</sup> high-risk investments<sup>353</sup> and other areas such as those outlined in paragraph 2.2 above. The Investigation has also seen statements such as those in the FCA's Mission document as to when the FCA would be more likely to act outside the Perimeter.<sup>354</sup>

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<sup>348</sup> FCA Business Plan 2015/16, at page 39.

<sup>349</sup> FCA Business Plan 2016/17, at page 22. This document listed the priorities as: (i) pensions; (ii) financial crime and anti-money laundering; (iii) wholesale financial markets; (iv) advice; (v) innovation and technology; (vi) firms' culture and governance; and (vii) treatment of existing customers.

<sup>350</sup> FCA Business Plan 2017/18, at page 4. The document listed various cross-sector priority work for the year ahead as: (i) firms' culture and governance; (ii) financial crime and anti-money laundering; (iii) promoting competition and innovation; (iv) technological change and resilience; (v) treatment of existing customers; and (vi) consumer vulnerability and access. Further sector priority work was listed on page 5 of the document.

<sup>351</sup> FCA Business Plan 2018/19, at page 8. This listed the cross-sector priority work for the year ahead as: (i) EU withdrawal; (ii) firms' culture and governance; (iii) financial crime (fraud & scams) & anti-money laundering; (iv) data security, resilience and outsourcing; (v) innovation, big data, technology and competition; (vi) treatment of existing customers; (vii) long-term savings, pensions and intergenerational differences; and (viii) high-cost credit. Further sector priority work was listed on page 5 of the document.

<sup>352</sup> FCA Representations, at paragraph 3.30-3.38.

<sup>353</sup> FCA Representations, at paragraph 3.39-3.40

<sup>354</sup> The "Our Mission 2017" document stated: "...Essentially, if we believe an issue is serious, but the relevant activity falls outside the perimeter or wider powers set out above, we may still be able act... we are more likely to act where the unregulated activity: - is illegal or fraudulent; - has the potential to undermine confidence in the UK system - is closely linked to, or may affect, a regulated activity." FCA, *Our Mission 2017: How we regulate financial service*, at page 22 (see: <https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf> (accessed 23 September 2020)).

4.4 While the Investigation accepts that the FCA did need to prioritise, and indeed did so, during the Relevant Period, the Investigation has not sought to undertake an evaluation of whether the FCA's prioritisations were appropriate. As already explained in paragraph 1.2 above, such an evaluation would require an excessive factual review of the totality of the FCA's activities which would be outside this Investigation's remit.

**5. The FCA's finite resources do not excuse or mitigate the failures described in subsequent chapters of this Report**

5.1 The Investigation has concluded that the FCA's finite resources do not, however, excuse or mitigate the failures described in subsequent chapters of this Report. LCF was an extreme case where the FCA received multiple express allegations that LCF was engaged in possible fraud or other misconduct during the Relevant Period.<sup>355</sup> The FCA also had multiple other indicators that LCF's business was irregular and/or in poor financial health, both of which might potentially impact on investors.<sup>356</sup> The FCA's failures to respond to these red flags cannot be explained away by a lack of resources or a need to prioritise. This is particularly so given the substantial resources of the FCA described in paragraph 3.2 above.<sup>357</sup>

5.2 To be clear, the Investigation is *not* suggesting that the FCA "*should be subject to a duty to mitigate every identified risk*" or that "*the FCA ought to have the necessary financial resources to tackle every risk which it identifies as arising (whether inside or outside the Perimeter)*".<sup>358</sup> Nor does the Investigation criticise the FCA for "*failing to achieve a total elimination of every identified risk*".<sup>359</sup> That would clearly be unrealistic.

5.3 However, the FCA's failure to respond to multiple allegations that LCF was engaged in possible fraud or irregularity over the Relevant Period, as well as other red flags, cannot be explained away by a lack of resource. For example, all too often the FCA failed to take even

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<sup>355</sup> See, for example, **Chapter 9** (Appropriateness of LCF's permissions); **Chapter 10** (Adequacy of the FCA's supervision of LCF) and **Chapter 12** (Information provided by third parties).

<sup>356</sup> See, for example, **Chapter 9** (Appropriateness of LCF's permissions).

<sup>357</sup> This issue is addressed in more detail with respect to the FCA's failures pertaining to its attitude to the Perimeter in Sections 3 and 7 of **Chapter 6** (The FCA's approach to the Perimeter).

<sup>358</sup> FCA Representations.

<sup>359</sup> FCA Representations.



basic steps (such as reviewing LCF's accounts) to look into allegations of possible fraud or other misconduct made against LCF to the FCA by third parties.<sup>360</sup> That is not an issue of resource because taking such basic steps to follow up such allegations would not, in the Investigation's view, have required significant resource.<sup>361</sup> Indeed, the initial discoveries in late 2018 by the Intelligence Team and the Listing Transactions Team<sup>362</sup> of possible irregularities in respect of LCF do not appear to have required significant resource, although the Investigation accepts that the subsequent intervention did require more significant resources.

## 6. Conclusion

6.1 The Investigation accepts that the FCA had a broad regulatory remit and limited resources which required prioritisation decisions based on, among other things, resourcing and risk considerations. The Investigation makes no findings on the FCA's *general* prioritisation decisions (e.g. what proactive supervisory steps (if any) the FCA should have taken during the Relevant Period in order to address risky products or business models) because, to do so, would have required an extremely complex analysis of each of the factors feeding into those decisions throughout the Relevant Period.

6.2 However, the Investigation considers that it is self-evident that those general resourcing and prioritisation decisions should be irrelevant where (as was the case in relation to LCF) the information available to the FCA presents multiple red flags which point to previously-identified risks, which have actually materialised in a specific case with potentially significant consumer harm. In those infrequent circumstances, it is incumbent on a conduct regulator to intervene at the earliest opportunity.

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<sup>360</sup> See especially **Chapter 9** (Appropriateness of LCF's permissions), **Chapter 10** (Adequacy of the FCA's supervision of LCF) and **Chapter 12** (Information provided by third parties).

<sup>361</sup> Furthermore, while it is correct that 50,000 consumer credit firms were transferred from the OFT (20,000 of which were ultimately authorised for credit broking) (FCA Representations, at paragraphs 3.37 and 3.38), LCF was different from multiple such firms on account of: (i) its unusual business model; and (ii) the express allegations of fraud made by third parties to the FCA concerning LCF. See, in particular, **Chapter 9** (Appropriateness of LCF's permissions) and **Chapter 12** (Information provided by third parties).

<sup>362</sup> Described further in **Chapter 13** (Other matters of importance to the Investigation).

- 6.3 The FCA failed to take basic steps to respond to express allegations of possible fraud and other misconduct made against LCF and also failed to respond to other red flags regarding LCF. Such failures cannot be explained away by reference to general resource or prioritisation issues.

## **CHAPTER 6: THE FCA'S APPROACH TO THE PERIMETER**

### **1. Introduction**

- 1.1 This Chapter addresses the FCA's approach to the Perimeter<sup>363</sup> and how it affected the FCA's regulation (and non-regulation) of LCF. This introductory section summarises the Investigation's conclusions on this critical topic.
- 1.2 The FCA's approach to the Perimeter<sup>364</sup> was of central importance to its regulation of LCF. This was because LCF operated both inside and outside the Perimeter. On the one hand, LCF, as a firm, was clearly within the Perimeter because it was FCA-authorized. In addition, LCF's financial promotions in respect of its issuing of bonds were also within the FCA's Perimeter and subject to the FCA's financial promotions rules.<sup>365</sup> On the other hand, LCF's issuing of bonds did not constitute regulated activity<sup>366</sup> and LCF, in that sense, operated outside the Perimeter.
- 1.3 The Investigation has concluded that the FCA's approach to the Perimeter was deficient and this impacted on its regulation of LCF. In general, the FCA did not sufficiently encourage staff to look outside the Perimeter when dealing with FCA-authorized firms such as LCF, which was an FCA-authorized firm whose business consisted of entirely (or almost entirely) unregulated business and which was trading off its FCA-authorized status to attract investors.<sup>367</sup> This resulted in multiple failures by FCA staff to respond to or pursue red-flags

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<sup>363</sup> The definition of the Perimeter for the purposes of this Report is set out at footnote 108 in **Chapter 2** (Executive summary).

<sup>364</sup> As explained in paragraph 5.1 below.

<sup>365</sup> Indeed, as described in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF), the FCA raised concerns on multiple occasions in connection with LCF's financial promotions.

<sup>366</sup> As explained in **Appendix 5** of this Report, the Investigation has concluded that LCF's issuing of bonds did not constitute regulated activity. Accordingly, LCF's issuing of bonds, which was the main activity LCF undertook, was, in the Investigation's view, outside the Perimeter. The Investigation is, however, aware that judicial review proceedings are ongoing which raise the question whether LCF's issuing of bonds constituted regulated activity. The Investigation's view is not binding or legally determinative of this issue which can ultimately only be resolved by the Courts rather than this Investigation. In the Investigation's view, however, the FCA was reasonably entitled to take the view that LCF's business of issuing bonds did not constitute regulated activity.

<sup>367</sup> The FCA stated in its representations that risks of misconduct outside the Perimeter were considered and acted upon by the FCA's Supervision and Enforcement Divisions before and during the Relevant Period. The FCA represented that such considerations included (among others) issues pertaining to: (i) the manipulation of LIBOR, EURIBOR and the LBMA Gold Price; (ii) misconduct in the foreign exchange market; (iii) money laundering failings; (iv) thresholds conditions cases such as requiring Coutts Automobiles Limited to conduct regulated activities; and (v) Principle 11 cases such as imposing

pertaining to LCF's issuing of unregulated bonds which are identified in subsequent chapters of this Report. For instance, red flags such as allegations of fraud or serious irregularity, which were made by the public against LCF to the FCA during the Relevant Period, were often not responded to or pursued by the FCA because they were in relation to LCF's (unregulated) bond business. Other red flags, such as worrying details in LCF's financial information, of which the FCA was aware, were also not pursued, or were pursued in an unduly restricted, manner because they related to LCF's bond business.

- 1.4 The result was that LCF benefited from an unmerited "halo effect"<sup>368</sup> and used its FCA-authorized status to present an unjustified imprimatur of integrity to the market. However, there were in fact serious underlying issues with LCF's business, of which the FCA was aware, which were not pursued adequately or at all by the FCA. In short, LCF benefited from having the status of an FCA-authorized firm without being subject to FCA scrutiny in respect of its bond business which many investors thought LCF's FCA-authorized status connoted.<sup>369</sup>
- 1.5 The risks associated with the Perimeter had been identified by the FCA at Senior Management level on multiple occasions during the Relevant Period. However, this failed to result in an appropriate level of awareness of such risks at lower levels of the organisation and the deficiencies in the FCA's regulation of LCF arising out of the FCA's approach to the Perimeter occurred nonetheless. Responsibility for such failures is identified in paragraphs 1.7(d) and 6.4 below.

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in 2019 of a £45.5 million fine on Bank of Scotland for failing to be open and cooperative: FCA Representations 4.15(c). The Investigation has not investigated these matters given its focus on LCF. However, the number and consistency of the FCA staff members' failures when dealing with LCF over the Relevant Period demonstrates that, in the Investigation's view, FCA staff were not sufficiently encouraged to consider issues outside the Perimeter in the case of firms such as LCF.

<sup>368</sup> A definition of "halo issues" is set out at paragraph 5.2(a) of this Chapter. As explained in this Chapter, this is relevant to LCF because LCF's marketing materials used the firm's FCA-authorized status to attract consumers to its bond issues, despite LCF's issuing of bonds constituting unregulated activity. The FCA has pointed out to the Investigation that the halo effect is unavoidable so long as authorized firms are also permitted to carry on unregulated activities. The Investigation's concern, however, is not with the existence of the halo effect *per se*, but its identification by the FCA as a specific area of Perimeter risk coupled with the subsequent failure by FCA staff dealing with LCF to take appropriate account of the implications of that risk in the light of LCF's particular and unusual business model.

<sup>369</sup> As explained in paragraph 9.4(1)(a) of **Chapter 1** (Introduction and background), LCF's FCA-authorized status was crucial for many investors in their decision to invest in LCF's bonds.

1.6 The Investigation appreciates that the Perimeter is set by Parliament, not the FCA, that the FCA does not have unlimited resources and must prioritise how it uses them, that the FCA's core area of responsibility is inside the Perimeter, and that there are limits on the extent to which the FCA can or should operate outside the Perimeter. However, LCF was an extreme case where the FCA was aware of multiple allegations of possible fraud or irregularity made against the firm during the Relevant Period,<sup>370</sup> as well as other red flags such as aspects of LCF's financial information which suggested serious irregularities with LCF's business.<sup>371</sup> LCF also used its FCA-authorized status in its marketing material, often in breach of the financial promotion rules, to promote investment in its bond business thereby achieving an unmerited halo effect.<sup>372</sup> The volume and seriousness of the red flags during the Relevant Period has led the Investigation to conclude that the FCA's failures to scrutinise LCF's business and to intervene earlier cannot be excused or mitigated on the basis that LCF's bond business was outside the Perimeter.<sup>373</sup>

1.7 The rest of this **Chapter 6** is structured as follows:

- (a) Section 2 summarises the powers which the FCA had, and the policies it stated it had adopted, to regulate and/or intervene in relation to unregulated activities carried on by regulated firms outside the Perimeter.
- (b) Section 3 explains that many of the failures of regulation by the FCA in respect of LCF identified in later Chapters of this Report involved deficiencies in the consideration of Perimeter risks.
- (c) Sections 4 and 5 explain that the deficiencies in the FCA's approach to the Perimeter occurred in a context where the FCA was, at a Senior Management level, aware: (i) that it was entitled to act outside the Perimeter and had a responsibility to do so (Section 4); and (ii) of problems with its approach to the

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<sup>370</sup> See, for example, **Appendix 6** which details numerous calls made to the FCA's Customer Contact Centre by the public which alleged fraud or serious irregularity against LCF.

<sup>371</sup> See, for example, the StoneTurn Accountancy Report at **Appendix 11**.

<sup>372</sup> See the summary of LCF's breaches of the FCA's financial promotions rules in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>373</sup> See **Chapter 5** (The FCA's finite resources and prioritisation) for a general discussion of whether the prioritisation issues raised by the FCA mitigate the deficiencies and weaknesses identified in this Report.

Perimeter and of associated risks which were relevant to the LCF case (Section 5).

- (d) Section 6 explains that, despite the awareness of the issues described in paragraph 1.5 above, the FCA's Senior Management failed to implement an appropriate level of awareness at lower levels of the organisation where LCF was actually dealt with. The FCA's failures of regulation in respect of LCF, which were associated with its approach to the Perimeter, accordingly occurred nonetheless. Responsibility for this failure rests with the CEO<sup>374</sup> and ExCo.<sup>375</sup>
- (e) Section 7 addresses whether the failures in respect of the FCA's approach to the Perimeter described in this Chapter are excused or mitigated by: (i) the FCA's finite resources which meant there was a limit to which it could address issues outside its Perimeter; and/or (ii) the FCA's legal remit. For the reasons explained in Section 7, the Investigation has concluded that the failures described in this Chapter are not so excused or mitigated.

## **2. The powers which the FCA had, and the policies it stated it had adopted, to regulate and/or intervene in relation to unregulated activities carried on by regulated firms**

2.1 The bulk of the FCA's rulebook is concerned with regulated activities. Nevertheless, in the case of an authorised firm such as LCF, the FCA rules include, and included during the Relevant Period, significant provisions which apply to an authorised firm and every aspect of its business including its unregulated activities. Such rules have particular relevance to activities which call into question the firm's integrity or competence or the financial viability of its business model, or raise concerns relating to financial crime, the welfare of consumers or the integrity of the UK financial system.

2.2 Rules which applied to LCF's unregulated activities and/or its business as a whole included:

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<sup>374</sup> In this context, the Investigation is referring to Mr Bailey.

<sup>375</sup> The FCA website describes ExCo as follows: "[t]he Executive Committee (ExCo) and the Executive Regulation and Policy Committee (ERPC) are the two highest ranking executive decision-making bodies of the FCA. ExCo oversees the general strategy, direction and activities of the FCA, including delivery of the annual Business Plan. It is responsible for monitoring the direction and performance of the organisation within the strategic framework set by the Board" (see: <https://www.fca.org.uk/about/executive-committees> (accessed on 22 November 2020)).

- (a) the threshold conditions in Schedule 6 of FSMA;<sup>376</sup>
- (b) the Principles for Businesses,<sup>377</sup> in relation to LCF's communication and approval of financial promotions; and in relation to other unregulated activities Principle 3 (Management and control) (but only in the prudential context described above), Principle 4 (Financial prudence) and Principle 11 (Relations with regulators);
- (c) SYSC 4 to SYSC 9 (excluding SYSC 6.3)<sup>378</sup> apply to the communication and approval of financial promotions and the carrying on of unregulated activities in a prudential context. (For this purpose a "*prudential context*" includes activities which have, or might reasonably be regarded as likely to have, a negative effect on the integrity of the UK financial system or the ability of LCF to meet the "*fit and proper*" test in threshold condition 2E and 3D);
- (d) the financial promotions rules in COBS 4<sup>379</sup>, in relation to LCF's communication and approval of financial promotions;
- (e) the FCA's financial resources requirements; and
- (f) (insofar as LCF was actually carrying on the regulated activities of providing advice and arranging deals in investments) the full panoply of principles, conflict management, conduct rules etc.

2.3 COND, in particular, required LCF to continue to meet:<sup>380</sup>

- (a) the Suitability Threshold condition (COND 2.5) which required a firm to be a fit and proper person, having regard to all the circumstances, including:
  - (i) the firm's connection with any person;

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<sup>376</sup> See: <https://www.legislation.gov.uk/ukpga/2000/8/schedule/6> (accessed on 22 November 2020).

<sup>377</sup> These are contained in PRIN in the FCA Handbook.

<sup>378</sup> SYSC is the part of the FCA's Handbook in High Level Standards which has the title "*Senior Management Arrangements, Systems and Controls*".

<sup>379</sup> COBS is the part of the FCA Handbook in Business Standards which has the title "*Conduct of Business Sourcebook*".

<sup>380</sup> COND is the part of the FCA Handbook in High Level Standards which has the title "*Threshold Conditions*".

- (ii) the nature (including the complexity) of any regulated activity that the firm carries on or seeks to carry on;
  - (iii) the need to ensure that the firm's affairs are conducted in an appropriate manner, having regard in particular to the interests of consumers and the integrity of the UK financial system;  
[...]
  - (iv) whether those who manage the firm's affairs have adequate skills and experience and act with probity;
  - (v) whether the firm's business is being, or is to be, managed in such a way as to ensure that its affairs will be conducted in a sound and prudent manner; and
  - (vi) the need to minimise the extent to which it is possible for the business carried on by the firm, or to be carried on by the firm, to be used for a purpose connected with financial crime,<sup>381</sup>
- (b) the Business Model Threshold Condition (COND 2.7) which required a firm's business model (that was, its strategy for doing business) to be suitable for a person carrying on the regulated activities that the firm carried on, including whether the business model was compatible with the firm's affairs being conducted in a sound and prudent manner, the interests of consumers and the integrity of the UK financial system.<sup>382</sup>

2.4 COND sets out high level and structural principles which need to be looked at, not solely in terms of individual detail, but holistically, how the business, both regulated and unregulated, was structured and operated as a whole. In LCF's case in particular, simply looking at the business solely in terms of the regulated activities for which it held permissions, was liable to be actively misleading.

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<sup>381</sup> FCA Handbook, COND Threshold Conditions (see: <https://www.handbook.fca.org.uk/handbook/COND/2/5.html?date=01-04-2014&timeline=True> (accessed on 22 November 2020)).

<sup>382</sup> FCA Handbook, COND Threshold Conditions.



### 3. Failures of the FCA's regulation of LCF involving inadequate consideration of Perimeter risks

3.1 As explained in paragraph 1.3 of this Chapter, the FCA's oversight of LCF was unduly limited because of the fact that LCF's issuing of bonds did not constitute regulated activity and that meant that there was, apparently, no appetite, or sufficient appetite, to investigate further. This meant that in practice the FCA did not respond to or pursue multiple red flags of which it was aware because those red flags related to LCF's issuing of unregulated bonds. The below is a brief non-exhaustive summary of some of the examples of these failings which are detailed more fully in later chapters of this Report.<sup>383</sup>

3.2 The FCA's scrutiny of LCF's during the firm's regulatory transactions<sup>384</sup> was unduly limited on account of the FCA's approach to the Perimeter.<sup>385</sup>

3.3 For example, during the First VOP Application,<sup>386</sup> the FCA received at least two allegations that LCF might be engaged in fraud or serious irregularity in respect of its unregulated bond business. However, the FCA did not respond to such allegations because they related to LCF's unregulated bond business.<sup>387</sup>

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<sup>383</sup> It is not intended to suggest that the FCA had a policy of ignoring any concerns relating to authorised firms unless they were within the Perimeter. FCA training materials for retail credit authorisation included references to concerns about fraud as a relevant authorisation consideration. However, as described in this Chapter, the FCA staff dealing with LCF were insufficiently responsive to matters such as allegations of fraud or the impact of the halo effect combined with LCF's unusual unregulated business model.

<sup>384</sup> Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF) describes LCF's regulatory transactions.

<sup>385</sup> As explained further in **Chapter 9** (Appropriateness of LCF's permissions).

<sup>386</sup> The First VOP Application is described in more detail in Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>387</sup> As explained in Section 6 of **Chapter 9** (Appropriateness of LCF's permissions), on one occasion, an individual in the Authorisations Division who was handling LCF's authorisation application was made aware by others in the FCA of an allegation against LCF in respect of its bond issuing business (i.e. the Anonymous Letter) but did not take steps to investigate the allegation such as reviewing LCF's financial information to determine whether there were indicators that LCF was engaged in fraud or serious irregularity. It appears the individual did not think it was the FCA's responsibility to do so and that allegation of fraud would be "*principally a matter for the police*".

As also explained in Section 6 of **Chapter 9** (Appropriateness of LCF's permissions), on another occasion, a separate allegation of fraud was made against LCF to the Financial Promotions Team but this was not even passed on to the individual reviewing the authorisations process. This is likely because the Financial Promotion Team's remit was very narrow and did not include consideration of issues outside the Perimeter.

- 3.4 In a further example of unduly limited regulation on account of the Perimeter, the FCA's authorisation processes failed to respond to red flags in LCF's financial information. The financial information which LCF submitted to the FCA during its authorisation processes contained multiple red flags in respect of its bond business. However, the FCA's approach to authorisation was overly focused on whether the firm had financial problems which could impact a firm's regulated business and, accordingly, significant problems in LCF's unregulated bond business were not appreciated or acted upon by the FCA in its authorisation process of LCF.<sup>388</sup>
- 3.5 Subsequent chapters of this Report<sup>389</sup> explain that failures also occurred in the FCA's supervision of LCF, in many instances again owing to practical problems with the FCA's approach to the Perimeter.
- 3.6 For example, the Supervision Division failed to respond to allegations that LCF was engaged in fraud or serious irregularity made by members of the public.<sup>390</sup> On occasion the Supervision Division did not pursue allegations of fraud or irregularity referred from the Contact Centre because they concerned unregulated activity. In one call on 20 July 2018, a caller made various serious allegations against LCF but the supervisor's notes to the 20 July 2018 call stated: “[c]oncerns relate to firm's unregulated activities. Reg history checked. Considered as within risk tolerance.”<sup>391</sup> The supervisor had not, however, taken steps such as interrogating LCF's financial information for evidence of irregularity.
- 3.7 Similarly, the FCA failed to consider the risk which LCF's unregulated bond business posed to consumers despite LCF's repeated abuse of its FCA-authorized status in its financial promotions. It is clear that the Financial Promotions Team was not required to consider LCF's business as a whole (including its unregulated business) nor was any other team in

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<sup>388</sup> Section 6 of **Chapter 9** (Appropriateness of LCF's permissions).

<sup>389</sup> See **Chapter 10** (Adequacy of the FCA's supervision of LCF), **Chapter 11** (FCA rules and policies relating to LCF's financial promotions) and **Chapter 11** (Information provided by third parties).

<sup>390</sup> Section 3 of **Chapter 10** (Adequacy of the FCA's supervision of LCF) and **Chapter 12** (Information provided by third parties).

<sup>391</sup> Case Detail (Document with Control Number 125069). The call and the FCA's response is summarised in paragraphs 3.30 to 3.32 of **Appendix 6**.

the Supervision Division expected to consider this either, despite LCF repeatedly breaching the FCA's financial promotions rules by using its FCA-authorized status improperly in promoting its unregulated bond business.<sup>392</sup> Again, therefore, LCF benefited in practice from unduly limited regulation in respect of its bond business despite enjoying an FCA-authorized status.

#### **4. The FCA was entitled, and recognised it was entitled, to look and act beyond the Perimeter**

4.1 During the Relevant Period, the FCA was entitled, and recognised that it was entitled, and, indeed, had responsibilities, to look and act beyond the Perimeter. This was reflected in internal FCA papers issued in and around the Relevant Period as set out below.

4.2 For example, a January 2013 paper presented to ExCo considered the FCA's proposed statutory function under section 1L of FSMA of "[maintaining] *arrangements for supervising authorised persons*". The paper recorded that the FCA could look beyond the Perimeter when discharging its supervisory function. The paper stated:

*"Following the amendments of the Financial Services Act 2012, FSMA will provide that the FCA must maintain arrangements for supervising authorised persons. This more general wording to that currently contained in FSMA was designed to support a more judgment-based, less rules-based approach to supervision. We can therefore look beyond the regulatory perimeter in formulating our policy for discharging our supervisory function, where we can reasonably show that this advances our operational objectives."*<sup>393</sup>

4.3 Similarly, a paper presented to ExCo in September 2016 demonstrates that the FCA recognised that it was entitled to act even in respect of activities which were not regulated activities. In commenting on the FCA's statutory objectives, the paper stated as follows:

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<sup>392</sup> See, for example, Section 4 of **Chapter 10** (Adequacy of the FCA's supervision of LCF).

<sup>393</sup> ExCo Summary Paper: FCA Approach to the Perimeter – Principles and Toolkits, 8 January 2013 [NB. the reference to 2012 in the document appears to be in error], at page 3. The draft minutes to the meeting for which the paper was prepared, suggest that ExCo, among other things, agreed to the proposed approach to the Perimeter.

*“The integrity objective is not tied specifically to regulated activities as it relates to the overall financial system, but is limited to the UK. Thus it allows considerable scope to intervene outside of regulated activities.*

*The consumer protection objective is tied to regulated activities. But as the definition of consumer also covers, for example, those who have used financial services or may do so in future, it again allows [the FCA] to make rules that impose requirements outside of regulatory activities...*<sup>394</sup>

4.4 Similarly, the minutes of a Board meeting dated 29 and 30 March 2017 recorded “[t]he FCA’s regulatory remit enables it to act beyond the perimeter...”<sup>395</sup>

4.5 Indeed, a range of FCA provisions applied to a firm’s activities as a whole regardless of whether those activities were regulated or unregulated. Among those requirements was that an authorised firm had to be a fit and proper person, including by reason of: (i) conducting its affairs in an appropriate manner, having regard in particular to the interests of consumers and the integrity of the UK financial system; (ii) conducting its affairs in a sound and prudent manner; and (iii) minimising the extent to which its business might be used for a purpose connected with financial crime.<sup>396</sup>

4.6 Accordingly, in the light of the above, it is clear that the FCA had powers under applicable rules and legislation in force throughout the Relevant Period to take action in appropriate circumstances against authorised firms, such as LCF, which conducted unregulated activity. Furthermore, the FCA appreciated that it had such powers as the papers referred to above also demonstrate.

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<sup>394</sup> ExCo Paper: FCA Mission – Perimeter, 26 September 2016, paragraph 3.3, at page 4.

<sup>395</sup> Minutes of FCA Board Meeting, 29 and 30 March 2017, paragraph 12.1, at page 4.

<sup>396</sup> COND 2.5.1A.

**5. The FCA understood that there were problems and risks associated with a regulated firm carrying on unregulated activity**

5.1 The FCA's failures of regulation in respect of LCF which related to its approach to the Perimeter occurred in context where the FCA was aware at a senior management level of Perimeter risks which were of direct relevance to the LCF case. These risks, and the attempts to formulate an approach for responding to them, were identified and summarised in numerous papers, in and around the Relevant Period, as explained below.

5.2 A November 2012 paper prepared for ExCo of a predecessor regulator (the FSA), but which was concerned with issues relating to the FCA,<sup>397</sup> articulated risks associated with the Perimeter. Those risks included regulated persons carrying out unregulated activity.<sup>398</sup> The paper identified a number of risks arising from the Perimeter which are of direct relevance to the LCF case, namely:

- (a) Halo issues: the paper defined halo issues in the following terms: “[f]irms or individuals may derive benefit from their links with regulated activities or authorised firms that is not warranted in relation to (some of) the activities that they do provide. These services are not part of regulated activities under FSMA but the firms’ association with regulated activities could mislead consumers as to the probity of such services...”<sup>399</sup> As already explained, halo issues are relevant to the LCF case because LCF’s marketing materials used the firm’s FCA-authorized status to attract consumers to its bond issues, despite LCF’s issuing of bonds constituting unregulated activity.
- (b) Limited regulation: The paper identified this risk as “[w]here existing regulation is limited and may not be adequate for potential risks”.<sup>400</sup> Again, this was relevant

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<sup>397</sup> The paper stated: “[t]his paper is primarily concerned with perimeter issues that related to the FCA”. (FSA’s Regulatory Perimeter (paper prepared for Chairman’s Committee discussion), November 2012, paragraph 4, at page 1.

<sup>398</sup> The paper stated: “[w]e refer to the perimeter for these purposes as a means of focusing on the risk to our statutory objectives arising from: activities which are unregulated by the FSA” one of which the paper referred to as “the unregulated activities of regulated persons”. *Ibid.*, paragraph 5, at page 1.

<sup>399</sup> *Ibid.*, at page 9.

<sup>400</sup> *Ibid.*, at page 10.

to the LCF case because, as explained above, red flags in respect of LCF were not pursued by the FCA, apparently on the grounds that LCF's business of issuing bonds did not constitute regulated activity.<sup>401</sup>

5.3 ExCo began to formulate a strategy for the FCA's approach to the Perimeter in early 2013. A paper prepared for ExCo dated 8 January 2013<sup>402</sup> recorded the importance of the FCA's approach to the Perimeter in its broader role of regulating firms and markets.<sup>403</sup> The paper proposed a number of principles to govern the FCA's approach to its Perimeter. These included looking proactively beyond the FCA's regulatory boundary<sup>404</sup> and ensuring that risks associated with the Perimeter were considered in the course of the FCA's risk management process.<sup>405</sup> ExCo agreed to the proposed approach.<sup>406</sup> Although formulation of a strategy for dealing with Perimeter issues appears subsequently to have stalled by mid-April 2013,<sup>407</sup> work appears to have continued subsequently with ExCo asking Risk &

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<sup>401</sup> The paper also identified regulatory ambiguity as a further risk. The paper stated: "[w]here it is not readily apparent if an activity is regulated to what extent or by which body. This can give scope for regulatory avoidance or lack of oversight of activities." (*Ibid.*, at pages 11 and 12). Again this was relevant to the LCF case. As explained above on multiple occasions the FCA failed adequately to oversee LCF's activities owing to the fact that its issuing of bonds did not constitute regulated activity.

<sup>402</sup> ExCo Summary Paper: FCA Approach to the Perimeter – Principles and Toolkits, 8 January 2013 [NB. the reference to 2012 in the document appears to be in error], at page 3.

<sup>403</sup> The paper stated in the "Summary" section under the heading "Key Issue – Legal Position and our mandate": "**Our ability to regulate firms and markets effectively is often heavily dependent on matters outside the perimeter and risks can and do materialise which might have been mitigated by a different more proactive approach to monitoring perimeter issues. However, we need to ensure that we act within our mandate in determining our approach to the perimeter**" (emphasis added). The paper also stated under "Solution", "... We think that provided when we look outside the perimeter we do so with the clear object of advancing the better discharge of our functions and that potential risks are anchored to the effect on our statutory duties, then these activities are within our mandate". (*Ibid.*, at page 1).

<sup>404</sup> The paper stated: "**[w]e will proactively look beyond the regulatory boundary to identify potential issues. As part of our stated approach to regulation, we intend to act earlier and to take preventative action. This is particularly important for perimeter issues; we need to have an early warning system to identify issues that could have a substantive effect on our role as regulator. Obtaining early indicators requires a proactive strategy to identify them and is likely to require a combination of systematic data gathering, the building of extensive external networks and also the extension of our current risk identification process beyond the perimeter**". (*Ibid.*, at page 1 of Annex 1).

<sup>405</sup> The paper stated: "**Perimeter risks should be an integral part of the risk management process. The process for identifying and managing risks is relatively generic. Any risks identified will be because they pose a risk to our statutory objectives. It follows therefore that risks inside and outside the perimeter should be part of the same process, simply that how they are identified and the manner in which they are taken forward and resolved may differ to some degree**". (*Ibid.*, at page 3 of Annex 1).

<sup>406</sup> *Ibid.*, at page 12 (page 2 of the draft ExCo Monthly Minutes).

<sup>407</sup> An FCA Internal Audit Final Report stated when considering the issue of "[p]roactive monitoring of the FCA's Perimeter" that "[i]n January 2013 ExCo agreed to establish a dedicated function to monitor the perimeter and approved

Strategy to set up a Perimeter process, to be integrated in due course into the FCA's risk management framework.<sup>408</sup>

- 5.4 The FCA again sought to articulate the risks in respect of, and develop a strategy in response to, the Perimeter in January 2014. An ExCo summary paper dated 28 January 2014 titled "*Perimeter Issues*" recorded that certain unregulated investments fell outside the FCA's "regulatory grip" and that these schemes conducted could be "*fraudulent or... highly speculative, with investors often not appraised of the high level of risk involved and that attractive projected returns are extremely unlikely to materialise.*"<sup>409</sup> This risk has obvious relevance to the LCF case because investors were attracted by LCF's high rates of return which were then not delivered when LCF collapsed.<sup>410</sup>
- 5.5 An ExCo Mission Paper dated 26 July 2016 further articulated the risks associated with the Perimeter. This articulation again included risks relevant to the case of LCF and, in particular, the risks of a firm conducting unregulated business which the public expected to

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*a proposed set of principles and toolkit of actions to embed the FCA's approach across the organisation. Since January 2013 there has been no further progress towards implementing this programme of work... Additionally, at the time of our review, it had not been decided whether principles agreed by ExCo in January 2013 were still relevant and would be implemented as written, or whether the FCA needed to review its definition of the perimeter (in the light of the findings of the Internal Audit Review of LIBOR) prior to implementing the programme of work to monitor it".* (FCA, *Internal Audit final report: A review of the risks to the statutory objectives associated with unauthorised activities*, 18 April 2013, at page 14).

<sup>408</sup> ExCo's request was referred to in the "*Background*" section of a subsequent ExCo Summary paper when summarising the consideration of the Perimeter by ExCo in late 2012 and early 2013 (ExCo Summary Paper, *Perimeter Issues*, 28 January 2014, at page 1).

<sup>409</sup> *Ibid.*, page 8.

<sup>410</sup> For completeness it is recorded that the paper also proposed that the Consumer Market and Intelligence ("CMI") department should take first line responsibility for capturing, investigating and assessing risks associated with the Perimeter (*Ibid.*, page 2). There was subsequent ongoing work in respect of the FCA's approach to the Perimeter. For example, the CMI Operational Highlights document for August 2014 duly included a section on Perimeter Risk (CMI Operational Highlights, August 2014, at slide 8). Furthermore, between around July 2013 and September 2015, the Policy, Risk and Research Department ("PRR") produced a series of Insight Reports which were intended to give an early view of emerging issues. From September 2015 these were replaced by House Views, which around 2017 were re-designated as Sector Views. The brief for the House / Sector Views was that they were designed to provide a common FCA view of how each financial sector was performing and were specifically to include any parts of the relevant sector which were unregulated. See, for example, a January 2018 paper on sector view methodology which stated that: "[t]he work to define the sector will map the markets in the sector, describe the key firms and explain why the sector is important for us as the regulator. It will also cover perimeter issues – what markets / products are within and outside the perimeter and if and how they are regulated". (FCA Sector View: Methodology, January 2018, at page 4).

have been regulated. The paper, which was concerned with the FCA's regulation in a variety of areas in the light of its finite resources, stated:

*“We have not clearly articulated our appetite on issues on the edge of our perimeter including our position on caveat emptor. This is particularly apparent in cases such as Connaught or Secured Energy Bonds, where misconduct primarily occurs in unregulated business, but the public expectation is for the FCA to act as one party within the transaction chain was regulated.”*<sup>411</sup>

5.6 ExCo Extraordinary meeting minutes dated 29 July 2016 further recorded that “[t]here needs to be clarity about when the FCA should seek to address issues outside the regulatory perimeter in order to protect the perimeter” and that “ExCo discussed the use of the ‘fit and proper’ test to cover unregulated activity by regulated entities.”<sup>412</sup>

5.7 That was obviously critical in circumstances where an authorised firm's unregulated activities outside the Perimeter might adversely affect the FCA's statutory and public interest objectives.

5.8 The FCA's mission document for 2017 subsequently included a formal policy statement on the FCA's appetite for intervention in respect of risks associated with the Perimeter, with the FCA publicly formulating a strategy as to how to prioritise and respond to Perimeter issues. The “*Our Mission 2017*” document stated:<sup>413</sup>

*“Essentially, if we believe an issue is serious, but the relevant activity falls outside the perimeter or wider powers set out above, we may still be able act... we are more likely to act where the unregulated activity:*

- *is illegal or fraudulent*

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<sup>411</sup> ExCo Mission Paper, 26 July 2016, page 4.

<sup>412</sup> ExCo Extraordinary Meeting Minutes, 29 July 2016, at page 3.

<sup>413</sup> FCA, *Our Mission 2017: How we regulate financial service*, at page 20 (see: <https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf> (accessed 22 November 2020)).



## Chapter 6: The FCA's approach to the Perimeter

- *has the potential to undermine confidence in the UK financial system*
- *is closely linked to, or may affect, a regulated activity.*<sup>414</sup>

(The first and third of these were, of course, precisely the features which the red flags relating to LCF's unregulated business strongly suggested.)

5.9 The mission statement subsequently provided the framework for the annual published business plan which sets the FCA's priorities for the year.<sup>415</sup>

5.10 A significant problem arising in relation to the Perimeter during the Relevant Period was consumer confusion as to circumstances in which consumers were protected, and the extent to which (if at all) the unregulated activities of an authorised firm were monitored or supervised by the FCA. Until the publication of the FCA's Perimeter Report 2018/19 in June 2019,<sup>416</sup> there appears to have been little public transparency about the issue, or attempts made to explain to consumers the problems, or perhaps misplaced expectations, to which the Perimeter gave rise.<sup>417</sup> This, in the Investigation's view, is something that could have been

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<sup>414</sup> For completeness, the Investigation records that it is aware that the FCA published its first perimeter report on 19 June 2019, albeit this occurred after the Relevant Period came to an end (see: <https://www.fca.org.uk/news/press-releases/fca-publishes-first-annual-report-perimeter> (accessed 22 November 2020)).

<sup>415</sup> In terms of practical application of these policies, the FCA has drawn the Investigation's attention to a range of actions taken by its Supervision and Enforcement Divisions against authorised firms on matters outside the Perimeter. These have already been discussed in footnote 367 in this **Chapter 6** (The FCA's approach to the Perimeter) above.

<sup>416</sup> FCA, Perimeter Report 2018/2019, June 2019.

<sup>417</sup> The FCA in its representations referred to certain documents which preceded the mission and which the FCA said showed it had taken steps to clarify publicly what authorisation meant and where the FCA's jurisdiction lay. Such documents included a link to a web-page for a press campaign in 2016 to highlight the risks of investment fraud particularly to over-55s. However, the link provided by the FCA focused on "*unauthorised* [firms] *selling unregulated products*" but did not state that the same risks applied to authorised firms selling unregulated products (see: <https://www.fca.org.uk/news/press-releases/over-55s-heightened-risk-fraud-says-fca> (accessed 22 November 2020)). The FCA also referred to the ScamSmart tool. However, for the reasons in Section 4 of **Chapter 13** (Other matters of importance to the Investigation), the ScamSmart tool failed to dissuade investors from investing in LCF's products and indeed this resource contributed to certain investors' belief that LCF had a badge of respectability based on its FCA-authorisation in circumstances where ScamSmart failed to warn investors of the risks associated with unregulated products sold by FCA-authorised firms. The FCA representations also referred to a consultation in 2016 preceding the mission's publication. However, that consultation is hardly likely (in the Investigation's view) to have been widely read by the general public and the Investigation considers that the FCA's reliance on it is, for that reason, misplaced.

In any event, the confusion that prevailed regarding the extent of consumer protection in respect of unregulated products sold by authorised firms is demonstrated by the fact that FCA-authorisation was crucial for many investors in their decision to invest in LCF's bonds. This confusion persisted despite the materials relied on by the FCA in its representations.

addressed at an earlier stage whether by warnings on the FCA's website, by instructions to the Customer Contact Centre to ensure that appropriate messages were given to callers, or otherwise. The problem was particularly acute in relation to an authorised firm such as LCF, whose unregulated business consisted of the issuing of bonds to raise money to lend to corporate borrowers; precisely the type of financial activity that an investor might understandably have thought was regulated or at least supervised, given the firm's regulated status.<sup>418</sup>

## 6. Responsibility for lack of consideration of Perimeter risks in dealing with LCF

6.1 The FCA's recognised that it was entitled to act beyond its Perimeter (Section 4 above), and the risks associated with the Perimeter at senior management level (Section 5 above). This recognition, however, did not result in an appropriate level of awareness or consideration of such risks at the levels of the organisation which actually dealt with LCF (Section 3 above), or of whether LCF's unregulated activities might merit a more proactive supervisory approach.

6.2 Similar concerns were expressed in an ExCo paper prepared for presentation to the FCA board on 12 December 2018 titled "*The Challenges of the FCA Perimeter*" reported that "[the FCA tends] to have a reactive approach to risks outside the Perimeter and [does] not have a coherent or consistent approach for identifying and acting against issues that are at or beyond the perimeter."<sup>419</sup> The paper again identified the "*Halo Risk*" which might arise

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<sup>418</sup> In interview, Mr Davidson stated that a supermarket has several financial services permissions "*but we wouldn't expect the business model analysis to go extensively into looking at how they made money on sales of food and so on*" (Interview with J. Davidson, 28 August 2020, at page 30). By letter to the Investigation dated 15 September 2020, Mr Bailey noted that his view had been that while the Perimeter needed more attention "*it could not crowd out the large agenda of issues inside the regulatory boundary*" (Letter from A. Bailey to Dame Elizabeth, 15 September 2020, at page 1).

However, in circumstances where LCF's entire business consisted of the marketing of financial products, it was reasonable for investors to expect such financial activity was regulated or supervised given the firm's regulated status. Indeed, Mr Davidson indicated in interview that the FCA should look outside the Perimeter where extra-Perimeter activities are closely related to those inside the Perimeter and might threaten market integrity (Interview with J Davidson, 28 August 2020, at page 5). In circumstances where all of LCF's business was outside the Perimeter, and consisted in the issuing of financial instruments, this clearly applied. Indeed, Mr Davidson acknowledged in interview that unlike the supermarket whose unregulated activity is "*probably mostly unrelated to the financial services regulated activity*", "*LCF, I think, the unregulated activity is quite closely related*" (Interview with J. Davidson, 28 August 2020, at pages 31 to 32).

<sup>419</sup> ExCo Paper: The Challenges of the FCA Perimeter, 20 November 2018, paragraph 3.2, at page 4. The paper also identified in paragraph 3.3 two key factors which could adversely affect the FCA's decision making in relation to risks outside the Perimeter. First, the paper stated there was "*a lack of clarity amongst the wider market (and occasionally within*

where regulated firms carried out unregulated activities and stated “[a] key issue... is ‘Halo Risk’ – where key stakeholders assume that activities must (or should) fall within our jurisdiction because the firms involved are well known as being regulated by us for other activities.”<sup>420</sup>

6.3 The FCA has represented to the Investigation that, as an organisational matter, it took various measures during the Relevant Period to address or mitigate Perimeter problems. Examples include staff training which included training on how to recognise and address fraud irrespective of whether the fraud took place inside or outside the Perimeter, and specific instances of training materials in Authorisations and the Contact Centre which required fraud to be considered and concerns relating to financial crime to be escalated. In Authorisations and Variation of Permission applications, the FCA was required to consider the fitness and propriety of the whole firm, not just its regulated activities, and that the risk appetite framework for Variation of Permission applications included upwards triggers which related to both the regulated and unregulated aspects of the firm’s business. While the Investigation accepts this, it does not excuse the failings in the authorisation and supervision of LCF described in Section 3 above and this Section.

6.4 The Investigation has concluded that responsibility for the lack of operational awareness described above as it affected the authorisation and supervision of LCF rests, in the first instance with the Executive Directors of Supervision, but ultimately with ExCo and the CEO.<sup>421</sup> As the papers described above demonstrate, ExCo was the body before which issues connected with Perimeter risks repeatedly came. However, as also described above, this

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*the FCA itself) of the regulatory provisions which can be used to address risks and misconduct outside the perimeter.”* Second, the paper stated there was an “*absence of a transparent and consistent methodology for making decisions to act at or beyond the Perimeter.*” The paper also reported that previous initiatives to address risks associated with the Perimeter were no longer operating.

<sup>420</sup> *Ibid.*, at page 7, paragraph 3.19.

<sup>421</sup> The FCA’s description of the CEO’s responsibilities include: “[t]he Chief Executive Officer is responsible for implementing the strategy agreed by the Board, in the formulation of which they will have played a major part” and “communicating throughout the FCA the strategic objectives and the values of the FCA agreed with the Board, **and ensuring that these are achieved in practice**” (emphasis added) (Senior Managers Regime, 2018, at page 41).

failed to result in appropriate consideration of or response to such risks by the FCA staff members dealing with LCF.

**7. The FCA's resources and legal remit do not excuse or mitigate the above failures**

7.1 The Investigation has considered whether the issues of: (i) resource; and (ii) legal remit excuse or mitigate the failures identified above in respect of the FCA's regulation of LCF arising out of its approach to the Perimeter. For the reasons set out below, the Investigation concludes that the above issues do not excuse or mitigate the above failures.

7.2 In respect of resource, there was obviously a limit to which the FCA could or should have regulated and responded to issues outside of its Perimeter.<sup>422</sup> However, in the case of LCF, significant additional resource would not have been required to prevent many of the failings described in Section 3 above. The Investigation does not suggest that the FCA should, for example, have been proactively monitoring all unregulated business carried on by authorised firms across the board, but that enough red flags were being raised in the specific case of LCF for a targeted application of resource in that particular instance.

7.3 For example, it would not have taken significant additional resource to have considered red flags in LCF's financial information or to have pursued allegations of fraud made against LCF during the First VOP Application.<sup>423</sup> The individual dealing with the First VOP Application had already conducted a detailed review into LCF's business and the failure to pursue such issues did not arise owing to lack of resource.

7.4 Similarly, many of the failures in respect of the supervision of LCF identified in Section 3 above did not arise owing to a lack of resource. It would, for instance, not have taken significant resource for supervisors to have interrogated the financial information of LCF for indicia of fraud or irregularity following an allegation against LCF made by a member of the public to the FCA.

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<sup>422</sup> ExCo Mission Paper, 26 July 2016.

<sup>423</sup> See paragraph 3.3 of this Chapter.

- 7.5 While it might have required additional resource to consider LCF's business as a whole in the light of the financial promotions breaches, the number of the breaches and the nature of those breaches<sup>424</sup> provides an obvious limiting factor on the number of potentially similar firms to LCF and the resource which would have been needed to have been allocated to pursuing further inquiries against similar firms.
- 7.6 In short, the Investigation has taken account of the points made by various interviewees as to the FCA's limited resources, particularly when it came to matters outside the Perimeter. However, against that must be balanced the fact that LCF was an extreme case. As already explained, the FCA was aware of multiple allegations of fraud or irregularity made against the firm over the period, as well as other red flags such as matters of concern in LCF's financial information available to the FCA. LCF also used its FCA-authorized status in its marketing material, often in breach of FCA financial promotion rules, to promote investment in its bond business thereby achieving an unmerited halo effect. Accordingly, the Investigation has concluded that the FCA's failure to regulate LCF adequately cannot be excused or mitigated on the basis that the FCA's limited resource constrained the extent to which the FCA could have pursued such issues. In an extreme, or outlier, case such as LCF, resource should have been available for pursuing at least some of the many red flags which accumulated against LCF during the Relevant Period and cross-referencing them with each other. This would be consistent with a risk-based and proportionate deployment of resources.
- 7.7 In respect of the FCA's legal remit, the Investigation also considers this does not excuse or mitigate LCF's failures of regulation set out above.<sup>425</sup> As described above, the FCA appreciated throughout the Relevant Period that it was entitled to act outside its Perimeter in appropriate circumstances and in many cases did so. This is particularly relevant in

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<sup>424</sup> In particular, LCF's use of its FCA-authorized status to promote its unregulated bond business.

<sup>425</sup> Mr Bailey referred to the FCA's legal remit in interview and emphasised that he was conscious of the need for the FCA to not be unduly constrained by the remit. Mr Bailey stated: "...if you look at the debates within the FCA over the preceding period, you see that the perimeter played a role in prioritisation exercises. To be honest with you, the legal advice comes through on quite few occasions. The perimeter is there for a reason. We don't go outside the perimeter.' The problem, and this is what we addressed in the mission document and the mission work, was that of course the perimeter is extremely complicated. It's pretty porous and the industry, of course, inevitably innovates around the perimeter. So give anybody a chance, they'll stick something outside the perimeter" (Interview with A. Bailey, 17 June 2020, at page 13).

circumstances where those issues clearly impacted on the FCA's statutory objectives<sup>426</sup> and LCF's entitlement to hold FCA-authorized firms to a fit and proper person standard.<sup>427</sup>

7.8 Indeed, from the documents the Investigation has reviewed, it does not appear that FCA staff failed to act in respect of LCF because they considered they were not entitled to do so. Accordingly, the Investigation has concluded that the FCA's legal remit does not excuse or mitigate the regulatory failures in the case of LCF.

## **8. Conclusion**

8.1 The FCA was aware at senior management level that it was entitled to look and act outside the Perimeter during the Relevant Period. The FCA was also aware of risks associated with the Perimeter which had direct relevance to the LCF case.

8.2 However, despite the above awareness, there was a lack of operational awareness and/or consideration of such risks at the lower levels of the organisation which dealt with LCF. In general, the FCA did not sufficiently encourage staff to look outside the Perimeter when dealing with FCA-authorized firms such as LCF, which was a small firm whose business consisted of entirely (or almost entirely) unregulated business and which was trading off its FCA-authorized status to attract investment in its unregulated business. The failures in respect of the FCA's regulation of LCF arising out of the FCA's approach to the Perimeter occurred nonetheless.

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<sup>426</sup> See paragraph 4.2 of this Chapter above.

<sup>427</sup> See paragraph 4.5 of this Chapter above.

## **CHAPTER 7: THE FCA'S AWARENESS OF MINI-BONDS AND THE RELATED RISKS**

### **1. Introduction**

- 1.1 The seriousness of the FCA's regulatory failures identified in this Report is the greater because the FCA identified, both before and during the Relevant Period, that "mini-bonds"<sup>428</sup> carried particular risks to consumers. Furthermore, LCF used the proceeds of its mini-bond products in an unusual way and this should have been clear to the FCA from the information available during the Relevant Period. Despite these factors, the FCA still failed to give LCF's business adequate consideration.
- 1.2 There was a clear gap between, on the one hand, management-level identification of the risks to consumers posed by mini-bonds and, on the other, the communication of those risks to those FCA employees dealing with firms and individuals on a day-to-day basis (e.g. the Financial Promotions Team), so that they would be in a position to know when to escalate unusual, or different, uses of mini-bonds for further consideration within the FCA. As a consequence, the unusual use of mini-bonds by LCF was not escalated or flagged by the front line staff.
- 1.3 In summary, there was a lack of effective and coordinated communications across the FCA to ensure that management and front line staff who dealt with LCF had a clear and contemporaneous picture on the use of mini-bonds and the related risks which would alert them to the unusual nature and risks associated with the LCF mini-bond model.
- 1.4 This Chapter is structured as follows:
- (a) Section 2 of this Chapter provides examples of the FCA's identification of mini-bonds as carrying particular risks for consumers.
  - (b) Section 3 of this Chapter explains how LCF used its mini-bond products in an unusual way.

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<sup>428</sup> As stated in **Chapter 1** (Introduction and background), this term is controversial and not generally used in this Report. It is used in this Chapter for ease of exposition given that term was used in contemporaneous documentation.

- (c) Section 4 of this Chapter briefly addresses the FCA's approach to mini-bonds after the Relevant Period.

## 2. Examples of the FCA identifying mini-bonds as carrying particular risks for consumers

2.1 As explained elsewhere in this Report, issuing mini-bonds was not a regulated activity<sup>429</sup> and was, therefore, outside the Perimeter. However, as demonstrated in **Chapter 6** (The FCA's approach to the Perimeter) of this Report, consumer harm arising from mini-bonds was still within the scope of FCA's responsibilities and there were multiple FCA documents in existence throughout the Relevant Period, which showed that the FCA had identified mini-bonds as carrying particular risks for consumers. The paragraphs below provide examples of such documents and the risks which the FCA had identified that mini-bonds posed to consumers.

### *Documents prior to/at the beginning of the Relevant Period*

2.2 An internal FCA "*CMI Insight Report*" paper titled "*Insight Paper Unlisted Mini-bonds*" from 2013 stated:<sup>430</sup>

- (a) mini-bonds were "*arguably inherently risky*" because: (i) the products were not covered by the FSCS; (ii) there was no secondary market for the products; (iii) high headline rates could mean consumers would fail to evaluate the underlying merits of the products; and (iv) the products were subject to less onerous disclosure requirements;<sup>431</sup>
- (b) "[t]he issue of mini-bonds is not formally on any risk maps.... In addition, if they [are] not sold on an advised basis, it seems that it would not be a sector team issue. This is a risk as there is a possibility that this issue is overlooked as each sector might consider it beyond the scope of their remit";<sup>432</sup>

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<sup>429</sup> See **Chapter 9** (Appropriateness of LCF's permissions) and **Appendix 5**.

<sup>430</sup> CMI Insight Report, Insight Paper: Unlisted Mini-Bonds.

<sup>431</sup> *Ibid.*, at page 1.

<sup>432</sup> *Ibid.*, at page 4.



*Chapter 7: The FCA's awareness of mini-bonds and the related risks*

- (c) the “*Financial Promotions team have seen an increasing number of promotions for retail bonds and have concerns about mini-bonds. They note that a recurring issue within these promotions is the lack of prominence of risk warnings*”;<sup>433</sup> and
- (d) in concluding, “[i]t is thus, imperative for the FCA to have awareness of this issue, be proactively monitoring the situation and taking decisive action to mitigate this risk.”<sup>434</sup>

2.3 Another internal FCA paper, namely a “*Three Sixty Insight Report*” dated 25 March 2014 contained a page on the transparency of mini-bond promotions:<sup>435</sup>

- (a) one of the headings on the page was “[m]isleading promotions in the rapidly growing mini bond market may be drawing customers into inappropriate products”;<sup>436</sup>
- (b) the description also stated that there were “*concerns about the lack of risk warnings within the marketing of these products and the limited investor protection*” and that “[a]s the market is growing rapidly and this is expected to continue, more proactive action is recommended to improve these promotions and protect consumers”;<sup>437</sup> and
- (c) in a section setting out planned work, the paper stated that the Financial Promotions Team would “*continue to proactively monitor the market and take swift action where breaches occur*”.<sup>438</sup>

2.4 It is unclear whether these papers reached the FCA’s senior management (i.e. ExCo or the Board) and what (if any) concrete steps were taken in 2013 and 2014 as a result of the issues identified in these papers. Indeed, Mr Bailey said during interview that, although these papers said the FCA should be focusing on mini-bonds (in particular, financial promotions

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<sup>433</sup> *Ibid.*, at page 2.

<sup>434</sup> *Ibid.*, at page 9.

<sup>435</sup> FCA, *Three Sixty: Insight Report*, 25 March 2014.

<sup>436</sup> *Ibid.*, at page 5.

<sup>437</sup> *Ibid.*

<sup>438</sup> *Ibid.*

for mini-bonds), there was very little evidence that any steps were actually taken between 2013 and 2016.<sup>439</sup>

2.5 The FCA has represented, and the Investigation accepts, that during this period the FCA took certain steps which, while not necessarily directed at mini-bonds as such, were potentially relevant to the mini-bond market. For example:

- (a) In 2014, the FCA made rules to restrict investment in Non-Readily Realisable Securities (“NRRS”) which would, in practice, include most mini-bonds. These restricted direct offer marketing (e.g. those promotions where an investor can immediately respond to make an investment) of NRRS only to certain types of retail client (including self-certified sophisticated or high net worth investors, advised clients or other retail clients who confirmed that they would not invest more than 10% of their net investable assets in NRRS).<sup>440</sup>
- (b) In February 2015, the FCA published a thematic review of the regulatory regime for crowdfunding and the promotion of NRRS by other media, which included a section on mini-bonds. It is evident from the paper that at this point the FCA was looking at the risks associated with mini-bonds which were issued by small companies seeking to raise capital to fund their own businesses.<sup>441</sup>

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<sup>439</sup> Interview with A. Bailey, 17 June 2020, at page 12. When discussing the 2013 and 2014 papers that covered mini-bonds in a subsequent interview with the Investigation Team, Mr Bailey commented: “[a]nd they do commit to do things... There was no evidence they ever did anything that I could ever find” (see: Interview with A. Bailey, 4 August 2020, at page 20). As noted elsewhere in this Report, Mr Bailey was a NED of the FCA Board from 2013 until he became CEO. However, as noted in paragraph 2.4 of this Chapter, it is unclear whether the 2013 and 2014 papers would have been escalated to the Board.

<sup>440</sup> PS 14/4, The FCA’s regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media Feedback to CP13/13 and final rules, March 2014 (see: <https://www.fca.org.uk/publication/policy/ps14-04.pdf> (accessed on 23 November 2020)).

<sup>441</sup> FCA, A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media, February 2015 (see: <https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf> (accessed on 23 November 2020)). Paragraphs 60 and 61 of this document state: “60. In essence, a mini-bond is a type of debt security, typically issued by small businesses. Such securities run for around three to five years, in general, and offer an interest rate of between 6% and 8% a year. We have seen an increase in the number of small companies issuing mini-bonds on crowdfunding platforms to raise capital for their business. Such businesses may have found it difficult to secure a loan from a bank or could be start-up companies looking for funding. 61. Mini-bonds are also becoming increasingly popular with investors, attracted by the interest rates on offer. However, it is important for prospective investors to understand the risks. Mini-bonds are illiquid and can be high risk, as the failure rate of small businesses is high. There is no protection from the Financial Services Compensation Scheme (FSCS) if the issuer fails. Firms promoting these securities to the public must make the risks clear to prospective investors.”

- (c) With effect from 2016, the FCA introduced higher capital requirements for SIPPs holding non-standard investments, which are typically higher risk, illiquid assets, the effect of which was to discourage SIPP providers from accepting mini-bonds and other high-risk investments into their SIPP products.<sup>442</sup>
- (d) On 12 December 2016 a paper titled "*The regulatory risk and consequences of high-risk investments*" was presented to a meeting of the FCA's Executive Regulatory Issues Committee ("ERIC"), which set out a strategy of cross-FCA work to tackle unregulated high-risk investments. The paper focused on a range of unregulated high risk investments such as non-mainstream pooled investments (units in unregulated collective investment schemes, securities issued by some special purpose vehicles, units in qualified investor schemes and traded life policy investments) and other unregulated investments such as forestry, carbon credits and land banking. A further paper was brought before ERIC on 19 April 2017 ("*The regulatory risk and consequences of high-risk investments – Proposed priorities and timelines*"), when the Committee agreed a first phase of follow up work on high-risk investments. The paper does not reference mini-bonds, though the broad concept of unregulated high-risk investments was potentially relevant to LCF's particular version of the mini-bond product.

2.6 In relation to these examples, the FCA has represented to the Investigation that as a result of the rules related to NRRS, as far as the FCA has been able to establish, LCF did categorise clients (i.e. self-certified sophisticated etc.) and provided investors with these warnings (i.e. the NRRS rules appear to have had an impact on how LCF handled investors). The FCA has also explained that, in connection with the NRRS rules, the Financial Promotions Team would have checked LCF's website to make sure there were restrictions in place to prevent ordinary retail investors from being able to apply and invest. The Investigation has not, however, seen any evidence of the FCA adequately interrogating LCF on the processes it had in place in connection with the NRRS rules. This is despite the fact that Individual A

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<sup>442</sup> PS 14/12: A new capital framework for Self-Invested Personal Pension (SIPP) operators, August 2014: <https://www.fca.org.uk/publication/policy/ps14-12.pdf> (accessed on 21 November 2020).

*Chapter 7: The FCA's awareness of mini-bonds and the related risks*

raised concerns in February 2018 that LCF was not complying with the NRRS rules.<sup>443</sup> Bondholders have informed the Investigation that individuals acting on behalf of LCF encouraged them to tick boxes as to which category they fell within (e.g. self-certified sophisticated etc.) without considering whether they actually met the relevant criteria and as a consequence, many individuals who were not experienced in financial matters were able to invest in LCF bonds.<sup>444</sup>

*The July 2017 paper*

2.7 The FCA identified further risks with mini-bonds in 2017 and 2018.

2.8 The issue of mini-bonds was brought before the risk committee of the Investment, Wholesale & Specialist (“SIWS”) part of the Supervision Division in July 2017.<sup>445</sup> A summary paper titled “*Supervisory Strategy for the Distribution of Mini-Bonds (and other non-standard investments) to retail consumers*”<sup>446</sup> was prepared for a meeting of the SIWS Risk Committee<sup>447</sup> on 26 July 2017. The paper highlighted the following concerns regarding mini-bonds:

- (a) by their nature, mini-bonds were high risk investments, particularly given the lack of FSCS protection;<sup>448</sup>

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<sup>443</sup> During the call with the Contact Centre, Individual A stated: “...*They're only supposed to sell it directly to high-net worth and sophisticated individuals...But they're not doing that, they're, because I know, you know, people that have actually applied for these bonds, and they are definitely not sophisticated. Unfortunately, it's a self-certification process, so these people lie.*” (Transcript of a call from Individual A to the FCA Contact Centre at page 2). The FCA has confirmed to the Investigation that the Contact Centre did not escalate Individual A's concerns in relation to LCF's potential non-compliance with the NRRS rules for further review.

<sup>444</sup> This information was provided by, among others, the Bondholder Group..

<sup>445</sup> For most of the Relevant Period, the Supervision Division was split into two: (i) SIWS, headed by Megan Butler; and (ii) Supervision – Retail & Authorisations (known within the FCA as “SRA”) headed by Jonathan Davidson (see: Slides for the Meeting between Independent Investigation Team & FCA, 20 September 2019, at slide 5).

<sup>446</sup> SIWS RiskCo Summary Paper, Supervisory Strategy for the Distribution of Mini-Bonds (and other Non-Standard Investments) to Retail Consumers, 26 July 2017.

<sup>447</sup> The SIWS Risk Committee is the risk management committee for the SIWS part of the FCA's Supervision Division.

<sup>448</sup> The paper stated: “[w]hile the interest rates mini-bonds offer can make them appear attractive to potential investors, the heightened risk of the business/SPV failing, the fact that mini-bonds are non-transferable and therefore illiquid, and the lack of FOS/FSCS protection in the event of default means they are often high risk” (see: SIWS RiskCo Summary Paper, Supervisory Strategy for the Distribution of Mini-Bonds (and other Non-Standard Investments) to Retail Consumers, 26 July 2017, at page 1).

- (b) mini-bonds could be used for fraudulent purposes;<sup>449</sup>
- (c) there was a potential gap in supervisory work being conducted in relation to authorised firms approving financial promotions for mini-bonds.<sup>450</sup>

2.9 The minutes of the SIWS Risk Committee meeting show that the meeting was chaired by the Executive Director of SIWS (i.e. a member of ExCo) and members of the Financial Promotions Team, who corresponded with LCF regarding its financial promotions breaches during the Relevant Period, attended the meeting for the purpose of discussing the summary paper on mini-bonds.<sup>451</sup> The minutes also confirm that the following decisions were made in respect of the supervisory strategy for mini-bonds:

- (a) “...SIWS would undertake targeted supervisory action on the small number of authorised firms we are already aware of that approve [non-standard investment] financial promotions”.
- (b) “SIWS would alter its risk tolerance and open cases to follow up with any authorised firms identified approving direct offer [non-standard investment] promotions. The Financial Promotions team would refer these promotions to the relevant SIWS department.”<sup>452</sup>

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<sup>449</sup> The paper stated: “[w]e are aware that mini-bonds are also being issued by pooled investment special purpose vehicles (SPVs), often investing in the purchase and/or development of property, land, renewable energy and other speculative (**and in some cases likely fraudulent**) investment ventures. The latest intelligence suggests that concerns about fraudulent investments may be moving away from mini-bond structures into listed securities” (emphasis added) (see: SIWS RiskCo Summary Paper, Supervisory Strategy for the Distribution of Mini-Bonds (and other Non-Standard Investments) to Retail Consumers, 26 July 2017, at page 1). This indicated that, at the level of SIWS RiskCo, the FCA no longer saw mini-bonds solely in terms of the FCA’s February 2015 thematic paper as “small companies issuing mini-bonds... to raise capital for their business” but was aware of the distinctive risks associated with the use of mini-bonds as a form of unregulated pooled investment vehicle.

<sup>450</sup> The paper stated: “[h]owever, we have identified a potential gap with respect to proactive supervisory work on the authorised firms approving financial promotions for mini-bonds / other non-standard investments for non-advised direct offer financial promotions. Relative to the advised channel, non-advised direct offer promotions pose a moderate risk of harm to consumers. While, we believe the volume of mini-bonds distributed via this channel is lower than via advised channels, the absence of any regulated activity means bondholders may not normally be able to complain to FOS or make a claim against the FSCS in the event of default, exposing them to greater harm. We therefore believe that further proactive FCA action is justified to target the regulated firms involved and try to prevent future harm. However, it should be noted that one unintended consequence of greater scrutiny of the regulated firms involved in approving financial promotions could be to move the promotion of non-standard investments to the unregulated space, which are more difficult for us to tackle” (see: *Ibid.*, at page 2).

<sup>451</sup> SIWS RiskCo Committee Minutes, 26 July 2017, at page 1.

<sup>452</sup> *Ibid.*

*Chapter 7: The FCA's awareness of mini-bonds and the related risks*

- 2.10 The July 2017 paper did trigger additional work by the FCA. First, the FCA completed the action items identified in the minutes of the 2017 paper (i.e. the items at paragraph 2.9(a) and (b) of this Chapter). Second, the paper factored into the FCA's business planning discussion for the purposes of identifying the organisation's priorities for the 2018/2019 business. Neither of these areas of work resulted in any review of LCF's business.
- 2.11 One of the action items from the July 2017 meeting was for the Financial Promotions Team to amend its procedures so that a referral to the SIWS team would be made for any firms approving financial promotions for direct offer investments such as mini-bonds.<sup>453</sup> In interview, a member of the Financial Promotions Team stated that the procedure came into force in September/October 2017 and their understanding was that this meant that "*where... a financial promotion case involved a mini-bond, we would work more closely with supervisors... to actually understand the due diligence that was undertaken by a firm approving a financial promotion for the purposes of Section 21 of [FSMA]*".<sup>454</sup>
- 2.12 In August 2017 (i.e. between the July 2017 meeting when this action item was agreed and the introduction of the new procedure in September/October 2017), the Financial Promotions Team wrote to LCF regarding a further breach of the financial promotions rules (the fourth time that the Financial Promotions Team had written to LCF regarding issues with its financial promotions in under six months).<sup>455</sup> This did not result in a referral from the Financial Promotions Team to SIWS or any other department within the Supervision Division.
- 2.13 Whilst it is correct that the procedure was not formally in place until September/October 2017, the Investigation finds it surprising that no referral was made, given that the individual in the Financial Promotions Team, who wrote the letter to LCF in August 2017, was present at the July 2017 meeting when the change of procedure was agreed.<sup>456</sup> In interview, the

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<sup>453</sup> *Ibid.*

<sup>454</sup> Interview Transcript E, at page 30.

<sup>455</sup> Letter from the Financial Promotions Team to LCF's CEO, 18 August 2017 (Document with Control Number 108068). See Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) for further information on the interactions between the Financial Promotions Team and LCF.

<sup>456</sup> SIWS RiskCo Committee Minutes, 26 July 2017, at page 1; Letter from the Financial Promotions Team to LCF's CEO, 18 August 2017 (Document with Control Number 108068).

Executive Director of SIWS stated that she would not have expected the Financial Promotions Team to have waited until the formal procedure was in place and, as such, she agreed that the issues with LCF's financial promotions which were identified in August 2017 "might" have resulted in a referral to SIWS in light of the action items arising from the July 2017 SIWS Risk Committee meeting.<sup>457</sup> In the Investigation's view such a referral should have resulted.

2.14 The point could be made that the decision to amend the Financial Promotions Team's procedures (i.e. the item at paragraph 2.9(b) above) did not extend to LCF for two reasons: (i) LCF was assigned to the Supervision – Retail & Authorisations ("SRA") part of the Supervision Division and this decision arose from the Risk Committee of the other part of Supervision, i.e. SIWS; and (ii) LCF was approving financial promotions for its bonds and this decision and the July 2017 paper were focused on authorised firms approving promotions for unauthorised firms. But the Investigation nonetheless concludes that the Financial Promotions Team should have referred LCF to the relevant team in the Supervision Division when a further financial promotions issue was identified in August 2017. The reasons for this include:

- (a) It is correct that LCF was, at the time, assigned to the SRA part of the Supervision Division but the FCA has informed the Investigation that this was an error. In any event, in circumstances where the July 2017 paper highlighted the risks arising from mini-bonds and it was decided that there needed to be coordinated action between the Financial Promotions Team and the Supervision Division, the Investigation does not consider that the fact that LCF was (erroneously) assigned to the SRA part of the Supervision Division should make any difference to the reaction. In addition, the new procedure that was subsequently implemented in September/October 2017 specifically stated: "[s]hould we identify in-scope firms

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<sup>457</sup> Interview with M. Butler, 19 June 2020, at pages 29 and 30. Ms Butler stated: "So that piece in August [i.e. the August 2017 letter from the Financial Promotions Team to LCF] comes between the decision in SIWS RiskCo in July and the up and running new way of working in – that was finally put in place in September. In that interim, I have to say I would expect, given that this was supposed to be a new way of working, the people making those decisions to be aware of that and acting accordingly. So it might have referred...I would have expected the Financial Promotions Team not to wait for the final process guide to be issued given the decision in July..."

*supervised by other parts of supervision (e.g. SRA), we will need to pass on this information to the relevant area for them to consider whether/how to action."*

- (b) Whilst the July 2017 paper did not specifically refer to an authorised firm issuing its own bonds, the Investigation considers that this was because the distribution channels for mini-bonds that the FCA frequently encountered were authorised firms approving financial promotions for bonds issued by unauthorised firms. The LCF case was an unusual case and the Investigation would have expected a referral to have resulted, or have been considered, given the July 2017 paper raised general concerns about financial promotions for mini-bonds that were directed at retail investors (which was the case with LCF and its financial promotions).

2.15 In the Investigation's view, it is, therefore, surprising that the financial promotions issues in August 2017 did not result in a referral to the Supervision Division given that the August 2017 letter to LCF stated:

*"We are particularly concerned that our records show that over the past year we have had to write to you on three other occasions concerning deficiencies in your promotions. We do not expect to see any further breaches. Should this occur we will seek a formal attestation by an approved person conducting a significant influence function from within your firm that there are adequate systems and controls in place for the approval of compliant financial promotions".*<sup>458</sup>

2.16 The Investigation considers that the August 2017 financial promotions issues should have, at a minimum, resulted in a referral from the Financial Promotions Team to the Supervision Division, regardless of whether or not the action items identified in the July 2017 paper had been implemented or technically required such a referral. No satisfactory explanation has been provided for why the Financial Promotions Team did not refer LCF to the Supervision Division in August 2017.

2.17 The FCA informed the Investigation that the July 2017 paper resulted in a package of work identified as a priority for 2018/2019 covering high risk investments and other complex

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<sup>458</sup> Letter from the Financial Promotions Team to LCF's CEO, 18 August 2017, at page 2 (Document with Control Number 108068).



products.<sup>459</sup> The FCA pointed to a statement in its Business Plan for 2018/2019 (published in April 2018) which described this work as a sector priority for the Retail Investments sector and stated:

*“High-risk investments are characterised by unusual, speculative or complex product structures, investment strategies or terms and features. As consumers look for better returns, some are buying products which are unlikely to meet their savings or investment needs. In 2018/19 we will carry out a programme of work to tackle incidences of consumers entering into high-risk investments which are unsuitable for their needs. This work will enable us to identify where there are problems with high-risk investments. We will also strengthen our authorisations gateway and supervision for firms that provide advice on high-risk and complex investments. This will ensure they improve their disclosure and reduce the risks of harm to retail investors.”*<sup>460</sup>

2.18 The FCA has confirmed that the supervisory action which arose from this work on high-risk investments did not cover LCF.<sup>461</sup>

2.19 Although mini-bonds fell into the general category of high-risk investments, the subsequent work did not focus specifically on mini-bonds or the evolving way in which the concept of mini-bonds were being marketed to retail consumers. The FCA has represented that this approach to mini-bonds in the Relevant Period must be *“set within the broader context in which the FCA and its senior leadership were operating at the relevant time, including as to the allocation of its resources and prioritisation of risks”*.<sup>462</sup> As explained in **Chapter 5** (The FCA's finite resources and prioritisation) of this Report, a detailed review of the FCA's

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<sup>459</sup> FCA Response to Information Request – LCF\_JUN\_015.

<sup>460</sup> FCA Business Plan 2018/2019, at pages 46 and 47 (see: <https://www.fca.org.uk/publication/business-plans/business-plan-2018-19.pdf> (accessed on 23 November 2020)).

<sup>461</sup> The FCA's response to the Investigation Team's information request on this issue stated: “[w]ithin Supervision, the Package [i.e. the package of work on high risk investments and other complex products] was then carried out through two core strands of work, each of them giving rise to follow-up supervisory cases on individual firms (which did not include LCF): • in follow-up to the Q4 2017 SIPP data survey, targeted work on discretionary fund managers (DFMs) and financial advisers identified as most active in NSI-related business; and • the development of the PRISM 2 data tool to identify financial advisers posing the greatest risk of providing unsuitable advice” (see: FCA Response to Information Request – LCF\_JUN\_015, at page 2).

<sup>462</sup> FCA representations, at paragraph 5.4.

*Chapter 7: The FCA's awareness of mini-bonds and the related risks*

prioritisation and resourcing decisions is not within the remit of the Investigation. That said, the Investigation still regards the lack of focus on mini-bonds as surprising given that: (i) the July 2017 paper highlighted concerns that that mini-bonds were high risk investments, which could be used for fraudulent purposes and in relation to which there was a potential gap in the supervisory work; and (ii) the FCA's 2017 Enterprise Wide Risk Management ("**EWRM**") Report, which was presented to the Board in June 2017,<sup>463</sup> identified financial crime as second in a list of ten of the FCA's "*top enterprise-wide risks*".

- 2.20 Although some supervisory work did take place as a result of the July 2017 paper, this work did not result in a review or consideration of LCF. Despite identifying mini-bonds as a high-risk product that could be used for fraudulent purposes and, even though the FCA had information demonstrating concerns over LCF's use of mini-bonds, no thematic (or other) supervisory work resulted in a review of LCF's business before the intervention in late 2018.

*Additional papers in 2017/2018*

- 2.21 A regulatory risk report presented to the FCA's ExCo by the Risk & Compliance Oversight Division ("**R&CO**") in September 2017 also highlighted the risks posed by mini-bonds and referred to the supervisory work agreed at the July 2017 SIWS Risk Committee meeting. The report included mini-bonds in a section on "[a]dditional below the line regulatory risks" which it described as "*risks just below the top regulatory risks and...recorded as [Medium High] or above on the risk register with mitigation planned or ongoing in response*". The entry for mini-bonds described the potential or actual harm as "[c]onsumers don't realise the

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<sup>463</sup> Enterprise Wide Risk Management Report, Risk & Compliance Oversight, 21 June 2017; Board Paper, Enterprise Wide Risk Management Report, 21 June 2017.

Chapter 7: The FCA's awareness of mini-bonds and the related risks

*high risk involved – non-transferable, lack of FOS/FSCS protection” and “[f]inancial loss caused by investing in fraudulent SPVs”.*<sup>464</sup>

2.22 A similar report prepared by R&CO in early 2018 and presented to the Executive Regulation and Policy Committee (the “**ERPC**”)<sup>465</sup> at the end of March 2018 also highlighted the increasing risk from new and complex products such as mini-bonds. The paper stated:

*“Intelligence suggests an increase in mini bond related complaints and issues. They were added as an emerging risk in Oct 2017 by Life Insurance and Financial Advice Supervision. Intelligence suggests that new versions of non-standard investments (NSIs) are packaged as listed bonds or [exchange-traded funds] and are sold to retail clients. Consumers could face potential large financial losses and little scope for redress from poor conduct from these high risk unregulated products. Supervision is also concerned with the risks of public confidence in FCA and the market as adverse media reports arise. There has been an increase in mini bonds issued by popular small corporates ... whereby returns may be paid in product discounts rather than cash. Consumers may not be aware that mini bonds need to be held to maturity, cannot be traded and are not covered by the protections of FSCS. In one crowdfunding platform, we observed that mini bonds are used to cover the firm's losses.”*<sup>466</sup>

2.23 The paper concluded as follows regarding new and complex financial products (including mini-bonds):

*“Increasing production innovation drives a number of questions for market participants who expect a view from the FCA. Equally, despite the potential benefits of these products there are unknown harms that need to be understood quickly. To address these challenges [the R&CO] believe the FCA should be in a position to respond more quickly to recent developments in new and complex financial products, particularly where there are questions*

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<sup>464</sup> Annex to the R&CO Q3 Regulatory Risk Report, 26 September 2017, at page 16.

<sup>465</sup> The FCA's website describes the ERPC as one of the “*two highest ranking executive decision-making bodies of the FCA*” (the second such committee is the ExCo). The website also explains that the ERPC “*is responsible for executive decision making on policy decisions and regulatory issues*” (see: <https://www.fca.org.uk/about/executive-committees> (accessed on 23 November 2020)).

<sup>466</sup> Annex 1: R&CO Q2 Report – Risk of Harm Landscape, 26 March 2018, at page 12.

*Chapter 7: The FCA’s awareness of mini-bonds and the related risks*

*involving the regulatory perimeter. This may involve scanning the external environment for new product developments and forming a view on products that are on the outskirts of our remit. This could form an extension of the sector views, and allow the FCA to join the debate with peer regulators in a proactive manner.”*<sup>467</sup>

2.24 Similar wording was also included in the 2018 EWRM which was presented to the Board on 28 June 2018.<sup>468</sup>

2.25 A paper presented to the ERPC in May 2018 set out the FCA’s annual “*Retail Sector Views*”<sup>469</sup> and highlighted the following concern expressed by R&CO:

*“There is no overall market map, which means there is potential for scope confusion with some activities/products potentially excluded from assessment – e.g. life insurance, equity release, mini-bonds.”*<sup>470</sup>

2.26 The paper also included further commentary from R&CO in relation to the Sector View for Retail Investments. The executive summary noted that R&CO recommended future iterations should consider including further analysis of product and technological innovation as “[i]t would be useful to understand more detail on the potential impact on retail consumers of some innovations (e.g. Cryptocurrencies and Mini Bonds), as well as their distribution, market dynamics and prevalence”.<sup>471</sup> R&CO also noted as follows regarding potential product gaps:

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<sup>467</sup> *Ibid.*

<sup>468</sup> This report stated: “[o]ver the past six months, the number of new and complex products attracting market and press attention has significantly increased: ICOs continue to grow (increase in scams) despite the FCA’s consumer warning, and minibonds have seen a rising number of complaints with consumers unaware that these are not covered by the FSCS.” The report also included a similar recommendation from the R&CO: “[t]hat the FCA is able to respond more quickly to developments, particularly where there are questions involving the regulatory perimeter. This could mean enhanced horizon scanning for new product developments to form an early view on products on the outskirts of our remit” (see: Enterprise Wide Risk Management Report, 28 June 2018, at page 16).

<sup>469</sup> The paper described the Sector Views as follows: “[a]s a key component of the FCA’s Sector Framework, the purpose of the Sector Views is to provide analysis to inform the Sector Strategies and business planning and prioritisation. They also provide a baseline of strong evidence and analysis which all FCA staff can use as an entry point to a sector and rely on as the FCA approved baseline of reliable data. They are intended to be used to inform local decisions on priority activity, such as developing supervision priorities through the Delivering Effective Supervision (DES) programme” (see: ERPC Paper, Retail Sector Views: Retail Investments, Pensions and Retirement Income, Retail Banking, Retail Lending, General Insurance and Protection, 21 May 2018, at page 4).

<sup>470</sup> *Ibid.*, at page 9.

<sup>471</sup> *Ibid.*, at page 11.

*“The boundary between [Sector Views] are not clearly defined, leading to the potential for products or services to be omitted from assessment. As value chains grow in complexity, together with changing business models, there is a growing need to look across the sectors to ensure complete coverage and a comprehensive assessment. For this sector [i.e. Retail Investments], mini-bonds is an example”.*<sup>472</sup>

2.27 This 2018 paper repeated the concern expressed in the 2013 paper that *“there is a possibility that this issue is overlooked as each sector might consider it beyond the scope of their remit”.*<sup>473</sup>

2.28 It is clear from the documents described above that the FCA was aware of the risks to consumers posed by mini-bonds, and that there were a variety of different ways in which mini-bonds were being used in the market, each with their own risks and nuances. It was also clear that mini-bonds were not just being used by small companies to fund their own businesses but also, potentially, as a form of unregulated pooled investment vehicle, whereby the issuer of the bond would on-lend, or apply, the funds subscribed by investors in loans to other entities.

### **3. LCF used mini-bonds in an unusual way**

3.1 LCF was using mini-bonds in an unusual manner, in that the firm was issuing these mini-bonds to investors for the purposes of funding onward loans to SMEs. Individuals within the FCA<sup>474</sup> were aware that LCF's use of mini-bonds was unusual but it still did not trigger a detailed review of the business nor did it result in an escalation for consideration by the teams within the FCA that had already identified mini-bonds as a risky product.

3.2 During the Relevant Period, the most common form of mini-bonds encountered by the FCA were as described in the FCA's February 2015 thematic paper; that is to say, bonds issued by companies to fund their own businesses, often with a pre-existing customer base whose pre-existing brand loyalty could be used to attract investment for their bond issuances. The

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<sup>472</sup> *Ibid.*, at page 13.

<sup>473</sup> CMI Insight Report, Insight Paper: Unlisted Mini-Bonds, at page 4.

<sup>474</sup> This included Associates in the Authorisations, Supervision and Financial Promotions Divisions (see: Interview Transcript E, at page 12; Interview Transcript X, at page 18; and Interview Transcript O, at page 18).

mini-bonds such companies issued were designed to raise capital for themselves in order to finance their wider commercial operations.<sup>475</sup>

3.3 As noted at paragraph 3.1 of this Chapter, by contrast with the usual use of mini-bonds, LCF's bonds were issued by a company (i.e. LCF) which had no pre-existing brand loyalty or wider commercial operations beyond issuing bonds. LCF's bonds were mass-marketed to the public at large, rather than to a pre-existing loyal customer base. LCF's bonds were also unusual in that they raised capital ostensibly to lend onward to SMEs rather than for LCF to use for general working capital in its own business. The result was that LCF's mini-bonds operated in commercial terms as an unregulated pooled investment vehicle, albeit the way they were structured meant that in the Investigation's view they did not come within the legal definition of a collective investment scheme. These factors meant that LCF's use of mini-bonds was highly unusual.

3.4 The unusual nature of LCF's use of mini-bonds was increased by the fact that LCF's whole business model was also highly unconventional. As an FCA employee, who was involved in reviewing the First VOP Application, acknowledged in interview, it was highly unusual for firms with corporate finance advice permissions to issue their own securities.<sup>476</sup> However, LCF raised millions from the issuance of its bonds. This meant LCF operated at a completely different level of risk from usual corporate finance advisory firms, because it received investors' money in return for issuing its own securities, which money<sup>477</sup> was then at risk in the event of LCF's insolvency. This is a further reason why LCF's use of mini-bonds was highly unusual.

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<sup>475</sup> The FCA paper presented to the SIWS Risk Committee in July 2017 and stated: "[a] *mini-bond is an unlisted, non-transferable debt security issued by a legitimate, commercial operation looking to raise capital...*" (see: SIWS RiskCo Summary Paper, Supervisory Strategy for the Distribution of Mini-Bonds (and other Non-Standard Investments) to Retail Consumers, 26 July 2017, page 4). Similarly the FCA "*CMI Insight Report*" stated: "[t]here are a growing number of mini-bonds on the market. The businesses offering mini-bonds are diverse and range from extremely popular brands... to niche, smaller and less well-established companies... The common characteristic of all these firms seems to be however, that they have a strong brand and a captive and dedicated group of consumers. This is why mini-bonds are sometimes informally referred to as being "*passion-bonds*" (see: CMI Insight Report, Insight Paper: Unlisted Mini-Bonds, page 7).

<sup>476</sup> The Case Officer stated that, before the First VOP Application, he had never seen a company applying for corporate finance advice permissions which also issued its own bonds (see: Interview Transcript Z).

<sup>477</sup> The Investigation regards it as irrelevant for present purposes that, upon the issue of LCF's bonds to an investor, the latter ceased to have any proprietary interest in the funds which he/she had advanced to purchase the bonds.

- 3.5 In addition to the individual involved in reviewing the First VOP Application, various other members of the FCA's Supervision, Financial Promotions and Authorisations Teams who encountered LCF during the Relevant Period acknowledged in interview that LCF's use of mini-bonds and its general business model was unusual. For example, a member of the Consumer Credit Team within the Supervision Division stated: "*it was unusual for a firm to be seeking investment in this way [i.e. via the issuance of mini-bonds] and then want to lend...you'd expect a firm to have sort of a regular funding source, wholesale funding source...we thought it was unusual for a firm to be soliciting investment via bonds*".<sup>478</sup> It does not appear that the individuals who identified the risk posed by the unusual nature of LCF's "*mini-bond*" business were encouraged to escalate this issue for further consideration by other teams within the FCA.
- 3.6 Some members of the FCA's Senior Management during the Relevant Period have suggested that the FCA's focus<sup>479</sup> on mini-bonds, was on a different type of mini-bond<sup>480</sup> from that offered by LCF. In the Investigation's view, even though that may have been the position to a certain extent, such statement does not present the full picture of the risks which, at the relevant time, were indeed appreciated by the FCA as existing in relation to mini-bonds. Nor does it excuse the FCA's failings to take sufficient steps to address and mitigate mini-bond risk prior to the collapse of LCF.
- 3.7 As explained above, it is correct that the most well-known mini-bonds prior to 2018 were those issued by high street companies. However, the papers produced within the FCA were not focused solely on the risks posed by those types of mini-bonds. The 2017 paper presented to the SIWS Risk Committee referred to mini-bonds being "*issued by pooled investment special purpose vehicles (SPVs), often investing in the purchase and/or development of property, land renewable energy and other speculative (and in some cases, likely fraudulent) investment ventures*"<sup>481</sup> (emphasis added). Accordingly, by at least 2017 the

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<sup>478</sup> Interview Transcript O, at page 18.

<sup>479</sup> As noted in the various papers identified in Section 2 of this Chapter.

<sup>480</sup> Essentially the type described in the FCA's February 2015 thematic paper.

<sup>481</sup> SIWS RiskCo Summary Paper, Supervisory Strategy for the Distribution of Mini-Bonds (and other Non-Standard Investments) to Retail Consumers, 26 July 2017, at page 1).

FCA was certainly aware that mini-bonds were a new and evolving product that could be used for fraudulent purposes, even if the most common/well-known iterations of mini-bonds did not carry significant consumer risks. As highlighted in this Chapter, the FCA's awareness of the potential risks of mini-bonds, together with the red flags mentioned elsewhere in this Report, should have resulted in more detailed review and supervisory activity in relation to LCF's mini-bonds, and more consideration of mini-bonds issued by other firms with a similar business model or profile to LCF, during the Relevant Period.

#### **4. Activity by the FCA in relation to mini-bonds post the Relevant Period**

4.1 After the collapse of LCF (in other words, when the risks previously identified in relation to mini-bonds had materialised), the FCA eventually took significant steps to try and address the risks posed by issuers of mini-bonds. Thus, following the collapse of LCF, the FCA created a specific team within the Supervision Division focusing, on a temporary basis, on firms issuing mini-bonds.<sup>482</sup> In addition, in November 2019, the FCA announced a temporary ban on the mass marketing of speculative mini-bonds to retail customers.<sup>483</sup> In announcing that ban, the FCA stated:

*“Over the last year, the FCA has undertaken an extensive programme of work to tackle the risks for investors from mini-bonds, reflecting the real risk of consumer harm. This includes:*

- 1. Investigating more than 80 cases of regulated activities potentially being carried out without having the right FCA authorisation.*
- 2. Assessing over 200 cases of financial promotions that appeared not to have complied with the FCA rules.*
- 3. Seeking to persuade the internet service providers, particularly Google, to take more action, for instance to take down websites promptly where they are likely to involve a breach of law or regulations.*

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<sup>482</sup> Interview Transcript AD.

<sup>483</sup> See: <https://www.fca.org.uk/news/press-releases/fca-ban-promotion-speculative-mini-bonds-retail-consumers> (accessed on 23 November 2020). As at the date of this Report, the FCA was going through a consultation process in relation to making the ban permanent (see: <https://www.fca.org.uk/publications/consultation-papers/cp20-8-high-risk-investments-marketing-speculative-illiquid-securities-including-speculative-mini-bonds-retail-investors> (accessed on 23 November 2020)).



*4. Contact with the Department of Culture, Media and Sport to urge inclusion of financial harm in the proposed legislation on online harms.*

*5. Developing tools for data analysis, for instance introducing web scraping to assist in the identification of mini-bond promotions.’<sup>484</sup>*

## **5. Conclusion**

5.1 The FCA had identified the risks to consumers posed by mini-bonds from as early as 2013 and the additional risks relating to the use of mini-bonds as a quasi-investment vehicle by at least 2017. The Investigation accepts that the FCA did take some steps to address and mitigate mini-bond risk prior to the collapse of LCF. However, based on the information available to the FCA at the time, the Investigation concludes that those steps were not sufficient. For example, the work that commenced in 2017 did not result in a detailed review of LCF, or of firms with a similar business model or profile to LCF, nor did it lead to monitoring of LCF on an ongoing basis. This is despite the fact that the teams within the FCA which had interacted with LCF had identified that: (i) LCF was using mini-bonds in an unusual manner; (ii) the FCA was also aware of multiple financial promotions breaches by LCF; and (iii) the FCA had received numerous consumer concerns regarding LCF's business model.

5.2 The Investigation considers that at least some of the steps implemented by the FCA following the collapse of LCF should have been taken during the Relevant Period, because of the risks which the FCA had correctly identified in relation to mini-bonds, and regardless of the fact that mini-bonds were outside of the Perimeter. In circumstances where the FCA had received communications from third parties expressing concerns in relation to LCF's use of mini-bonds (e.g. the Anonymous Letter) and the financial promotions of those mini-bonds, the Investigation considers that it is the more surprising that the FCA did not take steps to address such mini-bond risks at an earlier stage, or at least give consideration to the matter. Ultimately, however, the FCA only took concrete and significant steps to address the risks posed by LCF's mini-bonds on a reactionary basis once those risks had crystallised.

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<sup>484</sup> See: <https://www.fca.org.uk/news/press-releases/fca-ban-promotion-speculative-mini-bonds-retail-consumers> (accessed on 23 November 2020).

5.3 The Investigation considers that the failure to act sooner is, at least in part, because of a failure by ExCo to ensure that: (i) new and emerging risks, such as those identified in the SIWS RiskCo Summary Paper of 26 July 2017, were sufficiently cascaded to those front line employees in Supervision and Authorisations who were engaging with firms on a daily basis; and (ii) those same employees were encouraged to escalate new and emerging product types that they encountered when conducting supervision/authorisations work. Such steps would have improved the FCA's ability to scan the horizon for new risks, albeit that, in the case of LCF, the unusual nature of its mini-bond offering, its financial promotions breaches and the concerns raised by third parties should have been more than sufficient for the risks to be on the FCA's radar in any event.

## **CHAPTER 8: THE “DELIVERING EFFECTIVE SUPERVISION” AND “DELIVERING EFFECTIVE AUTHORISATIONS” PROGRAMMES**

### **1. Introduction**

- 1.1 During the course of the Investigation, the FCA drew attention to measures which it had already taken in response to deficiencies in its regulation of firms. The FCA provided information relating to two significant change programmes which it was undertaking between 2016 and the end of the Relevant Period. These programmes were DES<sup>485</sup> and DEA<sup>486</sup> (together, the “**Programmes**”). Their objectives were to overhaul the way in which the FCA supervised and granted authorisations to the firms it regulated.
- 1.2 Members of the FCA’s Senior Management team during the Relevant Period had suggested that the Programmes would be relevant to the Investigation in considering the questions set out in the Direction.<sup>487</sup>
- 1.3 The Investigation has concluded that the Programmes had no material impact on the authorisation and supervision of LCF during the Relevant Period. The Investigation has also concluded that serious deficiencies, including a lack of proactive supervision, existed in relation to the supervision of flexible firms like LCF at least until the DES programme was closed in November 2018. These deficiencies were identified by the FCA’s Senior Management and ExCo from late 2015 onwards<sup>488</sup> and were known to the Board from at least November 2016.<sup>489</sup>
- 1.4 Despite having identified these serious deficiencies, the DES programme was not closed until November 2018, five months later than originally planned.<sup>490</sup> In the Investigation’s

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<sup>485</sup> The FCA’s Delivering Effective Supervision programme as defined at paragraph 5.3(h) of **Chapter 2** (Executive summary).

<sup>486</sup> The FCA’s Delivering Effective Authorisations programme as defined at paragraph 1.5 of **Chapter 4** (Introduction to the preliminary issues).

<sup>487</sup> Interview with J. Davidson, 15 June 2020.

<sup>488</sup> E.g. Risk and Controls Self-Assessment for the SIWS Division, Statement of Assurance (as at 31 December 2015), 22 January 2016, at page 1.

<sup>489</sup> Presentation to the FCA Board: Delivering effective supervision, 1 November 2016, at page 2.

<sup>490</sup> Delivering Effective Supervision, Project Closure Report, 26 November 2018, at page 5.

view, that was too long in circumstances where the supervision of approximately 50,000 firms was known to have been inadequate for a prolonged period.<sup>491</sup> Although the FCA disagrees, the Investigation considers that more could and should have been done by the FCA to consider possible “quick fixes” or the adoption of interim measures to deal with the deficiencies in supervision. The Investigation further considers that the FCA should have at least considered a review or “look back” at what might have slipped through the net during the period when there was inadequate supervision of approximately 50,000 “flexible portfolio” firms. The Investigation also considers there is a question as to whether the DES programme was necessary or, at least, whether the programme needed to be of the size and scale it eventually became but that issue falls outside its remit.

- 1.5 The FCA represented that the FCA had only been established the year before the start of the Relevant Period, that it was still in the process of building capability and systems and that there was significant change in the structure and management of the organisation during the Relevant Period. The FCA suggested that all of these points had impacted its approach to the authorisation and supervision of firms. The FCA pointed to the following in particular:
- (a) As at the inception of the FCA’s establishment, the Authorisations and Supervision Divisions were merged, the FCA’s stated intention being to review the functions and create two new Divisions by April 2015.
  - (b) The existing Executive Directors of Supervision and Authorisations left the FCA in 2014 and, during the transition to the new arrangements, the merged functions were led by a single Executive Director.
  - (c) In April 2015, two new Divisions were created “Supervision – Investment, Wholesale and Specialists” (referred to elsewhere in this Report as SIWS) and “Supervision – Retail and Authorisations” (referred to elsewhere in this Report as SRA). The Executive Director of the previously merged supervision function was appointed as Executive Director of SIWS and an Interim Executive Director appointed to lead SRA.

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<sup>491</sup> Interview A. Bailey, 4 August 2020, at page 33.

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

- (d) Two further Executive Directors also left the FCA in early 2015, and were replaced initially by interim leaders.
- (e) In July 2015, it was announced that the Chief Executive of the FCA would stand down in September of the same year. In January 2016, the Treasury announced that Mr Andrew Bailey was to be appointed as permanent Chief Executive. He took up his post in July 2016.
- (f) In September 2015, the Executive Director of SIWS moved from SIWS and took over as Acting Chief Executive.
- (g) Also in September 2015, the current Executive Directors of SRA and SIWS joined the FCA and took up their current roles.
- (h) One effect of the significant changes over that short time-frame was that there was no permanent leadership in place between January and September 2015.

**2. Scope of consideration by the Investigation of the Programmes**

- 2.1 The Investigation considered whether: (i) the problems which the Programmes were designed to address; and (ii) the implementation of the Programmes, had any relevant effect on the supervision or authorisation of LCF during the Relevant Period.
- 2.2 The Direction requires the Investigation to focus on the FCA’s discharge of its functions in respect of LCF during the Relevant Period.<sup>492</sup> It does not require a broader review or assessment of the current effectiveness of the FCA’s Supervision and Authorisations Divisions as a whole. Accordingly, the Investigation has not considered whether the Programmes have been successfully delivered and embedded. For that reason, this Investigation has not addressed whether the Programmes have resulted in, or improved, the effectiveness of either or both of the FCA’s supervision and authorisation processes. That question falls outside the scope of enquiry for the Investigation and much of it relates to work done by the FCA after the Relevant Period.
- 2.3 The FCA represented to the Investigation that it has changed its policies and practices since the Relevant Period and expressed concern that this Report creates an impression that the

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<sup>492</sup> Paragraph 3(1) of the Direction.

“asserted failings” persist “to this day”. As is clear from the foregoing paragraph the Investigation has not reviewed and makes no findings in relation to the FCA’s current policies and procedures or whether the identified failings persisted post the Relevant Period.

2.4 As a result, the Investigation also has not considered whether delivery of the Programmes would prevent the problems which arose in relation to the FCA’s regulation of LCF happening in relation to other firms in future.

### 3. FCA’s supervisory strategy for firms previously regulated by the OFT prior to DES and DEA

3.1 In January 2012, the UK Government announced its intention to transfer consumer credit regulation from the OFT to the FCA and, as such, corresponding provisions were included in the Financial Services Bill.<sup>493</sup> As noted at paragraph 1.2 of **Chapter 1** (Introduction and background), the actual transfer took place on 1 April 2014 and, as a result, the FCA assumed responsibility for the regulation of over 50,000 consumer credit firms previously regulated by the OFT (the “**OFT Firms**”).<sup>494</sup> To put this in context, prior to 1 April 2014, the number of firms authorised by the FCA was approximately 25,000 firms<sup>495</sup> and the transfer of firms from the OFT to the FCA even under interim permissions (i.e. not all would necessarily end up as FCA-authorised firms)<sup>496</sup> was a significant increase in workload and responsibility for the FCA. It was noted by a NED (albeit who joined in 2016) that the UK Government had put pressure on the FCA by “dump[ing]” additional areas of responsibility on it, which was

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<sup>493</sup> The Treasury: A new approach to financial regulation: securing stability, protecting consumers, 27 January 2012, at page 30 (see: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/236107/8268.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/236107/8268.pdf) (accessed on 22 November 2020)).

<sup>494</sup> In February 2014, the FCA explained: “[w]e take over the regulation of around 50,000 consumer credit firms from the Office of Fair Trading on 1 April 2014” (see: <https://www.fca.org.uk/publications/policy-statements/ps14-3-final-rules-consumer-credit-firms> (accessed on 22 November 2020)).

<sup>495</sup> FCA Data Bulletin, October 2014, at page 3 (see: <https://www.fca.org.uk/publication/data/data-bulletin-issue-1.pdf> (accessed on 29 September 2020)). The table at paragraph 3.1 of **Chapter 5** (The FCA’s finite resources and prioritisation), which was provided to the Investigation by the FCA, shows a similar number (i.e. 26,000 authorised firms in 2014) and also shows a significant increase (i.e. from 26,000 in 2014 to 73,000 in 2015) following the transfer of the OFT Firms.

<sup>496</sup> Consumer credit firms wishing to continue to carry out consumer credit activities after 1 April 2014 needed to register for interim permission with the FCA (see: <https://www.fca.org.uk/publication/policy/ps13-08.pdf> (accessed on 22 November 2020)). Given the volume of firms, the FCA required consumer credit firms to apply for full permission in set “application periods” (see: <https://www.fca.org.uk/publication/policy/ps14-03.pdf> (accessed on 22 November 2020)).

Chapter 8: The “Delivering Effective Supervision” and  
“Delivering Effective Authorisations” Programmes

a challenge to the organisation which the FCA had no power to resist.<sup>497</sup> It was also pointed out that morale was already low at the FCA at that time because of a previous enquiry which was very damaging and the leadership were working hard to raise it up.<sup>498</sup>

3.2 Mr Bailey was a NED of the FCA from 1 April 2013 until his appointment as CEO in July 2016 (when he became an executive director).<sup>499</sup> He recalled being told in his NED role “*this [the transfer of responsibility for the OFT Firms] was going to be a big thing*”.<sup>500</sup> He observed that the FCA’s initial resourcing and strategy for dealing with the OFT Firms looked “*pretty hollow*”.<sup>501</sup>

3.3 The FCA said, which the Investigation accepts, that the increased number of firms meant that it was simply not possible for each firm to have a relationship with a supervisor, nor would it have been feasible or appropriate to respond by recruiting a substantial number of new people for the Supervision Division.<sup>502</sup> It was said by the Executive Director of the SRA Division of Supervision that “*with 59,000 firms and 14,000 pages of rules and guidance in the FCA’s handbook, an approach of actively monitoring all of those firms for all of those rules was impractical and had likely, I think, been ineffective in the past*”.<sup>503</sup> For that reason he said “*...we therefore needed to be very clear on where the harms were, the risks of harm were, where we had the powers to act ...in order to focus*”.<sup>504</sup>

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<sup>497</sup> Interview with Baroness Hogg, 22 September 2020, at pages 4 and 5.

<sup>498</sup> *Ibid.*, at page 6.

<sup>499</sup> See: [https://beta.companieshouse.gov.uk/officers/KU0Wr4swEuT32TyvLnZ\\_GwBrwW0/appointments](https://beta.companieshouse.gov.uk/officers/KU0Wr4swEuT32TyvLnZ_GwBrwW0/appointments) (accessed on 22 November 2020). Although, in interview Mr Bailey made the point that in his NED role on the Board, as then Deputy Governor for Prudential Regulation at the Bank of England, he was required by legislation to be in a different position from the other NEDs in respect of responsibilities for individual firms (Section 6 of Schedule 1ZA of FSMA states: “[t]he Bank’s Deputy Governor for prudential regulation must not take part in any discussion by or decision of the FCA which relates to—(a) the exercise of the FCA’s functions in relation to a particular person, or (b) a decision not to exercise those functions”). Mr Bailey also noted that the Board was “*more distant from the day to day running of the place, certainly than I was used to at the PRA*” (see: Interview with A. Bailey, 17 June 2020, at page 2).

<sup>500</sup> Interview with A. Bailey, 17 June 2020, at page 6.

<sup>501</sup> *Ibid.*

<sup>502</sup> Interview Transcript AE, at page 7; Interview with A. Bailey, 17 June 2020, at page 8.

<sup>503</sup> Interview J. Davidson, 15 June 2020, at page 33.

<sup>504</sup> *Ibid.*, at page 33.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

- 3.4 What was being described in the preceding paragraph was the risk-based approach to supervision, which the FCA adopted, as described more fully below. A risk-based approach was said by the FCA both to have been essential because of its workload and, in relation to consumer credit, to have been driven by a focus on the most severe harm to consumers, based on vulnerability. The Investigation does not suggest that adopting a risk-based approach was wrong in principle; it has considered the effectiveness of the risk-based supervision approach which the FCA adopted in relation to flexible firms such as LCF during the Relevant Period. As is obvious, the Investigation does not suggest that the FCA’s supervision regime should have achieved the elimination of every identified risk. However it does state its view, in this Report, as to what risks it considers the Supervision Division should have identified in relation to its supervision of LCF.
- 3.5 The OFT Firms had not previously completed a full authorisations process prior to the transfer to the FCA.<sup>505</sup> There was a dedicated team, the Credit Authorisations Division, within the Authorisations Division that, at its peak, had many hundreds of employees to deal with the large volume of applications for FCA authorisation arising from the transfer of OFT Firms to the FCA.<sup>506</sup>
- 3.6 An internal paper from December 2013 demonstrated that the FCA recognised the tension which would arise, in taking responsibility for the regulation of the OFT Firms, between, on the one hand, the FCA’s obligation to maintain arrangements for supervising authorised persons (under section 1L(1) of FSMA) and, on the other, the requirement that, in discharging its general functions, the FCA must have regard to using its resources in the most efficient and economical way (under section 3B(1)(a) of FSMA).<sup>507</sup> The paper explained that the FCA would balance these obligations by supervising “firms mainly

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<sup>505</sup> This was observed in the July 2016 report produced by PA Consulting Services titled “*Effectiveness assessment of the FCA approach to flexible firm supervision*” (discussed in more detail in Section 4 of this Chapter) at page 6 which noted in the consumer credit sector that: “firms having not completed a full authorisations process puts further strain on supervision as quality of conduct is unknown” and recognised the difficulties with reliable firm data given the size of the population (“largest flexible firm population with limited data make[s] supervision at a firm level difficult”).

<sup>506</sup> Interview with J. Davidson, 15 June 2020, at page 44; FCA Regulatory Narrative Document, paragraph 1.49, at page 8.

<sup>507</sup> Divisional Supervisory Risk Committee Summary Paper: Consumer Credit – interim approach to Pillar 1 supervision, 16 December 2013, at page 1.



Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

*through event supervision and some thematic work with less emphasis placed on firm specific proactive work*”.<sup>508</sup>

3.7 The paper also explained that this strategy was to be achieved by applying a modified version of the FCA’s three pillar supervision model (the “**Three Pillar Model**”) to the OFT Firms.<sup>509</sup> The modified approach was to target some firms for proactive or preventative supervision (i.e. Pillar One of the Three Pillar Model) based on information obtained from and an assessment of clusters of firms.<sup>510</sup> The concept of assigning firms to clusters was based on how the firm had been categorised for conduct supervision purposes. The FCA used four conduct supervision categories based on each firm’s potential impact on the FCA’s objectives with “C1” and “C2” being the larger firms with substantial numbers of retail customers, “C3” firms being those firms “*across all sectors with retail customers and/or a significant wholesale presence*” and “C4” firms being “*smaller firms, including almost all intermediaries*”.<sup>511</sup>

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<sup>508</sup> *Ibid.*

<sup>509</sup> A 2012 document explaining the transition of the FSA to the FCA described the Three Pillar Model as follows: “[o]ur supervision model is based on three pillars: 1. Firm Systematic Framework (FSF) – preventative work through structured conduct assessment of firms. 2. Event-driven work – dealing faster and more decisively with problems that are emerging or have happened, and securing customer redress or other remedial work where necessary. This will cover issues that occur outside the firm assessment cycle, and will use better data monitoring and intelligence. 3. Issues and products – fast, intensive campaigns on sectors of the market or products within a sector that are putting or may put consumers at risk” (see: Journey to the FCA, October 2012, at page 26: <https://www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf> (accessed on 23 November 2020)). A similar description of the Three Pillar Model was also included at SUP 1A.3.4 (see: <https://www.handbook.fca.org.uk/handbook/SUP/1A/3.html?date=01-04-2014&timeline=True> (accessed on 23 November 2020)). The wording of SUP1A.3.4 as at the date of this Report has amended the description of the “*three types of work*” (rather than “*pillars*”) to refer to: (i) “*proactive*”; (ii) “*reactive*”; and (iii) “*thematic*” (see: <https://www.handbook.fca.org.uk/handbook/SUP/1A/3.html?timeline=True> (accessed on 23 November 2020)).

<sup>510</sup> The December 2013 paper explained: “[g]iven the limited information available prior to the start of the interim regime and the importance of a body of data being available upon which to build Pillar 1 strategies, we are proposing a lighter approach to BAU Pillar 1 for new consumer credit firms during the interim regime, one which is not reliant on pre-existing data derived from reporting. The approach is based on the key principle that the FCA will do some firm-specific supervision on new incoming [consumer credit] firms in order to satisfy our statutory obligations and that this is seen to be the case externally. Once firms have been identified and an indicative classification assigned, sub-sector clusters would be formed drawing from those firms classified as either C2 or C3... Once sub-sector clusters are formed, our starting point would be to make certain assumptions about the firm risks within each cluster based on the sector analysis for each sub-sector” (see: Divisional Supervisory Risk Committee Summary Paper: Consumer Credit – interim approach to Pillar 1 supervision, 16 December 2013, at pages 2 and 3).

<sup>511</sup> Journey to the FCA, October 2012, at page 26.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

- 3.8 The December 2013 paper stated that none of the OFT Firms would be classified as C1<sup>512</sup> and that “*although there will [be] some new entry C2 and C3 firms*”, the “*vast majority [will be] categorised as C4*”.<sup>513</sup> LCF was categorised as a C4 firm<sup>514</sup> and, pursuant to the approach in the December 2013 paper, would not have been subject to any proactive supervision as an interim permission firm following the transfer from the OFT to the FCA. Indeed, in 2012, the FSA published a document setting out, among other things, how the FCA would approach supervision of C4 firms which stated that it intended “*having a ‘touch point’ with all C4 firms once every four years*” and that this “*could range from a roadshow, an interview, a telephone call, an inline assessment, or a combination of these*”.<sup>515</sup>
- 3.9 The FCA work plan for 2014 thematic reviews (i.e. Pillar Three of the Three Pillar Model) in respect of the OFT Firms was stated to be focused on high cost short term lending and debt management, neither of which covered LCF’s business.<sup>516</sup> The FCA has stated that, both during and after the Relevant Period, it did carry out certain thematic work on the flexible portfolio in the areas it identified in 2014. The Investigation has not considered this work as it did not impact on the supervision of LCF. The FCA has also stated in its representations that LCF was not necessarily considered to be high risk.
- 3.10 Accordingly, under the Three Pillar Model which was in place until the DES programme was rolled out, the only pillar of supervision which could, or would, have caught LCF would have been Pillar Two, viz. reactive supervision (described in the 2014 work plan as having the objective of dealing “*rapidly and efficiently with cases of potential or actual detriment to customers or risks to market integrity across the consumer credit space*”).<sup>517</sup> Ultimately, reactive supervision was the only pillar through which the FCA would, in theory, have supervised LCF throughout the Relevant Period under its supervision model, but, even when

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<sup>512</sup> The paper stated: “[w]e do not anticipate there will be any new entry C1 firms; however most of our existing C1 firms will be caught within the scope of the Consumer Credit Regime by the nature of the holistic financial services offered” (see: Divisional Supervisory Risk Committee Summary Paper: Consumer Credit – interim approach to Pillar 1 supervision, 16 December 2013, at page 1).

<sup>513</sup> *Ibid.*

<sup>514</sup> Change in Control: Working & Decision Paper, 20 December 2016, at page 1 (Document with Control Number 222930).

<sup>515</sup> Journey to the FCA, October 2012, at page 29.

<sup>516</sup> FCA Consumer Credit Work Plan for First Year, 11 February 2014, at page 10.

<sup>517</sup> *Ibid.*, at page 9.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

the FCA received significant indicators of potential detriment to consumers as a result of LCF’s activities, the FCA did not react rapidly, efficiently or effectively.<sup>518</sup>

3.11 In December 2014, the FCA published a strategy paper explaining that the supervision model was changing. This stated:

*“We will sharpen our focus on large firms, sectors and small firm supervision, integrating authorisations and supervision. This will mean that we will shift our approach to supervision for smaller firms, removing the distinction between C3 and C4 firms, supervising individual firms on a more risk-based model, and removing much of our standard Pillar 1 activity for those firms. For larger firms, we will take a whole market as well as a firm specific view of each firm, largely continuing the existing three pillar supervision model for C1 and C2 firms.”*<sup>519</sup>

3.12 This revised approach was further developed in 2015 and resulted in the FCA moving away from the classification of firms into the four conduct categories to differentiating between firms as either “fixed portfolio” or “flexible portfolio”.<sup>520</sup> Like the majority of firms, LCF was classified as a flexible portfolio firm.<sup>521</sup>

3.13 In September 2015, the FCA published papers explaining its approach to the supervision of fixed<sup>522</sup> and flexible portfolio firms.<sup>523</sup> The paper explained that flexible portfolio firms such as LCF would be “supervised through a combination of market-based thematic work and programmes of communication, engagement and education activity aligned with the key risks identified for the sector in which the firms operate”.<sup>524</sup> Flexible portfolio firms were to use the Customer Contact Centre as their first point of contact with the FCA.<sup>525</sup>

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<sup>518</sup> See **Chapter 10** (Adequacy of the FCA’s supervision of LCF).

<sup>519</sup> FCA: Our Strategy, 8 December 2014, at page 6 (see: <https://www.fca.org.uk/publication/corporate/fca-our-strategy-december-2014.pdf> (accessed on 23 November 2020)).

<sup>520</sup> The FCA’s Approach to Supervision for flexible portfolio firms, September 2015, at page 9.

<sup>521</sup> E.g. Change in Control: Working & Decision Paper, 20 December 2016, at page 1 (Document with Control Number 222930).

<sup>522</sup> The FCA’s Approach to Supervision for fixed portfolio firms, September 2015.

<sup>523</sup> The FCA’s Approach to Supervision for flexible portfolio firms, September 2015.

<sup>524</sup> *Ibid.*, at page 9.

<sup>525</sup> *Ibid.*, at page 9.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

3.14 The September 2015 paper on the supervision of flexible portfolio firms further explained the FCA’s approach:

*“We do not carry out work under Pillar 1 [i.e. proactive or preventative supervision] to assess flexible portfolio firms individually, instead we take a market based approach to the sector as a whole.”<sup>526</sup>*

3.15 The Pillar Three work (i.e. reviews of specific issues or products) was therefore the only supervision which flexible portfolio firms would receive, absent an event to engage reactive supervision (i.e. Pillar Two of the Three Pillar Model). The paper stated in relation to Pillar Three:

*“We will look at each sector to analyse current events and investigate potential drivers of poor outcomes for consumers and markets. We do this on an ongoing basis, so we can address risks common to more than one firm or sector before they can cause widespread damage...This work ranges from large and detailed studies to smaller sample based work and is our primary form of proactive work with flexible portfolio firms.”<sup>527</sup>*

3.16 Notwithstanding the intention of the Pillar Three work, it was recognised that the broad categorisation of around 50,000 firms into seven sectors made it difficult to identify risk on a sectoral basis because of the vast differences in the business carried on by the firms in each sector and because some firms operated cross-sector. Mr Davidson told the Investigation *“it is very important, in my view, that those areas with sectoral or, I would call it, business model expertise, identify the intrinsic risk stemming from certain business models and that they share these with those areas which...don’t have sectoral specialism, including authorisations and the Contact Centre and other areas of the FCA and financial promotions.....that process, when I arrived, was not working well.”<sup>528</sup>*

3.17 The Three Pillar Model operated in a way which meant that there would be very little focus on individual firms outside of the fixed portfolio and that Pillar One proactive/preventative

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<sup>526</sup> *Ibid.*, at page 13.

<sup>527</sup> *Ibid.*, at page 14.

<sup>528</sup> Interview with J. Davidson, 15 June 2020, at page 5.

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

work would be reserved for the larger (“*fixed*”) firms.<sup>529</sup> During interview, the Investigation was informed that the FCA had expected Pillar Two to deliver effective supervision of the thousands of flexible firms.<sup>530</sup> However, in reality, the Pillar Two model was “*purely reactive*” and operated using a binary set of risk tolerances which would either lead to action being taken or cases being closed without any further investigation or follow-up.<sup>531</sup>

3.18 Mr Bailey, commenting in interview on the 2012 FSA document which explained the FCA would have a “*touch point*” with firms such as LCF (i.e. C4 firms) once every four years, said “[*t*hat [i.e. a touch point once every four years] *is not supervision*”.<sup>532</sup> The Investigation agrees with him.

3.19 Put shortly, throughout the Relevant Period, the FCA’s strategy for supervision meant that LCF would not have been subject to any proactive supervision by the FCA.

3.20 It is clear for the reasons set out in paragraphs 4.2 to 4.5 below that the FCA identified from as early as 2016 that it should have been conducting more proactive supervision of flexible firms such as LCF and that this should include identifying high risk firms based on the data available to the FCA but that did not happen during the Relevant Period. The corollary is that the FCA must have appreciated, at least by 2016, that, by failing to conduct proactive supervision of flexible firms, there was a risk that those firms would cause harm to consumers or the market.

#### **4. The genesis of the DES and DEA Programmes**

4.1 In 2015, after the latest iteration of the FCA’s strategy for supervising flexible firms had been laid out (although not having been fully implemented or embedded) two new Executive

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<sup>529</sup> Interview with M. Butler, 19 June 2020, at pages 21 and 22.

<sup>530</sup> *Ibid.*, at page 21

<sup>531</sup> *Ibid.*, at page 22.

<sup>532</sup> Interview with A. Bailey, 17 June 2020, at page 6.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

Directors<sup>533</sup> joined the FCA to head the two divisions of the Supervision Division.<sup>534</sup> The Investigation recognises that the problems within the Supervision Division pre-dated their respective arrivals and were not of their making (nor of Mr Bailey who was appointed CEO in 2016); rather they “*inherited a broken machine*”<sup>535</sup> and had to find a way to address that.<sup>536</sup> Early in their tenure the Executive Directors identified that, in their view, the approach to supervising flexible firms being implemented by the FCA at the time was not functioning as required to ensure effective supervision.<sup>537</sup> They noted that there was not sufficient resource in the Supervision Division or across the FCA to engage with small firms and there were “*grave concerns about the (FCA’s) ability to take a joined up approach to...reactive intelligence across the different points of contact.*” It was said that the way intelligence was dealt with and escalated was inconsistent<sup>538</sup> and was not always routed to someone who had the understanding of the business model to consider whether the intelligence was relevant and what it might indicate in the way of harm.<sup>539</sup> Ms Butler noted that both incoming

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<sup>533</sup> Ms. Butler joined the FCA on 1 September 2015 as a secondee from the Prudential Regulation Authority as Executive Director of SIWS. She was appointed to that role on a permanent basis in May 2016 (see: <https://www.fca.org.uk/news/press-releases/megan-butler-appointed-permanent-director-supervision-%E2%80%93-investment-wholesale-and> (accessed on 23 November 2020)). Mr. Davidson joined the FCA as Executive Director of SRA in September 2015 (see: <https://www.fca.org.uk/about/executive-committees/jonathan-davidson> (accessed on 23 November 2020)). Both Ms. Butler and Mr. Davidson remain in their respective positions.

<sup>534</sup> As noted elsewhere in this Report, for most of the Relevant Period, the Supervision Division was split into two: (i) SIWS headed by Ms. Butler; and (ii) SRA headed by Mr. Davidson (see: Slides for the meeting between Independent Investigation Team & FCA, 20 September 2019, at slide 5).

<sup>535</sup> Interview with A. Bailey, 28 August 2020, at page 34.

<sup>536</sup> Interview with A. Bailey, 28 August 2020, at page 24. Mr Bailey was asked if he had not been aware of the scale of the problem as a NED for the FCA and said “...until I became chief executive if you said to me “*did you appreciate the scale of the problem? No, no way. It was much bigger, as a problem than I had imagined it would be. Now it may have been a failure of imagination on my part, I don’t know, and as you have rightly said, I had another regulator throughout that point, so I only had a limited amount of time to give to the FCA, but the honest answer is no*”.

<sup>537</sup> For example, the Executive Director for SIWS filled in a Risk and Controls Self-Assessment (i.e. assessing the adequacy of the controls in place for her division) as at 31 December 2015 which identified the supervision model as one of the top risks faced by her division: “[t]here are key risks concerning the effective operation of the model due to: (i) an inconsistent adoption of the model (including a divergence between SIWS and SRA), (ii) a failure to allocate appropriate resources to reflect the new model and organisational priorities, and (iii) the volume and pace of change (particularly changes to structure, IT systems, processes and their impact on governance). (iv) governance that does not fully reflect the new model and the need for decision making accountability to be clear and effective. Evidence of these key risks crystallising already exist” (see: Risk and Controls Self-Assessment for the SIWS Division, Statement of Assurance, 22 January 2016, at page 1).

<sup>538</sup> Interview with J. Davidson, 15 June 2020, at page 6.

<sup>539</sup> *Ibid.*

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

Executive Directors of Supervision were “*unconvinced by the model that was being rolled out*” and that there were “*extensive problems with aspects of its roll out*” and “*a lack of buy in from parts of Supervision*”.<sup>540</sup>

4.2 Soon after his arrival, Mr Davidson recorded in a risk assessment for his division during the period ending 31 December 2015 the numerous changes to the FCA and the Supervision Division and noted that he could provide only limited assurance that the Supervision Division’s key controls were functioning adequately and that significant improvements were required in the relation to changes to the supervision model which had not yet been embedded, including to the fixed and flexible portfolios and the Group Supervision model.<sup>541</sup>

4.3 As a result of these concerns, an independent consultant, PA Consulting Services Limited, was engaged by the Executive Directors of the Supervision Division in the first half of 2016 to review the effectiveness of the FCA’s approach to supervising flexible firms. This produced a July 2016 report titled “*Effectiveness assessment of the FCA approach to flexible firm supervision*” (the “**PA Report**”).<sup>542</sup> The PA Report, while noting that the FCA’s flexible firm strategy had some positive impacts on supervision, drew many adverse conclusions which were likely to have caused, and did cause, grave concern throughout the FCA. The conclusions most relevant to LCF included that there:

- (a) was an inconsistent application of the flexible supervisory framework across the organisation;
- (b) was no single system of governance supporting the approach to risk management;
- (c) was a lack of coordinated and consistent collaboration and knowledge sharing across the organisation;
- (d) was a supervision strategy which required supervisors to focus on market-based risks, rather than proactive, one-to-one firm based supervision;

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<sup>540</sup> Interview with M. Butler, 19 June 2020, at page 21.

<sup>541</sup> Risk and Controls Self Assessment – Statement of Assurance to AuditCo [via ExCo] in respect of the adequacy of the First Line of Defence, 25 January 2016.

<sup>542</sup> Effectiveness assessment of the FCA approach to flexible firm supervision, 27 July 2016, at page 46.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

- (e) were limitations linked to the availability of quality data and the inadequate use of internal intelligence directly impacted the ability to collate appropriate intelligence across many sectors;
- (f) was a limitation in the organisation’s ability to “*connect the dots*” and be confident in its ability to identify emerging risks; and
- (g) were inconsistencies in how risks were measured, monitored and reported.<sup>543</sup>

4.4 Mr Bailey, who had assumed his role as CEO of the FCA just before the PA Report was completed<sup>544</sup> candidly described the PA Report to the Investigation as a “*shocker*” as it suggested to him there was not “*a model of supervision really*” and that “*the machine had to be stripped down*”.<sup>545</sup> Mr Bailey’s assessment of the situation on his arrival as CEO of the FCA, notwithstanding his prior role as NED, was that “*the FCA’s approach to supervision was wholly inadequate*”.<sup>546</sup> The findings of the PA Report were said to have come as no surprise to the relatively new Executive Directors.<sup>547</sup>

4.5 Similar findings to those in the PA Report were also identified by the FCA’s Internal Audit Department which conducted a review of the “*design and rollout of the changes to the structure, supervision model and approach from January 2015 to September 2016*”.<sup>548</sup> The

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<sup>543</sup> *Ibid.*, at pages 1 and 2.

<sup>544</sup> Mr. Bailey became CEO on 1 July 2016 (see: <https://www.fca.org.uk/news/statements/tracey-mcdermott-leave-fca> (accessed on 23 November 2020)). His appointment was announced in January 2016 (see: <https://www.fca.org.uk/news/press-releases/andrew-bailey-appointed-new-chief-executive-fca> (accessed on 23 November 2020)).

<sup>545</sup> Interview with A. Bailey, 17 June 2020, at pages 6 and 7.

<sup>546</sup> Interview with A. Bailey, 4 August 2020, at page 26.

<sup>547</sup> Interview with M. Butler, 19 June 2020, at page 24.

<sup>548</sup> FCA: Internal Audit final report, The delivery of the FCA’s strategy by the Supervision Divisions, 21 February 2017, at page 2.



Internal Audit report was completed in February 2017 and identified four major findings<sup>549</sup> and two moderate findings.<sup>550</sup>

## 5. The FCA’s response to the PA Report and the Programmes

5.1 The DES programme was developed, with the Executive Directors of Supervision as co-sponsors, in response to, among other things, the draft mission<sup>551</sup> and the PA Report.<sup>552</sup> It was an ambitious undertaking, requiring substantial work by the FCA.<sup>553</sup> The Investigation has carefully reviewed all of the information provided to it in relation to the DES programme. This Report sets out briefly some features of the programme insofar as it was relevant to LCF. One Executive Director of Supervision and co-sponsor, in describing the programme overall, said: “*in my experience, we were effecting a very significant transformation in the structure, the governance, the systems, the processes, the risk frameworks, everything and that takes time and planning and it takes capability and culture change.*”<sup>554</sup> Similarly, Mr Bailey described the programme as addressing “*a very fundamental problem with the institution*”.<sup>555</sup> This reflects the Investigation’s understanding, based on its review, of why the DES programme was undertaken. The FCA has represented to the Investigation that its supervision of flexible firms during the Relevant Period, in particular LCF, was never inadequate, despite Mr Bailey’s comments to the contrary in respect of at least some of the

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<sup>549</sup> The report summarised these as: “1. *The strategic aims and objectives of the FCA or of the Supervision Divisions are partially set out in a number of different documents that are not linked to one another.* 2. *There is no Supervision Target Operating Model (TOM) setting out how the Supervision Divisions are to be structured, set up and resourced to deliver the FCA’s strategy.* 3. *Project and change management disciplines were not applied in delivering the changes to the supervision model, structure and approach in 2015.* 4. *The FCA does not have an organisation-wide or a Supervision-wide risk appetite linked to the risks to the achievement of the FCA’s strategic aims and objectives*” (see: *Ibid.*, at page 3).

<sup>550</sup> The report summarised these as: “5. *Improvements are required in the criteria used to determine the conduct classification of firms.* 6. *Accountability for decision-making in the Supervision Divisions, outside of the executive directors should be documented*” (see: *Ibid.*).

<sup>551</sup> On starting his role as CEO in July 2016, Mr. Bailey immediately determined that it was necessary for the FCA to prepare a mission statement that defined the FCA’s role and objectives (something he described as getting “*back to the real basics*”) (see: Interview with A. Bailey, 17 June 2020, at page 7). Work started on the “Mission” document in mid-July 2016 and the final document was published in April 2017 (see: <https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf> (accessed on 23 November 2020)).

<sup>552</sup> Presentation to the FCA Board: Delivering effective supervision, 1 November 2016, at page 2.

<sup>553</sup> The total cost of the DES programme, as at 26 November 2018, was forecasted to be £4.85 million (Delivering Effective Supervision Project Closure Report, 26 November 2018, at page 5).

<sup>554</sup> Interview with J. Davidson, 15 June 2020, at page 38.

<sup>555</sup> Interview with A. Bailey, 4 August 2020, at page 7.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

Relevant Period. The Investigation has not seen evidence of anyone within the FCA at the time asking why such a wide sweeping change, as that envisaged by the DES programme, would have been required, had the Supervision Division been performing adequately.

5.2 The overarching objective of the DES programme was described in an April 2017 Board paper as follows:

*“There has been considerable discussion about the purpose of conduct supervision. DES does not seek to answer this high level question, but rather build on the vision in the Mission and give supervisors a consistent framework to approach conduct supervision, putting the analysis of firms’ business models, and the resultant conduct risk this presents firms with, at the core of our approach. It also seeks to consistently embed the Mission’s intervention framework into our planning, prioritising and everyday supervisory decision-making, as well as improve how we gather intelligence on firms, anticipate issues and gain a better understanding of markets. As supervision requires cooperation with other regulatory functions, including Enforcement, Authorisations and Competition, to meet FCA objectives, DES also seeks to call out what is core to Supervisory interfaces with them and the standard they need to be delivered to.”<sup>556</sup>*

5.3 One key element of the DES programme for a firm such as LCF was the intention for “[a]ll firms (both Fixed and Flexible) [to be] subject to proactive supervision informed by annual sector/portfolio analysis and an aligned risk tolerance for crystallised risk”. The proactive supervision of flexible firms was described as follows in a November 2016 presentation to the Board:

*“The aim of proactive supervision is to identify potential risks for a firm, group or sector and take action before they have a serious impact...Proactive work will be agreed through the Supervision Operating Plans and will be a proactive, systematic but not continuous evaluation of sector based portfolios of firms. These flexible portfolios should be reviewed annually and a risk profile identified and agreed which will contribute to a plan to address these risks. Proactive supervision of flexible firms will be driven the both crystallised risk and probability of risk, prioritised against agreed risk tolerances. This will take the form of;*

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<sup>556</sup> ExCo Summary Paper: Delivering Effective Supervision, 27 April 2017, at page 2.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

*engagement/education; proactive thematic work; and, proactive and reactive multi-firm work focused on risks and issues across sector(s) or product(s). All firms will receive at least one ‘touch point’ from the FCA annually. As a minimum this will take the form of a Dear CEO type letter setting out the FCA’s expectations and activities for firms within a cluster, reflecting the cluster review and strategy. To minimise resource impact this will not seek a firm by firm response and any follow-up work will be captured in the first instance by the Contact Centre. In addition, flexible firms may also experience regulatory activity through the Contact Centre, conference invites, Reg Round-up, phone calls, inclusion in thematic or multi-firm work etc. To ensure that model is effective, focussed investment is required in delivering the data strategy. The House View process has exposed data need requirements across a number of sectors. The current lack of data and analytics, especially for the flexible firm population, limits risk identification and is a barrier to the delivery of effective supervision.”<sup>557</sup>*

5.4 An April 2017 update to the Board further explained the proactive supervision of flexible firms as:

*“This approach aims to make a behavioural switch from focusing solely on crystallised risks in our flexible firms to more proactive, preventative supervisory work to better address risk in the wider firm population. Supervisors of portfolios of flexible firms with common business models will use intelligence and industry data to evaluate the generic risks arising from these business models and to identify high risk outliers. Supervisors will then set a proactive supervisory strategy, including firm specific and multi-firm work, for their portfolio. Findings from this work will be communicated across the portfolio to ensure that flexible firms have a clear idea of what good looks like.”<sup>558</sup>*

5.5 Firms were previously split into seven business sectors but, pursuant to the DES programme, the sectors were to be further sub-divided into 43 portfolios of firms with similar business models. Within these portfolios, the risk created by the business models of the respective

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<sup>557</sup> Presentation to the FCA Board: Delivering effective supervision, 1 November 2016, at page 3.

<sup>558</sup> ExCo Summary Paper: Delivering Effective Supervision, 27 April 2017, at page 5.

firms were analysed with a view to having a data strategy for each portfolio to identify high risk firms which should be interrogated or investigated by Supervision.<sup>559</sup>

5.6 It was suggested to the Investigation that the identification of high risks firms in each portfolio (referred to by some FCA staff as “outliers”) would be a key outcome of the DES programme (i.e. so that the supervisor in charge of each portfolio knows where to target his/her attention).<sup>560</sup> The FCA’s 2017/2018 Business Plan described this as:

*“Supervision uses a consistent supervision model tailored to the risks presented by each firm: [...] For flexible-portfolio firms, we adapt our deployment of resources in response to the risks presented by the firms. Teams of supervisors are accountable for all the relevant risks of portfolios of similar firms. The teams use business model analysis and intelligence to identify emerging risks and high-risk outliers to prioritise proactive, reactive and sector-wide work”.*<sup>561</sup>

5.7 That policy appears to have been an ambition to be delivered as an outcome of DES programme rather than a strategy which was in place during the Relevant Period and, in any event, even if it were in place, it failed to identify the activities of LCF described elsewhere in this Report which raised numerous red flags.

## 6. Executive Committee and Board oversight of the DES programme

6.1 The need for the DES programme was said to have been shared with ExCo at all stages and there was extensive ExCo engagement, particularly in relation to governance, risk identification, escalation and the interfaces between Supervision and other areas within the FCA.<sup>562</sup> The two Executive Directors of Supervision (Ms Butler and Mr Davidson), both

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<sup>559</sup> FCA Regulatory Narrative Document, at page 26.

<sup>560</sup> Interview with J. Davidson, 15 June 2020, at page 11 “as a result of the PA report and our concerns, we launched a programme to improve both the data, data strategies around looking at different business models to identify what we called outliers”; Interview M. Butler, 19 June 2020, at pages 29 and 30 “[p]roactive supervision would mean we would not necessarily wait for any event. The business model analysis I think would be absolutely central to this as an approach which would mean... a much higher understanding of how firms make their money, how they use their regulated activity to make that money which of itself then would drive out outliers who may or may not be engaging in this conduct but at least would then be the subject of proactive supervisory work.”

<sup>561</sup> FCA Business Plan 2017/2018, April 2017, at page 81 (see: <https://www.fca.org.uk/publication/business-plans/business-plan-2017-18.pdf> (accessed on 23 November 2020)).

<sup>562</sup> Interview with M. Butler, 19 June 2020, at page 25; Interview with J. Davidson, 15 June 2020, at page 36.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

members of ExCo, were the sponsors of the DES programme and were, therefore, primarily accountable for the programme.<sup>563</sup> In addition, the cost of the programme had to be approved by the Executive Operations Committee and the Board.<sup>564</sup>

6.2 A Senior Adviser to the FCA commented that, at the time, cultural change was also required in order to change Supervision as the Division had been following the Pillar Two approach to supervising flexible firms (i.e. reactive supervision) since the time the FCA was formed. His explanation for the cultural change was: “*if you are told that your job is to wait for something to go wrong and then go in and investigate it, you are not going necessarily to be as curious as you might wish that you were...one of the challenges all of a sudden is “we want you to be more proactive” in a world where you would only ever be reactive.*”<sup>565</sup>

6.3 As the Senior Adviser had been brought in by Mr Bailey, it is assumed that the fact that cultural change was going to be required within Supervision was known to the CEO and ExCo.<sup>566</sup> Indeed, an email containing internal notes of the April 2017 Board meeting show that, during the discussion of the DES programme, one of the NEDs asked whether there would be an extensive communication plan and was told there would be as “[h]earts and minds and behavioural change is important as process”.<sup>567</sup>

6.4 As noted in Section 5 of this Chapter and in interview, the Board was regularly updated on the necessity for and progress of the DES programme. For example:

- (a) In November 2016, a paper was produced for a FCA Board Business Prioritisation Away Day (the “**Board Away Day**”) entitled “*Delivering Effective Supervision*”.<sup>568</sup> The paper provided a summary of the drivers for the DES

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<sup>563</sup> Delivering Effective Supervision, Project Closure Report, 26 November 2018, at page 2.

<sup>564</sup> Interview with J. Davidson, 15 June 2020, at page 37.

<sup>565</sup> Interview Transcript AE, at page 18.

<sup>566</sup> *Ibid.*, at pages 3 and 6.

<sup>567</sup> Email from a head of department in the Supervision Division, 5 May 2017, at 8:08am. In the Investigation’s experience terminology such as “*winning the hearts and minds of staff*” is often used when discussing cultural change within an organisation.

<sup>568</sup> Presentation to the FCA Board: Delivering effective supervision, 1 November 2016, at pages 1-3.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

programme and the key principles of the modified supervisory approach that would be delivered under the DES programme.

- (b) In April 2017, the Board was provided with an update on progress on the DES programme.<sup>569</sup> The Board was advised that the DES changes would be piloted from May 2017 with implementation and embedding from September 2017 to March 2018.<sup>570</sup>
- (c) A further update was provided to the Board in October 2017 which explained that the programme was moving from the design into the implementation phase and that implementation phase was due to complete in the third quarter of 2018.<sup>571</sup>
- (d) The CEO’s report to the Board in January 2018 explained that there had been a delay with the implementation of one element of the programme: “*the Risk Management workstream which will detail designs for changes to Risk Taxonomy and Labelling have not been completed in time to meet the deadline for the March [2018] Intact release due to a delay in finalizing business requirements*”.<sup>572</sup>

6.5 There is no doubt that ExCo and the Board knew that there were serious deficiencies in the FCA’s performance of its supervisory obligations in relation to flexible firms, such as LCF; from at least 2016, in the case of the Board, which had been told of the findings of the PA Report and the suggested need for the DES programme at the Board Away Day; and from at least late 2015 in the case of ExCo, when the newly appointed Directors of Supervision, both members of ExCo, had made their concerns clear about the existing supervision model, leading to the PA Report being commissioned later.<sup>573</sup> Of course, these deficiencies had been permitted to develop under the watch of ExCo and the oversight of the Board since 2014.

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<sup>569</sup> ExCo Summary Paper: Delivering Effective Supervision, 27 April 2017.

<sup>570</sup> *Ibid.*, at pages 6 and 7.

<sup>571</sup> Delivering Effective Supervision: Update for the FCA Board, 18 October 2017, at page 20.

<sup>572</sup> CEO Report to the FCA Board, 18 January 2018, at page 25.

<sup>573</sup> See above paragraphs 4.2 and 4.3 of this Chapter.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

6.6 The Executive Directors of Supervision were united in telling the Investigation that the DES programme could not have been delivered more quickly because of its scale.<sup>574</sup> The FCA has made similar representations to the Investigation. Mr Bailey suggested that it was unrealistic to think that the FCA could have done it more rapidly given the “*other very big things [to do] at this time*”.<sup>575</sup>

6.7 The Investigation has nonetheless concluded that the Board was unjustifiably relaxed in its oversight of the timing and delivery of the DES programme relating to the supervision of flexible portfolio firms.<sup>576</sup> This finding has been disputed and challenged extensively in representations, indeed it has been suggested that there is no evidence to support such a conclusion. However, after careful further consideration and review of the documents, this remains the view of the Investigation for reasons which include the following:

- (a) The considerable deficiencies in the supervision of flexible firms identified by an audit in 2015 and the PA Report with the resulting need for the expansive DES programme were made known to the Board in November 2016 at the Board Away Day.<sup>577</sup>
- (b) The delivery date for the DES programme changed from March 2018 to June 2018 to September 2018 and was eventually delivered to “Business As Usual (“BAU”) (i.e. transitioning from the DES programme to ordinary day-to-day management of Supervision) in December 2018.<sup>578</sup> Initial timelines shown in early DES

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<sup>574</sup> Interview with M. Butler, 6 August 2020.

<sup>575</sup> Interview with A. Bailey, 28 August 2020, at page 32.

<sup>576</sup> The Investigation has not considered any aspects of the DES programme that were focused on fixed portfolio firms.

<sup>577</sup> The background to the need for the DES programme was explained to the Board at an “Away Day” in November 2016. In a paper titled “*Delivering Effective Supervision*” dated 1 November 2016 (which it is assumed was produced to the Board) it was recognised that “*the current model is still developing and many elements are working well. However, in parts (particularly for Flexible Supervision) the model could be further modified and improved.*” The proposed modifications were said to reflect the PA Report and the Group Audit as well as the draft mission and experience of FCA supervisors. The Investigation finds that anyone being made aware of the findings of the PA Report and Audit could not avoid the conclusion that there was inadequate supervision of flexible firms at the time.

<sup>578</sup> *Ibid.*, at page 8. In the paper, ExCo was advised that the delivery date for the DES programme was intended to be March 2018 as seen on page 8 which states the intention to “*roll out the approach across each individual supervision department and embed ways of working and behavioural changes*” and also to “[e]mbed and make changes to systems by March 2018”. ExCo was also informed that there would not be a “*big bang*” approach to implementation, rather that they “*will steadily need to pilot and iteratively implement changes over the next year to ensure we are winning the “hearts and minds” of*

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

programme documents show that delivery of the DES programme was initially projected to be completed in March 2018.<sup>579</sup> An Executive Operations Committee (“EOC”)<sup>580</sup> paper produced in December 2017 raised the risk that the Risk Management workstream of the DES programme was likely to be delayed and would “not deliver systems changes in March 2018” but “would need to align to the next system release date of June 2018”. The DES Business Case document proposed June 2018 as the expected date for closure of the DES programme, with no explanation of why the March 2018 date had been varied<sup>581</sup>. The intended closure date given in the closure report for the DES programme reflected the June 2018 date in the business case and outlined how the project was delayed by five months, following two change requests, from June 2018 to September 2018 and then from September 2018 to end of November 2018.<sup>582</sup> At no time during these repeated delays in delivery does there appear to have been any challenge recorded in either the ExCo or Board Minutes in relation to the cause or necessity of the delays, or questioning whether delivery of the programme could be accelerated.

- (c) In the February 2018 Board Minutes it was noted that the DES programme was reporting red (i.e. it was going to miss the planned completion date) and that “the Board was keen that this be resolved as soon as possible”.<sup>583</sup> The Investigation considers that response to be insufficiently forceful given the seriousness of the deficiencies in the supervision of flexible firms. That view is reinforced by that fact the delivery and timing of the DES programme does not appear to have been

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*supervisors*” (page 8). There is no record in the minutes the Investigation has seen of any ExCo or Board member challenging whether that was timely enough.

<sup>579</sup> ExCo Summary Paper: Delivering Effective Supervision, 27 April 2018, at page 8; FCA Presentation – DES Summary of Changes / DES High Level Plan, 13 June 2017, at page 2; Delivering Effective Supervision – Business Case, 10 July 2017, at page 26.

<sup>580</sup> The EOC is described on the FCA website as being “responsible for monitoring the FCA’s economic and efficient use of resources, internal risk management, people strategy and culture and operating platform and resilience” (see: <https://www.fca.org.uk/about/executive-committees> (accessed on 22 November 2020)).

<sup>581</sup> Delivering Effective Supervision – Business Case, at page 26.

<sup>582</sup> Delivering Effective Supervision, Project Closure Report, 26 November 2018, at pages 17-18 & 20-21.

<sup>583</sup> Minutes of FCA Board Meeting, 21-22 February 2018, at paragraph 9.1 (see: <https://www.fca.org.uk/publication/minutes/minutes-fca-board-21-and-22-february-2018.pdf> (accessed on 23 November 2020)).



raised before the Board again until the closure report came before it in December 2018. Given the importance of the programme, the Investigation would have expected to see the Board demanding regular updates on progress and delivery from at least that point onwards.<sup>584</sup>

(d) The Investigation was told that no concerns were raised by the Board as to the timeline for the DES programme.<sup>585</sup> From the Investigation’s review of Board minutes, other than referenced above, that appears to be correct.

6.8 The former Chairman of the FCA, until April 2018, said that the Board did have concerns regarding the timeline for the DES programme but would have been told by the Executive Directors that it was progressing as fast as possible and progress was being made.<sup>586</sup> He also observed that “*each time that [Ms Butler or Mr Davidson] came to the Board, we had the impression this was difficult.*”<sup>587</sup>

6.9 While it is not disputed that ExCo and the Board no doubt wanted the DES programme to be completed promptly, the Investigation has not seen any evidence that the Executive Directors’ statements on timing were ever seriously tested or challenged by the Board.

6.10 The Investigation concludes that the timing for delivery of the DES programme was not sufficiently challenged or tested and that the programme was not driven forward on a sufficiently expedited basis by either ExCo or the Board, given the underlying need for it to be undertaken, i.e. in order to ensure effective supervision of the flexible portfolio.

6.11 Given the seriousness of the deficiencies in the FCA’s supervisory function, which meant there was no adequate proactive supervision of almost 50,000 flexible firms for a period of at least four years, the Investigation concludes the Board and ExCo should have been pressing management at every turn for the fastest possible delivery of the DES programme

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<sup>584</sup> The Investigation further notes that one, or in most cases both, of Mr Davidson and Ms Butler were stated to be present at virtually every board meeting between from the inception of the DES programme until its closure and therefore would have been available to the Board to provide an update, if requested.

<sup>585</sup> Interview with M. Butler, 6 August 2020, at page 13.

<sup>586</sup> Interview with J. Griffith-Jones, 10 September 2020, at page 18.

<sup>587</sup> *Ibid.*, at page 16.

and challenging the timelines, particularly when they slipped. Neither the Board nor ExCo appear to have done this based on the information reviewed by the Investigation.

6.12 Three years from identification of the serious deficiencies in supervision until closure of the DES programme in November 2018<sup>588</sup> was too long for the delivery of the necessary changes in all the circumstances and given the potential for harm to be caused to consumers.

## 7. Closure of the DES programme and outstanding issues

7.1 A closure paper for the DES programme was produced in November 2018 by the Project Manager for the Executive Directors of Supervision (as sponsors of the programme) and the Project Board. While noting that the programme had been delivered five months late, the report stated that the DES programme had delivered all major deliverables with the exception of Single View of a Firm and some elements of risk tolerance.

7.2 The closure report also noted that, as is often the case in change programmes, delivery into BAU of the key deliverables meant a handover from the project team to the Supervision Division, not that all the changes were yet operating effectively. Accordingly, closure of the DES programme was to be followed throughout 2019 by work within the Supervision Division on “[e]mbedding, monitoring, improving and reporting on DES deliverables”.<sup>589</sup> This additional activity was to take place throughout 2019 (i.e. after the Relevant Period) and so has not been reviewed.

7.3 A Senior Advisor, who was brought into the FCA by the CEO in 2016 to assist in the review of supervision, noted the complexity of supervising the flexible portfolio and said in September 2020 that there had been a great deal of progress but there is still “*a great deal left to do*”.<sup>590</sup>

7.4 The Investigation was informed that certain work identified as necessary to ensure effective supervision of the flexible firms is not yet complete, including: certain aspects of the operation of the FCA’s technology systems; developing the data strategies for the portfolios

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<sup>588</sup> Delivering Effective Supervision, Project Closure Report, 26 November 2018.

<sup>589</sup> *Ibid.* at page 25.

<sup>590</sup> Interview Transcript AE, at page 7.

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

which were said to be central to the revised strategy for effective supervision;<sup>591</sup> the provision of Management Information (“MI”); and the addition of quality assurance and capability building, all of which are still ongoing.<sup>592</sup>

7.5 Worryingly, the Investigation was informed in September 2020 that the portfolio assessment required by the Portfolio Assessment Model (“PAM”) (an element of the DES programme and a key part of identifying “*high-risk outliers*”) for the Corporate Finance portfolio of firms (now re-named as Wholesale-Other), i.e. the portfolio to which LCF was assigned under the DES programme in 2017<sup>593</sup>, was not yet complete, despite having begun in June 2018, because of “*the additional time required to carry out a thorough analysis of a group of firms with a relatively high level of variation between and complexity within their business models*”.<sup>594</sup> Given that this approach was said by the Executive Directors of Supervision to be at the heart of the model for effective supervision of the flexible portfolio as a result of the DES programme,<sup>595</sup> it should be a matter of concern for the FCA that this was apparently still not the case.<sup>596</sup>

7.6 The Investigation has been told about how the FCA’s supervision efforts were hampered initially by the multiplicity of the IT systems it was using (including in relation to the provision of documents to the Investigation). Yet, while progress has been made in rolling out and enhancing the functionality of the FCA’s INTACT system (which is primarily used for case management), it appears that even today, the FCA still does not “*have a system*

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<sup>591</sup> Interview with J. Davidson 28 August 2020, at pages 20-22. Further at page 49, Mr Davidson said “...and we believed that by moving towards... clearer accountabilities, portfolio supervision, changing all of the technology and process and systems and data and analytics, we could make it a lot better.”

<sup>592</sup> Interview J. Davidson, 15 June 2020, at page 30; Interview J. Davidson, 28 August 2020, at page 22.

<sup>593</sup> After the evidence gathering stage of the investigation had closed, the FCA informed the Investigation that LCF may not have been in the corporate finance portfolio in the light of the creation of a supervisory team specifically focused on firms issuing mini-bonds (albeit, as explained in **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks)). At that late stage, the Investigation has not re-visited this issue. The point nevertheless remains that the FCA did not seem to have up-to-date information on the risk assessment for the portfolios. This “risk taxonomy” was said to be a key part of the DES programme and it appears that this had not been completed by August 2020.

<sup>594</sup> FCA Clarification to earlier Response of Request 80 made by the Investigation.

<sup>595</sup> Interview J. Davidson, 28 August 2020, at page 19.

<sup>596</sup> FCA Clarification to earlier Response of Request 80 made by the Investigation.

where all information is available in one place”.<sup>597</sup> The lack of a cohesive IT system where information is appropriately cross-referenced is illustrated in the case of LCF by two examples:

- (a) During the Relevant Period, the FCA failed to identify that an individual associated with LCF (“**Individual X**”) had been connected with two other authorised firms (“**Firm A**”<sup>598</sup> and “**Firm B**”<sup>599</sup>), both of which had been investigated by the FCA previously. The Investigation asked the FCA whether Individual X’s involvement with Firm A and Firm B should have triggered a review by the FCA. In response, the FCA admitted that “[t]here were insufficiently clear policies in relation to the circumstances in which information on individuals who were not the subject of a formal investigation should be logged in the FCA’s central intelligence system”.<sup>600</sup> The FCA stated that information about Individual X was not logged in its central intelligence system. The FCA recognised that, had this happened, it “could have given rise to further assessment of LCF’s activities” “when LCF was granted its credit broking limited permission... or subsequently its corporate finance permission...”.<sup>601</sup>
- (b) The FCA also admitted that, as a result of an error in updating the FCA’s IT Systems, when LCF was granted its corporate finance permission, it was not re-assigned to the correct supervision team. That team had been carrying out some

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<sup>597</sup> Interview with M. Butler, 6 August 2020, at page 14.

<sup>598</sup> The FCA investigated Firm A during 2014-15. An FCA report dated 5 June 2015 identified concerns as to (i) the appropriateness of the investments in unlisted companies which Firm A was promoting to investors; (ii) the way in which investors in Firm A self-certificated themselves as high net worth or sophisticated (as required by COBS 4.7.7); and (iii) conflicts of interest resulting from Individual X (who was described in the report as a CF30 and de facto compliance officer for Firm A) being connected with two of the companies being promoted as, variously, promoter, shareholder and/or office holder.

<sup>599</sup> The FCA investigated Firm B during 2016-17. An internal FCA draft memorandum dated April 2017 stated that “[Firm B] is essentially “phoenix” of [Firm A]”, operating from the same building as Firm A, undertaking the same type of business and employing individuals who had previously worked for Firm A. These individuals included Individual X who was the compliance officer and Money Laundering Reporting Officer for Firm B and also a consultant to two of Firm B’s clients. Other concerns regarding Firm B included allegations of cold calling in breach of COBS 4.8 and that Firm B might not be complying with COBS 4.7.7 (which imposes restrictions on a firm communicating financial promotions relating to non-readily realisable securities to retail clients).

<sup>600</sup> FCA’s response to the Investigation’s information request (LCF\_NOV\_006).

<sup>601</sup> FCA’s response to the Investigation’s information request (LCF\_NOV\_006).

casework on Firm B and had identified the links between Firm B and Firm A. Therefore, and by the FCA’s own admission, “*a review of LCF’s links with [Firm A] and [Firm B] could have been triggered had cases on LCF... been correctly referred to this team rather than the consumer credit team*”.<sup>602</sup>

7.7 This is a clear example of where, if the FCA had had access in one place to the relevant information it already possessed, it would have been in a better position appropriately to assess the risks presented by LCF.

7.8 In a letter to the Investigation in September 2020, Mr Bailey said that the question of the effectiveness of the FCA given the scale and scope of its responsibilities (a point about which he was asked during interview) would be best undertaken “*as the FCA approaches the completion of its transformation programme, with a view to answering the question [of effectiveness] in the light of the changes both in the implementation of DES and DEA and as they are being further developed and rolled out*”.<sup>603</sup> That broader question is outside the remit of the Investigation, which must focus on the effectiveness of the FCA in the context of LCF during the Relevant Period. As set out in this Report, the FCA did not discharge its functions in respect of LCF in a manner which enabled it effectively to fulfil its statutory objectives.

## **8. Insufficient consideration of interim measures or a look back**

8.1 The Investigation concludes that, in view of the known serious deficiencies in the supervision process, which the CEO described as “*wholly inadequate*”,<sup>604</sup> ExCo, the Board and Senior Management could and should have done more to identify any interim steps which could have been taken, quick wins, reviews or easy fixes (collectively described as “*interim measures*”) in order to reduce the possibility of harm arising to consumers.

8.2 The Investigation concludes that consideration of interim measures should have been ongoing throughout the Relevant Period. It should have been apparent from the transfer of responsibility for the OFT Firms to the FCA that there was no adequate strategy in place to

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<sup>602</sup> FCA’s response to the Investigation’s information request (LCF\_NOV\_006).

<sup>603</sup> Letter from A. Bailey to Dame Elizabeth, 15 September 2020, at page 1.

<sup>604</sup> Interview with A. Bailey, 4 August 2020, at page 26.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

fulfil the FCA’s statutory functions in respect of supervision of a firm such as LCF and that interim measures were required.

- 8.3 It was particularly the case that interim measures should have been considered in more detail when Senior Management, ExCo and the Board respectively realised or were informed that the DES programme was necessary to ensure effective supervision and that it would take at least two years from mid-2016 to be delivered. Even then the DES programme would have to be embedded, taking at least a further year. In fact, delivery of the DES programme was delayed by almost six months and interim measures should again have been considered when the delay became known.<sup>605</sup>
- 8.4 In its representations, the FCA suggested that interim measures had in fact been considered in relation to the identified deficiencies that the DES programme was designed to address and that a number of interim measures were put in place. During interviews, there was not a consensus on whether interim measures were considered, implemented, or even feasible. A number of interviewees<sup>606</sup> and the FCA in its representations, referred to the changes brought in by the phased implementation of the DES programme as examples of interim measures. The Investigation did not see any, or any sufficient, evidence of there having been innovative or comprehensive consideration of what might be done to ameliorate the issues with ongoing supervision, whilst the longer-term change targeted by the DES programme was being pursued, for example, ExCo or the Board seeking a report from the project team or directing such work to be done. Senior Management suggested in interview that they did what they could and it would not have been possible to do more.<sup>607</sup>
- 8.5 In its representations, the FCA drew attention to other measures designed to improve its supervisory model, which it described as “*interim steps*”. Included in these measures was the introduction of new policies and procedures in relation to whistleblowing in November

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<sup>605</sup> Delivering Effective Supervision, Project Closure Report, 26 November 2018, at page 5.

<sup>606</sup> Interview with A. Bailey, 17 June 2020, at page 8; Interview with A. Bailey, 4 August 2020, at page 31; Interview with A. Bailey, 18 August 2020, at page 37; Interview with J. Griffith-Jones, 10 September 2020, at pages 25 and 26; Interview Transcript AE, at page 20; Interview with J. Davidson, 15 June 2020, at pages 60 and 61.

<sup>607</sup> Interview with M. Butler, 6 August 2020, at page 18; Interview with J. Davidson, 15 June 2020, at pages 63 to 65; Interview with J. Davidson 28 August 2020; at pages 14 to 15; Interview with A Bailey 28 August 2020, at pages 37 and 38.

2017, which is covered at paragraphs 8.21 to 8.23 of this Chapter. However, the other measures referred to by the FCA appear to be extraneous to the DES programme and irrelevant to the question of appropriate interim measures being considered or implemented. In its representations, the FCA referred to the following as interim steps:

- (a) *The 2016 Enforcement and Market Oversight Review (the “EMO Review”).* This review was in fact commissioned “[f]urther to the recommendations of HM Treasury’s Review of enforcement decision-making at the financial services regulators, published in December 2014, and those of Andrew Green QC’s Report into the FSA’s enforcement actions following the failure of HBOS, published in November 2015”.<sup>608</sup> The EMO Review itself had no link to the DES programme or the related issues but in May 2017, as part of the implementation of the EMO Review, a joint project was launched (the “**EMO Project**”) between Supervision and Enforcement to improve “ways of working together”.<sup>609</sup> However, it is clear that the EMO Review was not intended as an interim step to the DES programme and it was intended “that the two initiatives complement each other”.<sup>610</sup> The work from this project was stated to be “embedding at the same time as the Delivering Effective Supervision (DES) work”<sup>611</sup> and roll-out of the new operating model designed by the EMO Review was intended to be January – March 2018.<sup>612</sup>
- (b) *The gathering of data on over 2,000 firms in December 2016 following the introduction of new financial crime reporting obligations.* These reporting obligations were not linked to interim measures in Supervision but rather were brought about by new anti-money laundering legislation passed in 2017.<sup>613</sup>

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<sup>608</sup> ExCo Paper – Supervision & Enforcement: Working Better Together, 13 December 2017, at page 3

<sup>609</sup> *Ibid.*

<sup>610</sup> *Ibid.*, at page 8.

<sup>611</sup> *Ibid.*, at page 11.

<sup>612</sup> *Ibid.*, at page 13.

<sup>613</sup> The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (SI 2017/692).

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

- (c) *The reorganisation of the FCA’s Specialist Directorate to better support both Supervision Divisions.* The Investigation found no evidence of this being discussed as an interim step to further changes in Supervision and this was not mentioned at interview by any interviewee or in response to the Investigation’s requests for documents.
- (d) *The implementation of the financial promotions protocol for NRRS (such as mini-bonds)<sup>614</sup> and other types of pooled investment in October 2017.* Again, the Investigation found no evidence of this being discussed as an interim step to further changes in Supervision and it appears that the protocol was the product of a separate review carried about by the SIWS RiskCo.<sup>615</sup>

8.6 The Investigation did not consider, and therefore makes no comment on, whether the above measures had the effect of making positive changes to supervision process within the FCA. However, it is clear that each of the above were distinct projects, independent of each other, and not implemented as part of interim steps to mitigate the issues which led to the DES programme.

8.7 The Investigation believes that within the FCA there may have been too great a focus placed on the delivery of the DES programme, which was to take a minimum of two years, rather than on interim measures. While the Investigation accepts there was work done on a rolling basis towards the delivery of the DES programme from late 2016, it should have been appreciated that the structure and design of the programme meant that there would not have been sufficient change in the way flexible firms, such as LCF, would be supervised until the DES programme was delivered and the portfolio risk assessment approach was embedded and operationally effective, the latter stage coming only after closure of the programme in 2018.

8.8 The Investigation saw no evidence of the Board urging ExCo or Senior Management to consider what interim measures could be taken, or asking whether any form of look back

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<sup>614</sup> The rules introduced by the FCA in 2014 in relation to NRRS are discussed in more detail in **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks).

<sup>615</sup> SWIS RiskCo Summary Paper - Supervisory Strategy For The Distribution Of Mini-Bonds (And Other Non-Standard Investments) To Retail Consumers, 26 July 2017.



*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

should, or could, be undertaken into whether firms might have slipped under the radar when no effective model of proactive supervision was in place. The Board and ExCo members should have had among them sufficient experience of change programmes to know that they should have been pressing management to identify any possible interim measures as short term solutions to mitigate the position rather than leaving the supervision of small firms as inadequate until the DES programme was delivered.

- 8.9 Although the Investigation has not carried out any analysis as to the effectiveness or resources implications of any specific interim measures, the Investigation suggested examples in interview of possible interim measures which the FCA might have considered and which the FCA was likely to have seen employed by some of the firms it supervises to address identified lacunae.

*Training*

- 8.10 The Investigation suggested intensive training could have been provided to staff to help improve their deficient skills and change their cultural approach, possibly through external training providers.
- 8.11 It was suggested in response that the staffing issues were initially only identified as being high turnover and lack of experience. It was said to be only much later in the DES programme, probably the end of 2017, that the FCA identified there was a wider issue of capabilities which would need to be addressed separately to the DES programme. Only at that stage it was said that a syllabus to train people how to look at things and improve their capabilities be put in place. When this issue became apparent, a quality assurance programme was said to have been put in place to assure the work of individuals through sampling.<sup>616</sup>
- 8.12 The Investigation concludes that the issue of capabilities should have been identified and addressed sooner and, if the FCA was unable to do so, they should have considered engaging external consultants to assess capabilities and deliver intensive training where required.

*External resource*

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<sup>616</sup> Interview J. Davidson, 29 August 2020, at page 20.

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

8.13 The Investigation also suggested that the FCA could have hired additional external resource, or consultants, on an interim basis with a greater understanding of the business risk presented by the small firms or what their financial information disclosed.

*Look back/review*

8.14 A look back or review of the flexible firms could have been carried out on a sample basis using a simple form of data analytics to permit the FCA get some idea of whether the lack of adequate supervision for small firms since 2014 had allowed outliers to slip through the net. The Investigation accepts that this approach would not necessarily have identified LCF, but it would at least have made the FCA better informed about what harm had flowed from its lack of adequate supervision and possibly able to take some proactive steps to respond to what it found.

*Use of data analytics*

8.15 The data which was available to the FCA, imperfect though it was said to be, could have been interrogated searching for cumulative criteria to provide informed sampling and targeted supervisory work. The Investigation suggested possible identifying criteria for any problem firms or outliers. These included:

- (a) firms that have repeat interactions with the Financial Promotions Team over a set period of time;
- (b) firms where the Customer Contact Centre has received repeated calls from consumers but which file regulatory returns showing zero (or limited) revenue from regulated activity; and
- (c) firms offering products which have been identified by the FCA as high risk.

8.16 While not all of these questions might have thrown up positive hits for LCF, and it might not have been identified at all, such action would have given the FCA a materially better chance of identifying it or other outlier firms like it. The type of data analytics exercise described would not, in the Investigation’s view, have been particularly resource intensive, although the review of the results would have to be done by appropriately qualified personnel. The Investigation of course accepts that it has not carried out any time and cost analysis in reaching such a view, but, nevertheless, believes it to be reasonable.

Chapter 8: The “Delivering Effective Supervision” and  
“Delivering Effective Authorisations” Programmes

- 8.17 Mr Davidson agreed that the use of data analytics was an aim of the FCA but suggested two reasons why that couldn't happen. The first was *“the fundamental challenge was the way that interventions, if you like the Fin Proms or contact centre calls, were recorded on INTACT was inconsistent across every department and, indeed, the whole way that it was done for large firms versus small firms was very different. All the tagging had to be standardised and that took a lot of time and even then, implementing it took a lot of time.”*<sup>617</sup>
- 8.18 The Investigation accepts there were considerable imperfections in the FCA's data and IT systems, but the FCA eventually managed to produce much of the information from its systems for the Investigation, even though those systems are not yet fully operative. The fact that the exercise would have been difficult and possibly produce imperfect results should not, without greater reason, have prevented it being tried. The Investigation saw no evidence that the possibility of this approach was considered and analysed during the Relevant Period.
- 8.19 Mr Davidson suggested that addressing the challenges of his first point would only get you *“to square one”*. In his second point he suggested that there was no means of taking data about volumes of cases and generating alerts without migrating the data into a data lake and building a decision-making hub IT system to scan the data with pre-agreed business rules.<sup>618</sup> He suggested this was because of the weaknesses in the Contact Centre and the weaknesses in the escalation procedures. It was also suggested that in order to achieve these sort of outcomes, all the data had to be migrated into a data lake and then a *“decision making hub”* to scan the data with pre-agreed business rules. This might be a good long term solution, but this would not have precluded the tactical review suggested by the Investigation as an interim measure, i.e. carrying out the data analytics, and then hiring some specialised resource outside the Contact Centre for a short period of time to review the results. In the context of

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<sup>617</sup> Interview with J. Davidson, 29 August 2020, at pages 21 to 22.

<sup>618</sup> Interview with J. Davidson, 28 August 2020, at page 22. In particular, Mr Davidson said: *“but that, in a sense, gets you to sort of square one. We do have a system, and if I just take the contact centre one, in the contact centre, there is a system ...where they're supposed to assess the risk. And they say, 'Well, this one looks, in a sense – there is a risk of misconduct and harm here. Let's escalate it to supervision.' Yes? And in theory you would like to know...are there lots and lots that haven't been escalated? Doesn't that tell you something?”* Mr Davidson went on to explain that *“... there was no means and there still is no means to do that properly; to do that in a way where it's taking that information and running decision rules like, 'If we've had five of these, let's develop an alert.' .... And in order to do what we want to do, we first had to migrate all of our data into a thing that's called the data lake,... an IT system which will scan that data with pre-agreed business rules like the ones you mentioned, and will generate alerts for someone to go and look at it, if that makes sense. We still haven't been able to fully implement that because of constraints over technology investment.”*

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

the FCA’s expenditure on the DES and DEA Programmes,<sup>619</sup> this targeted one-off exercise, in the Investigation’s view, could have been done relatively cheaply.

8.20 The Investigation concludes that, even given known data limitations and multiplicity of the IT systems, ExCo, the Board and Senior Management could, and should, have considered a look back or review through sampling, guided by data analytics, of any small firms which might have slipped through the net when no effective model of proactive supervision was in place. It is, of course, accepted by the Investigation that this would not necessarily have identified LCF.

8.21 The Investigation also notes that the FCA announced a revised data strategy in January 2020 (i.e. outside the Relevant Period).<sup>620</sup> This strategy refers to the importance of using the FCA’s “*data and advanced analytics to transform the way [the FCA regulates and reduces] the burden on firms*”. The Investigation has not considered this data strategy in detail but notes that the FCA has previously (including before the Relevant Period) identified the importance of analysing existing intelligence and data for the purposes of effective regulation.<sup>621</sup>

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<sup>619</sup> The total cost of the DES programme, as at 26 November 2018, was forecasted to be £4.85 million (Delivering Effective Supervision Project Closure Report, 26 November 2018, at page 5).

<sup>620</sup> See: <https://www.fca.org.uk/publications/corporate-documents/data-strategy> (accessed on 23 November 2020).

<sup>621</sup> E.g. a 2012 document describing the transition from the FSA to the FCA noted that Pillar Three supervision would “*use data analysis, market intelligence and input from the firm assessment process...*” (Journey to the FCA, October 2012, at page 27: <https://www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf> (accessed on 23 November 2020)).

### Whistleblowing

- 8.22 One area in which the FCA did put in place a quick fix was whistleblowing and the management of whistleblowing information.<sup>622</sup> This area was described as “*high-risk*”, with Senior Management at the FCA unable to track the number of whistleblowing cases or any progress made in these cases.<sup>623</sup> A system was put into place on INTACT which addressed these issues and allowed Senior Management to review whistleblowing cases and prevented FCA employees from being able to close whistleblowing cases with no further action, without sign-off from the head of department.<sup>624</sup>
- 8.23 The Investigation notes the FCA had focused in its 2016/2017 Business Plan for the firms it regulated on whistleblowing and this might have encouraged the acceleration of adequate whistleblowing procedures being put in place internally.<sup>625</sup>
- 8.24 The Executive Directors referred to other interim steps and tactical fixes which they had put in place during the Relevant Period and to resource constraints which prevented them doing more.<sup>626</sup> The Investigation has nevertheless concluded that more should have been done in the interim before the DES programme was delivered given the extreme seriousness of the situation in supervision.

## 9. Delivering Effective Authorisations

- 9.1 The DEA programme focused on improving the authorisation process generally and, to a degree, improving the experience for firms being authorised.<sup>627</sup> The Investigation did not review the DEA programme in the same detail as the DES programme because: (i) the DEA

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<sup>622</sup> The FCA’s policies in relation to whistleblowing are discussed in further detail in **Chapter 12** (Information provided by third parties).

<sup>623</sup> Interview with J. Davidson, 15 June 2020, at page 36.

<sup>624</sup> *Ibid.*, page 37.

<sup>625</sup> FCA Business Plan 2016/17, 1 April 2016, at pages 34 and 35 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2016-17.pdf> (accessed on 23 November 2020)).

<sup>626</sup> Ms Butler said one of the tactical steps that was taken was to put in place a change of operating model between Financial Promotions and the Supervision Division without waiting for the whole process to restructure (Interview with M. Butler, 19 June 2020, at page 26).

<sup>627</sup> Delivering Effective Authorisations: Strategic Framework – ExCo Annex, May 2017, at page 8.

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

programme had advanced less far during the Relevant Period; and (ii) the DEA programme did not, in any event, affect the FCA’s authorisation processes in respect of LCF.<sup>628</sup>

9.2 The Programmes shared the same operating model approach and certain workstreams but had different overall aims which were to be delivered through separate but coordinated projects.<sup>629</sup> The DEA programme constituted one tranche of the FCA’s vision and strategic ambition for the Authorisations Division and was designed to improve the authorisation process, in alignment with the FCA Mission<sup>630</sup>. The ExCo sponsor for the DEA programme was Mr Davidson.<sup>631</sup>

9.3 At its outset, the DEA Foundation Project in 2016 was approved by the EOC, with its deliverables scheduled for 2017.<sup>632</sup> An extensive paper was prepared for ExCo describing the overall vision of DEA as “[adding] *public value by enhancing trust in markets and improving how they operate through a consistent transparent and proportionate approach to authorising firms and individuals and responding to firm and consumer contacts*”.<sup>633</sup>

9.4 In its proposals in May 2017, the FCA set out its aims for the DEA programme. The two aims which were of most relevance to the LCF’s case were: (i) the FCA’s aims first for the wider UK economy that “[b]y *improving trust in the process used by Authorisations, firms and consumers can have greater confidence that financial services firms have met certain standards, hence reducing the risks and therefore costs of doing business*”; and (ii) to engender “[t]rust that we are ensuring that the firms we regulate prudentially have sufficient

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<sup>628</sup> In particular, the DEA Transformation Programme was only approved on 22 May 2017 (see paragraph 9.8 of this Chapter) and as such was approved too late to affect materially or at all the authorisation of LCF during either the Initial Authorisation Application (as defined and summarised in Section 2 of **Chapter 3** (Key events in the FCA’s regulation of LCF)) or the First VOP Application (as defined in Section 3 of **Chapter 1** (Introduction and background) and summarised in Section 2 of **Chapter 3** (Key events in the FCA’s regulation of LCF)). The Second VOP Application (as defined in Section 3 of **Chapter 2** (Executive Summary) and summarised in Section 2 of **Chapter 3** (Key events in the FCA’s regulation of LCF)) started on 10 September 2018 but stalled when the FCA’s Intelligence Team identified adverse intelligence regarding LCF and related individuals in mid-October 2018. However, as already explained in **Chapter 3** (Key events in the FCA’s regulation of LCF), even during the Second VOP Application, the FCA raised no concerns regarding LCF’s business demonstrating that the DEA programme did not materially affect this authorisation process either.

<sup>629</sup> *Ibid.*, at page 8.

<sup>630</sup> *Ibid.*, at page 1.

<sup>631</sup> ExCo Paper, Delivering Effective Authorisations – Strategic Approach, 22 May 2017, at page 1.

<sup>632</sup> Delivering Effective Authorisations (DEA) Transformation, 7 June 2017, at page 1.

<sup>633</sup> Delivering Effective Authorisations Strategic Approach, 22 May 2017, at page 1.

Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes

*capital reduces the due diligence that market participants need to undertake*”. In relation to consumers, the DEA programme aimed to ensure “[r]obust authorisations decisions [which] assures consumers that providers must meet a common set of rules and standards and users are confident that criminals and those not qualified are kept out of the markets” and that “consumers are able to easily check if a firm is authorized and can call the contact centre for advise (sic) about whether a firm is regulated”.<sup>634</sup>

- 9.5 Recognition was made in the paper supporting the DEA programme of better interfaces being desirable between the departments within the FCA including “[i]mproved engagement between Authorisations and Supervision teams & (sic) clarity on respective roles in the “System of Supervision” [and] [m]uch greater sharing of information and insight and collaborative working”.<sup>635</sup>
- 9.6 Further aims of the DEA programme related to the interactions of the Authorisations Division with other departments at the FCA and targeted “*closer engagement between Authorisations and enforcement legal when refusing an application... [and] [m]uch greater sharing of information, intelligence and insight-both ways. Ensuring Authorisations is fully supported in its role and contributes to the FCA’s intelligence picture of the UK [financial services] industry... [and] [m]ore joined up approach to publishing information on the register.*”<sup>636</sup>
- 9.7 The Investigation notes that the FCA’s aim for the DEA programme referred to in paragraph 9.4 above suggests that many of the issues, which arose in relation to the interaction (or the lack thereof) between the various departments within the FCA and were relevant in the regulation of LCF throughout the Relevant Period, were recognised by the FCA as issues which needed to be addressed and that had been drawn to the attention of ExCo by May 2017.

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<sup>634</sup> *Ibid.*, at page 9.

<sup>635</sup> *Ibid.*, at page 10.

<sup>636</sup> *Ibid.*

*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

9.8 At the ExCo meeting on 22 May 2017, the DEA programme was granted approval to proceed.<sup>637</sup> Discussion at the meeting noted that the aim was to move to a more service-focused approach to ensure the authorisation process was adaptive, transparent, timely and consistent which would require a degree of culture change. Improving the transition between Authorisations and Supervision was also specifically discussed by ExCo, to be taken forward through a DES Steering Group, which may have been relevant to LCF if such a change was delivered during the Relevant Period.

9.9 A further paper was provided to the EOC on 7 June 2017 seeking approval for the costs of the programme, which was granted.<sup>638</sup> On 11 December 2018 the DEA programme came back before the EOC.<sup>639</sup> At that stage it was reported that the DEA programme had successfully delivered a variety of changes and improvements resulting in “*greater supervisory focus [in] the identification of harms resulting in benefit for firms, individuals and consumers.*”<sup>640</sup>

9.10 The Investigation notes that the DEA programme changes came too late to have changed the course of the FCA’s handling of the authorisation process in relation to LCF.

## **10. Conclusion**

10.1 The FCA’s supervision of LCF was inadequate throughout the Relevant Period. More detailed analysis of the specific inadequacies is set out in **Chapter 10** (Adequacy of the FAC’s supervision of LCF) of this Report.

10.2 There was no proactive supervision of LCF during the Relevant Period.

10.3 LCF should have been identified as an “outlier” even under the inadequate supervision regime during the Relevant Period, but was not.

10.4 The DES programme had no material impact on the FCA’s supervision of LCF during the Relevant Period.

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<sup>637</sup> ExCo Minutes, 22 May 2017, at page 10.

<sup>638</sup> EOC Summary Paper, Delivering Effective Authorisations (DEA) Transformation, 7 June 2017. In this summary paper the target budgeted cost of the DEA programme was £2.4 million.

<sup>639</sup> DEA Update Paper – EOC Paper, 11 December 2018 at page 1.

<sup>640</sup> *Ibid.*, at page 4.



*Chapter 8: The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes*

- 10.5 ExCo was aware of the inadequacies in its supervision of flexible firms from at least 2015 and the Board from, at the latest, November 2016.
- 10.6 The Board, ExCo and the Executive Directors of the Supervision Division should have driven expedited delivery of the Programmes and identified steps which could be taken to identify quick fixes or easy wins to improve supervision in the interim.
- 10.7 Having identified that there had been inadequate supervision of flexible firms by the FCA since at least 2014, the Board, ExCo and the Executive Directors of Supervision should have considered instituting a lookback or review during the Relevant Period to identify firms which might have slipped through the net.
- 10.8 The Investigation was not asked to consider whether the Programmes have resulted in effective supervision or authorisation of the FCA’s flexible firm portfolio, but notes that important elements of the Programmes remained outstanding during the Investigation.
- 10.9 As the DEA programme was not sufficiently advanced during the Relevant Period to have made any difference to the FCA’s regulation of LCF, and does not seem to have focused specifically on the shortcomings identified in this Report, the Investigation has not forensically reviewed the DEA programme, particularly as it would have had no effect on the Authorisations process as it related to LCF.

## **PART C: ANALYSIS OF ISSUES IN THE DIRECTION**

### **CHAPTER 9: APPROPRIATENESS OF LCF'S PERMISSIONS**

#### **1. Introduction**

1.1 This Chapter considers whether the permissions which the FCA granted LCF were appropriate for the business activities which it carried on.<sup>641</sup> The Investigation concludes that LCF's permissions were inappropriate for the business activities that it carried on for three reasons:

- (a) First, the Investigation considers that, although LCF's issuance of "mini-bonds"<sup>642</sup> was not itself a regulated activity, LCF may have carried on some related regulated activities for which it did not have permission. However, the Investigation concludes that the FCA was not at fault in not having identified that LCF may have been conducting regulated activities without permission.<sup>643</sup> This issue is, therefore, of limited importance to the Investigation.
- (b) Second, and more importantly, the FCA appears to have granted LCF permissions for regulated activity which it did not carry on.<sup>644</sup>
- (c) Third, the Authorisations Division failed to appreciate the risks which LCF's business (albeit unregulated) posed to consumers and this resulted in the First VOP Application being approved when it should have been rejected or only approved subject to conditions or monitoring.<sup>645</sup>

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<sup>641</sup> This responds to the question at paragraph 3(1)(d) of the Direction (i.e. "*whether the permissions that LCF were granted were appropriate for the business activities that it carried on*").

<sup>642</sup> As already explained in **Chapter 1**, (Introduction and background) "mini-bonds" is a legally imprecise term which the Report avoids using unless absolutely necessary. This Chapter will avoid using the term and refer to LCF's bond issues.

<sup>643</sup> Section 3 of this Chapter and **Appendix 5**.

<sup>644</sup> Section 4 of this Chapter.

<sup>645</sup> Sections 5 and 6 of this Chapter.

1.2 The second and third reasons are particularly important because FCA-authorisation gave LCF the FCA's imprimatur of respectability which, Bondholders have informed the Investigation, was crucial in attracting them to LCF's unregulated bond business.<sup>646</sup>

## 2. Public statements made by the FCA on authorisation

2.1 The deficiencies in the permissions granted to LCF by the Authorisations Division occurred in the context of the FCA making public statements which purported to provide reassurance that the FCA-authorisation process kept undesirable firms out of the market. As is clear from the Authorisations Division's handling of, in particular, the First VOP Application, such reassurances were unjustified.<sup>647</sup>

2.2 The FCA's Business Plan 2018 / 19 stated: "**Authorisation:** *We use authorisation primarily to prevent harm from occurring. Authorisation ensures that all regulated firms and individuals meet minimum standards from the start, and keeps those that do not out of the market. When we assess these standards we take a proportionate look at many factors, such as a firm's business model, key personnel and overall resources... We want to remove unnecessary barriers for new firms that can hinder effective competition, while still ensuring all firms maintain minimum standards to prevent harm to our consumer protection and market integrity objectives.*"<sup>648</sup>

2.3 Similar statements made by the FCA in other public documents purported to provide reassurance regarding the ability of the authorisations process to filter out potentially harmful firms. The FCA's Business Plan 2014/15 stated that the FCA was "[g]uarding the gateway to the financial markets through authorisation" and that the FCA "monitor[s] the gateway to the financial markets by assessing firms as they apply to [the FCA] to be authorised. [The FCA uses] all the relevant information available to [it] to gain a thorough understanding of [firms'] internal culture, their business models and the way they treat their customers. A key part of this is ensuring that certain individuals are accountable for the

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<sup>646</sup> See paragraph 9.4(a) of **Chapter 1** (Introduction and background) of this Report.

<sup>647</sup> For further details of LCF's regulatory transactions, see Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report.

<sup>648</sup> FCA Business Plan 2018/19, at page 12 (see: <https://www.fca.org.uk/publication/business-plans/business-plan-2018-19.pdf> (accessed on 23 November 2020)).

*behaviour of the firm, placing the onus on them to ensure good conduct. We analyse how much risk a firm may pose to our objectives and prioritise our resources where we see potential or actual harm being caused to consumers or markets.”*<sup>649</sup> The plan said that the FCA did this “*to prevent firms from entering the market that [the FCA] believe[s] may pose a significant risk to consumers or to the market itself through poor behaviour.*”<sup>650</sup>

2.4 So too, the FCA's Business Plan 2016/17 stated that “[f]irms undertaking ‘regulated activities’ have to be authorised or registered by us, unless they are specifically exempt. They must meet our threshold conditions before we allow them to operate in the market. Where we believe firms’ behaviour may pose a significant risk to consumers or the market, we work with them to raise their standards, and failing that, we prevent them from entering the market. Our authorisation process can vary in terms of the level of scrutiny we apply, depending on the risks a firm poses to our objectives. For firms that pose significant risks to our objectives, we apply a high degree of scrutiny in our review of business plans, resources, systems and controls to ensure we are confident that they have the right leadership and good practices in place to provide good outcomes for their customers. Firms which pose smaller risks to our objectives are authorised using a proportionate level of scrutiny.”<sup>651</sup>

2.5 Furthermore, in certain instances, call-handlers in the FCA's Customer Contact Centre reassured callers that LCF was unlikely to be operating fraudulently based on its FCA-authorized status.<sup>652</sup>

2.6 These statements suggested that a firm which had obtained FCA-authorized status had been through a rigorous review process designed to keep firms which posed a significant risk to consumers out of the market. These statements did not make clear the limited extent of the

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<sup>649</sup> FCA Business Plan 2014/15, at page 18 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2014-2015.pdf> (accessed on 23 November 2020)).

<sup>650</sup> *Ibid.*

<sup>651</sup> FCA Business Plan 2016/17, at page 39 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2016-17.pdf> (accessed on 23 November 2020)). See also the FCA's Business Plan 2015/16, at page 62, which stated “[w]e examine firms as they apply to us to be authorised, using all the relevant information available to us to gain a thorough understanding of their internal culture, their business models and the way they treat their customers. We use a risk-based approach across all authorisation processes, according to the nature, scale and complexity of the proposed business” (see: <https://www.fca.org.uk/publication/corporate/business-plan-2015-16.pdf> (accessed 23 November 2020)).

<sup>652</sup> See Section 5 of **Chapter 12** (Information provided by third parties) and Section 4 of **Appendix 6** of this Report.

FCA's review of a firm's unregulated business as part of the authorisations process. This was despite the fact that the FCA was aware of the "halo" effect that FCA-authorisation provided to a firm's unregulated business.<sup>653</sup> This point is of particular relevance to the case of LCF, because the FCA's authorisation of LCF appears to have provided unwarranted credibility to its unregulated bond business and, as Bondholders have explained to the Investigation, was highly influential in attracting investment.<sup>654</sup>

2.7 Further, in the light of these statements it would, in the Investigation's view, have been reasonable for investors, or potential investors, to have assumed that: (i) the numerous allegations of fraud received by the FCA relating to LCF, and (ii) the red flags apparent in LCF's accounts and business model, would have been taken into account by the FCA on a proportionate and risk-based approach to authorisation.

### 3. LCF carried on regulated activity for which it did not have permission

3.1 In order to determine whether the permissions that the FCA granted to LCF were appropriate, it is necessary to consider what (if any) regulated activities LCF was conducting during the Relevant Period. However, it is also relevant to consider the extent to which the FCA was, or should have been, aware of those activities because that determines the extent to which the FCA was at fault in the event that LCF's permissions were inappropriate.<sup>655</sup>

3.2 The Investigation has concluded that LCF's business of issuing bonds did not constitute regulated activity.<sup>656</sup> In summary, the Investigation broadly agrees with the FCA's General

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<sup>653</sup> As explained in more detail in **Chapter 6** (The FCA's approach to the Perimeter) of this Report, the Investigation has seen various FCA papers which demonstrate that the FCA recognised the risk that FCA-authorisation could provide the public with reassurance regarding the unregulated activities of FCA-authorised firms.

<sup>654</sup> See paragraph 9.4(a) of **Chapter 1** (Introduction and background) of this Report.

<sup>655</sup> This is accordingly a different question from simply asking whether LCF was carrying on any regulated activity (i.e. where it is not necessary to consider whether the FCA could or should have been aware of such activity). That question is relevant to the compensation decisions of the FSCS (and, thereby, the judicial review proceedings brought by a group of Bondholders in connection with the FSCS's compensation decisions), but is not directly relevant to the issues within the remit of the Investigation.

Pursuant to section 213(3) of FSMA, the compensation scheme set up by the FCA must provide for the scheme manager (i.e. the FSCS) "to assess and pay compensation, in accordance with the scheme to claimants in respect of claims made in connection with (i) a regulated activity carried on (whether or not with permission) by relevant persons..." (i.e. the FSCS must look at the firm's actual conduct rather than the FCA's awareness of such conduct) (see: <https://www.legislation.gov.uk/ukpga/2000/8/section/213> (accessed on 23 November 2020)).

<sup>656</sup> This point is explained in more detail in **Appendix 5**.

Counsel's Division which, in February 2016, considered whether LCF issuing its own bonds fell within the regulated activity of dealing in investments as principal and concluded:

*“As discussed on the telephone, your concern focusses on whether or not [LCF] are authorised to carry out the regulated activity of dealing in investments as principal, an activity that is regulated by virtue of Art. 14 FSMA 2000 (Regulated Activities) Order 2001 ('RAO 2001'). However, Art. 18 (1) RAO 2001 excludes from the scope of Art.14 “the issue by a company of its own shares or share warrants, and the issue by any person of his own debentures or debenture warrants”. In this instance, therefore, it looks as if [LCF] are permitted to issue their own bonds as principal provided that the promotion of the same is approved by [Sentient Capital].”<sup>657</sup>*

3.3 Although LCF's core business of issuing bonds was not a regulated activity,<sup>658</sup> the Investigation considers that, in certain limited instances, LCF may have carried on regulated activity for which it did not have permission.<sup>659</sup> The instances where LCF may have carried on regulated activity for which it did not have permission are:

- (a) where, prior to June 2017, LCF or Surge Financial Limited (“**Surge**”), acting on LCF's behalf, advised investors or potential investors on investments,<sup>660</sup> and

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<sup>657</sup> Email from an Associate in the FCA's General Counsel's Division to the Associate in the Consumer Credit Department, 3 February 2016 at 2.02pm (Document with Control Number 096025).

<sup>658</sup> The claimants in the judicial review proceedings appear to agree that this was the case for LCF's bond issuances prior to the introduction of MiFID II on 3 January 2018. For example, the claimants' Amended Detailed Statement of Facts and Grounds at paragraphs 51, 59 and 114 (see: <https://shearman.sharefile.com/share/view/s13a21097cc041508> (accessed on 23 November 2020)). The claimants consider that MiFID II changed the position such that the exemption under Article 18 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001 No. 533), as amended from time to time, (the “**RAO**”) would be unavailable where the “MiFID Override” applied (see: the claimants' Amended Detailed Statement of Facts and Grounds, at paragraphs 51 to 59). As explained in **Appendix 5**, on balance, the Investigation disagrees.

<sup>659</sup> As explained in **Appendix 5**, this is on the assumption that the FSCS is correct in having found that LCF carried on regulated activity in certain limited instances.

<sup>660</sup> As explained in **Appendix 5**, LCF had permission for corporate finance advice from June 2017. There is a technical question as to whether that permission extended to the activity described in (a). The Investigation concludes that LCF's permission is unlikely to have extended to this activity because it would not have extended to advising retail clients (potential investors in LCF's bonds would normally be retail clients).

- (b) where LCF made arrangements for an investor to switch their investment from an existing investment in a stocks and shares ISA to an LCF bond such that LCF arranged the disposal of the existing investment.<sup>661</sup>

3.4 The key question for the purposes of the Investigation is whether the FCA knew or should have known that LCF was carrying on the activities in paragraph 3.3(a) and (b) above during the Relevant Period.

3.5 In relation to whether the FCA was aware that LCF or Surge, acting on its behalf, may have been advising on investments prior to June 2017:

- (a) The business plan submitted by LCF in October 2015 with the Initial Authorisation Application was very much focused on LCF's proposed regulated activities of consumer credit lending and credit broking and it was certainly not suggested in that business plan that LCF (or anyone acting on its behalf) would be advising on investments.<sup>662</sup>
- (b) The updated business plan submitted by LCF in February 2016, in connection with its request to add corporate finance permissions to the Initial Authorisation Application, stated that LCF's proposed business would include "*advising firms on their capital structure, financial needs, growth & capital investment*".<sup>663</sup> The business plan did not, however, suggest LCF was already advising on any investments.
- (c) The updated application form submitted by LCF in December 2016 in connection with the First VOP Application did refer to Surge as providing "*investor communication services*" in the section that listed the functions that LCF would be outsourcing.<sup>664</sup> However, the Investigation does not consider that this reference

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<sup>661</sup> This would potentially fall within the regulated activity of arranging deals in investments pursuant to Article 25 of the RAO. From June 2017, LCF had an arranging permission although, for the reasons set out in **Appendix 5**, the Investigation's view is that LCF's permission did not extend to the activity described in (b).

<sup>662</sup> London Capital & Finance Limited, Regulatory Business Plan, October 2015, at pages 1 to 4.

<sup>663</sup> London Capital & Finance plc, Regulatory Business Plan, 14 February 2016, at page 2.

<sup>664</sup> London Capital & Finance plc, Application for Authorisation – Supplement for securities and futures firms (complex), December 2016, at page 6.

should have caused the FCA to investigate whether Surge was advising on investments on behalf of LCF.

(d) Although there was at least one call to the Customer Contact Centre which mentioned the role of Surge, the caller did not indicate that Surge had advised on investments.

3.6 The Investigation has not seen any evidence to suggest that the FCA was aware or should have been aware that LCF was arranging investments by transferring existing stocks and shares ISAs into LCF bonds. The FSCS decision in January 2020 suggests this activity was limited to 159 Bondholders.<sup>665</sup>

3.7 In the circumstances, the Investigation concludes that the FCA was not aware, nor should it have been aware, that LCF may have been, in some very limited circumstances, conducting regulated activity without the necessary permissions. Accordingly, this issue is of limited importance to the Investigation. Instead, the more important issues are that the FCA granted LCF permissions for regulated activity which it did not in fact carry on and that there were deficiencies in the approach of the Authorisations Division.

#### **4. The FCA granted LCF permissions for business which it did not carry on**

4.1 This Section explains why the Investigation has concluded that the FCA granted LCF permissions for regulated activities which LCF did not carry on.<sup>666</sup>

4.2 Prior to FCA authorisation, LCF had a consumer credit licence from the OFT to carry on “*consumer credit (lending)*” and “*consumer hire*”.<sup>667</sup> After responsibility for the regulation of consumer credit was transferred from the OFT to the FCA on 1 April 2014, LCF obtained the following permissions:

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<sup>665</sup> The update on the FSCS website on 9 January 2020 stated: “*FSCS will protect the 159 bondholders who switched from stocks and shares ISAs to LCF bonds*” (see: <https://www.fscs.org.uk/failed-firms/lcf/> (accessed on 23 November 2020)).

<sup>666</sup> The Investigation has not consulted current or former officers or employees of LCF in reaching this view.

<sup>667</sup> Slides for the meeting between Independent Investigation Team & FCA, 20 September 2019, at slide 13.



- (a) Interim permissions for consumer credit and consumer hire business:<sup>668</sup> these permissions were effectively carried over from the previous licence from the OFT pending LCF obtaining full FCA-authorisation.
- (b) Following the Initial Authorisation Application, and with effect from 11 May 2016, the FCA approved LCF to carry on credit broking as a “*limited permission*” firm, meaning that credit broking was ancillary to its main business.<sup>669</sup>
- (c) Later, following the First VOP Application, the FCA confirmed to LCF by email dated 13 June 2017 that it had granted LCF Part 4A permission.<sup>670</sup> This included, among other things, permissions for corporate finance advice. Essentially, the First VOP Application envisaged the provision by LCF of a range of services to other firms, including advising other firms on raising funds through securities issuances.<sup>671</sup> The amended application form submitted in connection with the First VOP Application made it clear that LCF was funding its activities by issuing bonds.<sup>672</sup>

4.3 It appears LCF did not, in fact, carry on the regulated activities for which it had obtained permission. LCF submitted documentation to the FCA that repeatedly showed that LCF was not generating any revenue from regulated activity. For example, LCF's:

- (a) regulatory business plan dated 4 October 2016 stated that actual revenue from regulated business in 2015 and 2016 was £0 (although it projected regulated revenue of £601,000 and upwards from 2017 onwards);<sup>673</sup>
- (b) CCR007 regulatory return (Consumer Credit Data: Key data for credit firms with limited permissions) for the period 1 May 2016 to 30 April 2017 stated that its total revenue from credit-related regulated activities was £0 against a total revenue

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<sup>668</sup> *Ibid.*, at slides 14 to 16.

<sup>669</sup> Email Message Detail 7 June 2016 at 1:29pm (Document with Control Number 121907).

<sup>670</sup> Email Message Detail 13 June 2017 at 3:32pm (Document with Control Number 122815).

<sup>671</sup> London Capital & Finance plc, Regulatory Business Plan, 4 October 2016, at pages 2 to 3.

<sup>672</sup> London Capital & Finance plc, Application for Authorisation – Supplement for securities and futures firms (complex), December 2016, at page 18.

<sup>673</sup> London Capital & Finance plc, Regulatory Business Plan, 4 October 2016, at page 8.

(including from activities other than credit-related regulated activities) of £6,678,685;<sup>674</sup>

- (c) FSA030 regulatory returns (Income Statement) provided to the FCA on various dates from August 2017 (i.e. after LCF had become a full permission firm in June 2017) repeatedly stated that all LCF revenue fell into the “[o]ther revenue” category (in other words, no revenue had accrued or was expected from the firm’s regulated activities);<sup>675</sup> and
- (d) FIN-A regulatory return (Annual Report and Accounts) for the reporting period ending on 30 April 2018 and submitted by LCF to the FCA in August 2018 similarly stated that the firm did not generate income from regulated activities during the accounting period.<sup>676</sup>

4.4 It is clear from these documents that LCF’s regulatory returns consistently demonstrated that it was not using the permissions that the FCA had granted. However, this did not lead to the FCA re-considering the propriety of LCF’s permissions despite the fact that provisions were in place under sections 55L and 55J of FSMA to vary or cancel firms’ permissions in the event that a firm did not carry out regulated activity.<sup>677</sup>

4.5 The FCA’s failure to consider the significance of LCF not conducting the specific regulated activities, for which it had been granted permission, rested primarily with the Supervision Division rather than the Authorisations Division and, as such, this issue is considered further in **Chapter 10** (Adequacy of the FCA’s supervision of LCF).

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<sup>674</sup> London Capital & Finance plc, CCR007 for the Reporting Period 1 May 2016 to 30 April 2017, submitted 6 June 2017.

<sup>675</sup> FCA response to information request – LCF\_DEC11/12\_05.

<sup>676</sup> LCF’s FIN-A Annual Report and Accounts for the period ending 30 April 2018, submitted 22 August 2018.

<sup>677</sup> In this regard, SUP 7.2.2G states: “[t]he circumstances in which the FCA may vary a firm’s Part 4A permission on its own initiative or impose a requirement on a firm under sections 55J or 55L of the Act include where it appears to the FCA that... (3) a firm has not carried out a regulated activity to which its Part 4A permission applies for a period of at least 12 months” (see: <https://www.handbook.fca.org.uk/handbook/SUP/7/2.html> (accessed on 23 November 2020)). Similar statements appear in paragraph 8.1 of the FCA’s Enforcement Guide (see: [https://www.handbook.fca.org.uk/handbook/document/EG\\_Full\\_20140401.pdf](https://www.handbook.fca.org.uk/handbook/document/EG_Full_20140401.pdf) (accessed on 23 November 2020)).

## 5. The handling of the Initial Authorisation Application

- 5.1 LCF went through the Initial Authorisation Application between October 2015 and June 2016. This process resulted in LCF obtaining limited permission as a credit broker.<sup>678</sup>
- 5.2 The Investigation considers it may be possible to argue that, during the course of the review conducted as part of the Initial Authorisation Application, the FCA failed to appreciate the significance of various red flags and the risk which LCF posed to consumers. However, the Investigation notes that the FCA reviewed LCF's Initial Authorisation Application (which was viewed as low risk on the basis that it was for credit broking permissions) in circumstances where the relevant team was handling applications from a large volume of consumer credit firms following their transfer from the OFT to the FCA.<sup>679</sup>
- 5.3 First, the FCA's authorisation process was amended during this period to focus on the consumer credit activities of incoming firms from the OFT to the FCA.<sup>680</sup> One of the amendments was to dis-apply the business model threshold conditions for limited permission applications. As such, the relevant member of the Credit Authorisations Division<sup>681</sup> who reviewed the Initial Authorisation Application would not necessarily have been expected to have reviewed LCF's business model and financial information or to have detected the red flags in LCF's non-consumer credit bond issuing business.

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<sup>678</sup> Further details regarding the Initial Authorisation Application can be found in Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>679</sup> The table at paragraph 3.1 of **Chapter 5** (The FCA's finite resources and prioritisation) of this Report shows that the FCA handled just under 20,000 authorisation applications in 2015.

<sup>680</sup> The FCA prepared a narrative document for the Investigation which provided regulatory context to the issues being considered by the Investigation (the "**Regulatory Narrative Document**"). The Regulatory Narrative Document stated: "[1.32] Limited permission firms represented the majority of firms by number (56% of the firms that the FCA ultimately authorised), and were individually deemed to present a relatively low risk of harm. [1.33] In recognition of this perceived lower risk of harm, HMT modified the Threshold Conditions for Limited Permission firms, dis-applying the business model Threshold Conditions entirely, and modifying the application of two others (Effective Supervision and the Appropriate Resources). For example, most Limited Permission firms were only required to have one approved person at the firm rather than Full Permission firms who typically required multiple individuals performing significant influence functions" (see: FCA Regulatory Narrative Document, paragraphs 1.32 to 1.33, at page 6).

<sup>681</sup> The Regulatory Narrative Document explained: "[g]iven the requirement to assess applications from circa 49,480 consumer credit firms with [interim permission], alongside 1,009 existing ('in flight') applications and potential new applications received after 1 April 2014, the FCA decided to set up a separate division to operate alongside its existing Authorisations Division" (see: *Ibid.*, paragraph 1.48, at page 7).

- 5.4 Second, the amount of financial information which LCF submitted as part of the Initial Authorisation Application was much less detailed than that submitted as part of the First VOP Application.<sup>682</sup> Consequently, there was less opportunity for the FCA to scrutinise LCF's financial information to detect red flags than during the First VOP Application which began in October 2016.<sup>683</sup>
- 5.5 That said, the Investigation reviewed the financial information provided to the FCA by LCF as part of the Initial Authorisation Application and identified areas of concern, including that at least some of the financial information seemed unlikely to be accurate, given the nature of LCF's business. For example, the balance sheet showed LCF's bank balance increasing on a month-by-month basis without any change to the sums due to creditors.<sup>684</sup>
- 5.6 Although the Investigation Team identified some red flags in the information provided by LCF as part of the Initial Authorisation Application, the team obtained the assistance of a chartered accountant to confirm the Investigation's view that there were obvious issues with the financial information provided by LCF to the FCA during the Relevant Period. A chartered accountant from the StoneTurn advisory firm prepared a report based on his review of the financial information and that report (the "**StoneTurn Accountancy Report**") is included at **Appendix 11** of this Report. The StoneTurn Accountancy Report sets out certain issues regarding the quality and reliability of information which LCF submitted to the FCA as part of the process.<sup>685</sup>

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<sup>682</sup> The financial information submitted to the FCA by LCF with the Initial Authorisation Application in October 2015 was a balance sheet, a cashflow statement, abbreviated accounts and a regulatory business plan. The accounts submitted by LCF with the Initial Authorisation Application were abbreviated accounts for the period ending 31 March 2015 and, for the avoidance of doubt, they were different accounts to those reviewed by Mr Liversidge and referenced in the Liversidge Letter in November 2015. The concerns identified by Mr Liversidge in the Liversidge Letter (see: paragraphs 4.2 to 4.9 of **Chapter 3** (Key events in the FCA's regulation of LCF)) were following his review of the accounts for the period ended 30 April 2015 which were lodged at Companies House on 26 November 2015. It should be noted that LCF filed at Companies House an amended set of accounts for the period 31 March 2015 (i.e. an amended set of the accounts submitted to the FCA with the Initial Authorisation Application) on 15 November 2015 (see: <https://find-and-update.company-information.service.gov.uk/company/08140312/filing-history> (accessed on 23 November 2020)). It does not appear that LCF provided the FCA with a copy of these amended accounts or the accounts for the period ended 30 April 2015.

<sup>683</sup> Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF) and Section 6 of this Chapter for further details of the First VOP Application.

<sup>684</sup> London Capital & Finance Limited, Balance Sheet, (provided by LCF in October 2015), at pages 1 and 2.

<sup>685</sup> Section 3 of the StoneTurn Accountancy Report at **Appendix 11**.

- 5.7 Unreliable or unrealistic financial information would not, by itself, have indicated to the relevant member of the Credit Authorisations Division reviewing the Initial Authorisation Application that there were irregularities with LCF's business. However, the Investigation would have expected to have seen some evidence of the team member probing (even at a high level) LCF's financial information during the course of the Initial Authorisation Application. This is particularly the case in circumstances where: (i) the FCA's Financial Promotions Team had already written to LCF in early 2016 regarding concerns with its website;<sup>686</sup> (ii) management information produced by the FCA's Customer Contact Centre showed that LCF frequently appeared in the list of firms about which the Contact Centre received the most consumer calls in late 2015 and early 2016 in the "*consumer investment products*" area;<sup>687</sup> and (iii) an FCA employee who was a member of the Credit Authorisations Division during the Relevant Period (albeit not the individual who handled the Initial Authorisation Application) noted in interview that LCF's business model was unusual for a consumer credit firm.<sup>688</sup> Further, the guidance on the process in effect in the Credit Authorisations Division at the time for limited permissions case stated: "[i]f anything unusual stands out in the application, please investigate in the normal way".<sup>689</sup>
- 5.8 The individual handling the Initial Authorisation Application did not test LCF's financial information. In the light of the amendments to the authorisations process for limited permissions applications, and the fact that LCF was seeking credit broking permissions (i.e. an activity viewed as low risk), the failure in the handling of the Initial Authorisation Application is much less serious than those which occurred during the First VOP Application, but it cannot be excused entirely. The cumulative effect of the circumstances

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<sup>686</sup> The correspondence between the Financial Promotions Team and LCF in early 2016 is described in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>687</sup> Such management information was produced and distributed within the FCA at the time (see: FCA Consumer Emerging Themes – Information request – request for comparator analysis, at pages 3 and 10).

<sup>688</sup> Interview Transcript I, at page 20.

<sup>689</sup> The process required the Case Officer to conduct "*T.R.I.P.*" checks which meant checking: (i) whether there were any issues or concerns with the firm's trading name; (ii) all risk flags and providing an explanation why the Case Officer was satisfied that the risk had been addressed; (iii) whether the firm's consumer credit income (i.e. income from regulated activities) was unusual; and (iv) whether the permissions made sense (see: FCA Internal Presentation, A TRIP through Limited Permission, Hybrid, and VOP Cases, at pages 4 to 10).

outlined in paragraph 5.7 (above) meant that the relevant team member had cause to investigate “*in the normal way*”.

5.9 If the team member had probed LCF's financial information, the individual should have asked LCF to provide more recent accounting information, particularly given the Case Officer started reviewing the Initial Authorisation Application over five months after LCF had submitted the application and the supporting financial information.<sup>690</sup> If the Case Officer had asked for updated financial information, it is possible that LCF would have provided the accounts for the period ended 30 April 2015 which were submitted to Companies House in November 2015.<sup>691</sup> These are the accounts discussed in the Liversidge Letter and, as such, it is possible the Credit Authorisations Division may have identified the same concerns as set out in the Liversidge Letter in connection with LCF's business.<sup>692</sup>

5.10 Although the Investigation has identified certain areas where the FCA could have probed LCF's financial information further as part of reviewing the Initial Authorisation Application, the Investigation has *not* reached the conclusion that it was unreasonable for the FCA to have granted LCF's credit broking permissions.

## **6. Failures in the FCA's handling of the First VOP Application**

6.1 This section explains the deficiencies in the FCA's handling of the First VOP Application. LCF submitted the First VOP Application on 14 October 2016 and the Case Officer assigned to the application approved it on 13 June 2017.<sup>693</sup>

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<sup>690</sup> The Initial Authorisation Application was submitted on 21 October 2015 and the initial call took place between the Case Officer and LCF on 8 April 2016 (see: Email Message Detail 8 April 2016 at 3:42pm (Document with Control Number 121842)).

<sup>691</sup> See: <https://find-and-update.company-information.service.gov.uk/company/08140312/filing-history> (accessed on 23 November 2020).

<sup>692</sup> See paragraphs 4.2 to 4.9 of **Chapter 3** (Key events in the FCA's regulation of LCF) (above) for more detailed analysis of the concerns raised in the Liversidge Letter.

<sup>693</sup> LCF applied for the following permissions: (i) making arrangements with a view to transactions in investments; (ii) arranging safeguarding and administration of assets; (iii) arranging (bringing about) deals in investments; and (iv) advising on investments (except on pension transfers and pension opt outs). The application form stated that these permissions would be subject to the following standard requirements: (i) may hold/control client money if rebated commission; and (ii) corporate finance business only. Further details of the First VOP Application are set out in Section 2 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report.

6.2 During the course of the First VOP Application, the FCA failed to appreciate the risks which LCF posed to consumers. The Investigation concludes that this was, as described below, due to the FCA's failure to appreciate the significance of red flags in respect of LCF. Paragraphs 6.4 and 6.5 below describe some of the red flags regarding LCF's business that should have been identified by the FCA during the course of the First VOP Application.

6.3 Paragraphs 6.6 to 6.26 below explain the reasons why the failures in the First VOP Application occurred and the responsibility for those failures. In summary, the failures in the First VOP Application occurred because:

- (a) First, the FCA's approach to risk rating LCF's application was overly focused on whether the firm had financial problems that could impact LCF's regulated business. While LCF applied to hold "*client money*" permissions, LCF's application was subject to detailed scrutiny. However, when LCF abandoned its application for client money permissions, detailed scrutiny of LCF's application ceased. This was despite the fact that LCF's unregulated business posed a significant degree of risk to consumers, irrespective of the fact that LCF was not (technically) holding client money.<sup>694</sup>
- (b) Second, the individual with responsibility for reviewing the First VOP Application was inadequately trained to interpret LCF's financial information and then step back and consider LCF's business holistically. As a result, this individual noticed a number of potentially concerning aspects about LCF's business but ultimately did not question whether there was something fundamentally wrong.<sup>695</sup>
- (c) Third, the FCA's approach to the Perimeter also contributed to failures in the handling of the First VOP Application. The First VOP Application was overly focused on regulated activity, with the result that insufficient, if any, attention was given to the risks posed by LCF's unregulated bond business. Indeed, even when the FCA received the Anonymous Letter during the First VOP Application

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<sup>694</sup> Paragraphs 6.6 to 6.13 of this Chapter.

<sup>695</sup> Paragraphs 6.14 to 6.19 of this Chapter.

alleging that LCF was engaged in possible fraud or other misconduct, the individual reviewing LCF's First VOP Application (who was provided with a copy of the Anonymous Letter) did not review LCF's financial or other available information to determine whether there was any truth to these allegations. This appears to have happened because the individual took the view that allegations of fraud would be principally a matter for the police. Furthermore, an additional allegation that LCF was engaged in possible fraud was made to the Financial Promotions Team during the course of the First VOP Application. This allegation did not even come to the attention of any FCA employees involved in reviewing the First VOP Application, again owing to the FCA's approach to the Perimeter.<sup>696</sup>

- (d) Fourth, despite LCF's highly unusual business model, and the fact that LCF's regulatory returns showed that it did not conduct regulated activity, the FCA did not make LCF's permissions subject to any conditions or enhanced monitoring to ensure that the appropriateness of those permissions was kept under review.<sup>697</sup>

*Failure to understand the significance of red flags*

- 6.4 As required by the FCA, LCF provided financial information including a business plan and supporting information as part of the First VOP Application.<sup>698</sup> The Investigation reviewed this financial information and identified a number of red flags. To confirm the conclusions which the Investigation had reached of its own accord regarding this financial information, the Investigation obtained the assistance of a chartered accountant from the StoneTurn advisory firm and his analysis of this financial information is similarly set out in **Appendix 11**. In summary, the Investigation considers that the financial information provided by LCF during the First VOP Application should have raised questions about:

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<sup>696</sup> See paragraphs 6.20 to 6.23 of this Chapter. A wider discussion of the FCA's approach to the Perimeter is set out in **Chapter 6** (The FCA's approach to the Perimeter) of this Report.

<sup>697</sup> See paragraphs 6.24 to 6.25 of this Chapter.

<sup>698</sup> For example: (i) the regulatory business plan provided to the FCA in October 2016 (see: London Capital & Finance plc, Regulatory Business Plan, 4 October 2016); (ii) LCF's annual report and financial statements for the year ended 30 April 2016 provided to the FCA in December 2016 (see: London Capital & Finance plc, Annual Report and Financial Statements for the year ended 30 April 2016, 10 October 2016); and (iii) projected profit & loss information provided to the FCA on 26 January 2017 (see: LCF Projected Profit & Loss 2017).



- (a) *The ability of LCF to meet its financial obligations as they fell due.* The net current liability position of LCF indicated the firm did not have sufficient current assets and liquidity to meet its liabilities in the following 12-month period. Consequently, the financial information suggested that LCF needed to raise significant funds from either issuing further bonds or external sources of funding on a continuing basis.<sup>699</sup>
- (b) *The rapid growth of LCF's business.* While not a red flag in itself, taken together with the other financial concerns, the rapid growth of LCF's business could have been an indicator of the enhanced risk presented by LCF, given that overly rapid expansion is a known generator of risk.<sup>700</sup> Furthermore, the fact that LCF's business depended on significant new bond issues<sup>701</sup> to fund its existing liabilities should have at least raised some concern as to how LCF's business model worked and whether there was a risk that the proceeds of new bond issues might be used to meet payment obligations on LCF's existing bonds.<sup>702</sup>
- (c) *The credibility of LCF's business model.* As explained in Section 6 of the StoneTurn Accountancy Report at **Appendix 11**, the terms under which LCF lent money were highly unfavourable to borrowers in respect of interest,<sup>703</sup> loan-to-

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<sup>699</sup> Information which LCF provided as part of the First VOP Application should have raised such concerns. See, for example, the following paragraphs of the StoneTurn Accountancy Report at **Appendix 11** in respect of information provided to the FCA on (i) 20 December 2016 (paragraphs 4.5 to 4.18); (ii) 14 March 2017 (paragraphs 4.19 to 4.25); (iii) 8 May 2017 (paragraphs 4.26 to 4.29); and (iv) 22 May 2017 (paragraphs 4.30 to 4.35).

<sup>700</sup> Indeed, one of the concerns raised by a member of the Listing Transactions Team in September 2018 was the growth of LCF's loan book (see: Email from a Senior Associate in the Listings Transaction Team to an Associate in the Retail Lending Evaluation Team within the Supervision Division, 11 September 2018 at 10:50am (Document with Control Number 217291)).

<sup>701</sup> The profit & loss information provided by LCF in January 2017 projected that the firm would issue over £100 million in new bonds in 2017 (see: LCF Projected Profit & Loss 2017).

<sup>702</sup> Section 5 of the StoneTurn Accountancy Report at **Appendix 11**. The information which LCF provided as part of the First VOP Application should have raised such concerns (see, for example, the references in Section 5 of the StoneTurn Accountancy Report to documents submitted during the October 2016 to June 2017 window of the First VOP Application).

<sup>703</sup> Paragraph 6.11 of the StoneTurn Accountancy Report which explains that the effective annual interest rate LCF charged to its borrowers could potentially amount to 29%.

value ratios<sup>704</sup> and repayment terms.<sup>705</sup> For example, the effective annual interest rate that LCF charged its borrowers could have been as high as 29%.<sup>706</sup> Such terms would have been so unfavourable to borrowers that it is difficult to see how LCF would have been able to attract sufficient customers willing to take out loans. This issue, combined with the highly unusual nature of LCF's business model and the risk of LCF being unable to meet its liabilities as they fell due, should have raised questions as to the credibility of LCF's business model.

- (d) *The quality and reliability of financial information submitted by LCF.* While a certain level of tolerance in this area may be appropriate for small, low risk businesses (e.g. a conventional credit broker or corporate finance business) other factors should have suggested that LCF's business was highly unusual. This, combined with the other factors set out above, should have been a further cause for concern regarding LCF's financial information.<sup>707</sup>

6.5 Despite the questions raised by LCF's financial information, the First VOP Application was successful and the FCA granted LCF corporate finance permissions (in addition to its consumer credit permissions) in June 2017. The FCA failed to detect the serious risk which LCF's business posed to consumers during the First VOP Application notwithstanding the red flags. The reason for those failures are set out in the sections which follow.

*Issues with the risk rating of the First VOP Application*

6.6 The risk appetite framework that applied to the First VOP Application followed a formulaic approach, whereby each case was assigned to a risk channel based on the sector and conduct classification of the firm and the riskiness of the relevant permissions. There were four risk channels (Standard Lite; Standard; Enhanced; Enhanced+) and the approach a member of

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<sup>704</sup> Paragraph 6.12 of the StoneTurn Accountancy Report which references LCF's 2016 financial statements that LCF's loans were fully secured with a notional value (of secured assets) ratio being 15%.

<sup>705</sup> Paragraph 6.17 of the StoneTurn Accountancy Report which notes that LCF stated during the First VOP Application that loans were repayable on 14 days' notice.

<sup>706</sup> Paragraph 6.11 of the StoneTurn Accountancy Report.

<sup>707</sup> Section 3 of the StoneTurn Accountancy Report. See, in particular, paragraphs 3.24 to 3.62 which concern the reliability of information submitted by LCF during the First VOP Application.

the Authorisations Division would be required to take would depend on the risk channel to which the case had been assigned.<sup>708</sup>

6.7 The First VOP Application submitted in October 2016 included a request for client money permissions.<sup>709</sup> This resulted in LCF's application being originally assigned to the "Enhanced" risk channel owing to: (i) the fact that it was unusual for a corporate finance advisory firm to hold client monies; and (ii) the risk to client monies in the event of the firm's collapse.<sup>710</sup>

6.8 The assignment of the First VOP Application to the "Enhanced" risk channel meant that the relevant member of the Authorisations Division would seek to verify what he was told by the applicant. This contrasted with the "Standard" risk channel whereby the relevant member of the Authorisations Division was required to take statements made by the applicant at face value unless there was reason to disbelieve them.<sup>711</sup>

6.9 However, following repeated queries from the relevant member of the Authorisations Division regarding the need for client money permissions, LCF withdrew its application for client money permissions in correspondence with the FCA in May and early June 2017.<sup>712</sup> As a result and following a discussion within the Authorisations Division, the First VOP Application was downgraded from the "Enhanced" risk channel to the "Standard" risk

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<sup>708</sup> FCA, New Authorisations Risk Appetite: VoPs, October 2016, at slide 7.

<sup>709</sup> LCF, Variation of Permission Application, 14 October 2016, at pages 5 to 12. The "client monies" envisaged by LCF's application, for the avoidance of doubt, were not the monies of investors which invested in LCF's bonds. Rather, they were to be monies which LCF held while waiting for a firm which LCF was advising to issue its own securities.

<sup>710</sup> FCA Variation of Permission: Recommendation, 13 June 2017, at page 1. This document stated: "[t]he application had been assessed as enhanced due to the inclusion of the client money permission" (*Ibid.*, at page 2). The document also stated that LCF's client money application "was queried as i) this was not conventional in relation to corporate finance business and there appeared to be no reason for the applicant to be holding the funds before passing these to the firm and ii) the applicant had not demonstrated appropriate resources by way of a suitably experienced individual to carry out the client money oversight function" (*Ibid.*).

<sup>711</sup> The FCA's risk appetite framework for Variation of Permission cases that was in force at the time of the First VOP Application explained that the overarching principle of a "Standard" case was to "[v]alidate" which it described as "[e]ngagement with firm as required"; "[a]ssessment based mainly on information received"; and "[f]ollow up questions limited to missing or inadequate information". By contrast, the overarching principle of an "Enhanced" case was "[i]nvestigate" which the document described as "[r]egular engagement with firm" and "[a]sk probing questions" (see: New Authorisations Risk Appetite: VoPs, October 2016, at slide 21).

<sup>712</sup> LCF Responses to Variation of Permission Queries, Fourth Series, 16 May 2017, at page 1. This point is also confirmed in the recommendation to approve the First VOP Application (see: FCA Variation of Permission: Recommendation, 13 June 2017, at page 1).

channel and, as such, the Authorisations Division amended its approach to take LCF's statements and responses at face value.<sup>713</sup> This change in approach applied to all issues being considered by the relevant member of the Authorisations Division in connection with the First VOP Application, including LCF's explanations in respect of its (unregulated) bond business such as the adequacy of security for loans which LCF advanced.<sup>714</sup>

6.10 During the period when LCF's application had been assigned to the "*Enhanced*" risk channel (i.e. from the start of the Authorisation Division's review in December 2016 up until late/early June 2017), the FCA had subjected LCF to detailed questioning.<sup>715</sup> However, this ceased following the switch to the "*Standard*" risk channel as the relevant member of the Authorisations Division accepted the information provided by LCF at face value and did not investigate the issues any further.<sup>716</sup> LCF definitively confirmed that it would no longer be requesting permission to hold client monies on 9 June 2017.<sup>717</sup> The First VOP Application was approved on 13 June 2017.<sup>718</sup>

6.11 The Investigation has concluded that downgrading the risk channel from "*Enhanced*" to "*Standard*" was inappropriate. Up to late May/early June 2017 (i.e. the time the First VOP Application switched to the "*Standard*" risk channel), the FCA had access to information which indicated that LCF posed a far higher level risk to consumers than a conventional corporate advisory firm, in particular owing to LCF's (unregulated) business of issuing its own bonds, but nevertheless failed to act upon it:

- (a) As already explained in **Chapter 7** (The FCA's awareness of mini-bonds and the related risks) of this Report, most corporate advisory firms did not issue their own

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<sup>713</sup> Interview Transcript X, at pages 6 and 7. The relevant team member also described the distinction between "*Standard*" and "*Enhanced*" cases as "*Tell us what you are doing*' rather than '*Show us what you are doing*'".

<sup>714</sup> For example, when asked in interview whether the FCA obtained evidence to demonstrate that the loans were adequately secured, the relevant team member stated: "[w]ell, we are in the habit of essentially – unless we have reason to disbelieve a firm or to doubt what they're telling us – to take their statements as being correct and true. It is normally in authorisations that if a firm states something we will believe them, unless we have some reason to believe the contrary" (see: Interview Transcript X, at page 33).

<sup>715</sup> For example: LCF Responses to Variation of Permission Queries, Fourth Series, 16 May 2017.

<sup>716</sup> Interview Transcript X, at page 40.

<sup>717</sup> Email Message 9 June 2017 at 11:14am (Document with Control Number 122799).

<sup>718</sup> Email Message 13 June 2017 at 3:32pm (Document with Control Number 122816).

securities.<sup>719</sup> Consequently, LCF's business model carried a far higher level of risk to consumers because LCF received money from investors for its bond issuances which was at risk in the event that LCF collapsed.

- (b) LCF's financial information indicated a rapidly growing bond business but one which also was potentially unable to meet its financial obligations as they fell due.<sup>720</sup>
- (c) At an early stage of the Authorisations Division's review of the First VOP Application, the FCA received the Anonymous Letter which alleged that LCF may have been engaged in fraud and other irregularities.<sup>721</sup> Although the relevant member of the Authorisations Division was provided with a copy of the Anonymous Letter, that individual did not appear to have taken any proactive steps to consider the issues in the letter by reference to the financial information with which he had been provided. That was despite the fact that he was in a position to do so because he was in charge of assessing LCF's business in the context of the First VOP Application. Given the queries the relevant member of the Authorisations Division subsequently raised regarding LCF's bond business,<sup>722</sup> the allegations in the Anonymous Letter should have steered the Authorisations Division to retain the "Enhanced" risk channel status.
- (d) By the date LCF confirmed definitively that it would no longer be requesting permission to hold client monies (i.e. 9 June 2017),<sup>723</sup> the Financial Promotions Team had intervened on four occasions in respect of breaches of the financial

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<sup>719</sup> Section 3 of **Chapter 7** (The FCA's awareness of mini-bonds and the related risks). In addition, the relevant team member stated in interview that, at the time of dealing with the First VOP Application, that individual could not recall having seen previously a corporate finance advisory business which had issued its own bonds, let alone one which issued bonds on the scale of LCF (see: Interview Transcript Z, at page 22).

<sup>720</sup> Paragraph 6.4 of this Chapter and Section 4 of the StoneTurn Accountancy Report at **Appendix 11**. As noted above, the profit & loss information provided by LCF in January 2017 projected that the firm would issue over £170 million in new bonds in 2017 (see: LCF Projected Profit & Loss 2017).

<sup>721</sup> As explained in Section 4 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report, the FCA received the Anonymous Letter alleging fraud on the part of LCF in January 2017.

<sup>722</sup> For example: LCF Responses to Variation of Permission Queries, Fourth Series, 16 May 2017

<sup>723</sup> Email Message 9 June 2017 at 11:14am (Document with Control Number 122787).

promotions rules by LCF in respect of its bond business.<sup>724</sup> In fact, as explained at Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report, the Financial Promotions Team's correspondence with LCF in early April 2017 appears to have been triggered, at least in part, by a member of the public who submitted a report regarding LCF's financial promotions that stated: "*I feel that this* [i.e. LCF's financial promotion] *has to be a scam*".<sup>725</sup> The concerns expressed in this consumer's report were not escalated to those within the FCA involved in reviewing the First VOP Application. The FCA has confirmed that information regarding each of the Financial Promotions Team's interactions with LCF would have been available to the relevant member of the Authorisations Division via the case management system.<sup>726</sup> Based on the information reviewed by the Investigation, it does not appear that *any* of the financial promotions breaches factored into the Authorisations Division's assessment of the First VOP Application at any stage.

- (e) On 6 June 2017, LCF submitted a CCR007 (Consumer Credit data: Key data for credit firms with limited permissions) which showed LCF had zero revenue from regulated activities.<sup>727</sup> Although the Authorisations Division was still assessing the First VOP Application at the time this CCR007 was received by the FCA, it does not appear that the fact that LCF was not using its existing permissions was factored into its ultimate decision. It should have been.

6.12 The risk appetite framework for Variation of Permission cases that was in force at the time of the First VOP Application also set out various "*upward triggers*" which, if present, prompted an increased focus on the issue.<sup>728</sup> These triggers were:

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<sup>724</sup> Section 3 of **Chapter 3** (Key events of the FCA's regulation of LCF) of this Report.

<sup>725</sup> Email Message 20 March 2017 at 10:44pm (Document with Control Number 123602).

<sup>726</sup> FCA response to information request – LCF\_JUL\_006, at pages 1 and 2.

<sup>727</sup> London Capital & Finance plc, CCR007 for the Reporting Period 1 May 2016 to 30 April 2017, submitted 6 June 2017.

<sup>728</sup> New Authorisations Risk Appetite: VoPs, October 2016, at slide 17.

- (a) “*Business Model Risk*” – the examples given included “[i]nnovative/unusual/unfamiliar/high risk business proposition for the (sub)sector”;
- (b) “*Firm-related issues*” – the examples included “[a]dverse intelligence alerts”; and
- (c) “*Management – Individuals & Governance*” – the examples included “[p]ast conduct – firm/individual has sold particular high-risk products to retail customers (e.g. CFDs, Keydata, Connaught, PPI)”.<sup>729</sup>

6.13 The Investigation concludes that the information available to the Case Officer showed there were multiple “*upward triggers*” and, as such, the downgrading of the First VOP Application from “*Enhanced*” to “*Standard*”, with the consequences described above, was inappropriate. These failures in connection with the risk allocation of the First VOP Application arose from a combination of human error and weaknesses in the FCA’s applicable control framework:

- (a) Some responsibility rests with the members of the Authorisations Division who were responsible for changing the risk channel from “*Enhanced*” to “*Standard*”. While the focus of the First VOP Application was on regulated activity, reflecting the FCA’s broader attitude to the Perimeter,<sup>730</sup> the relevant member of the Authorisations Division was not prohibited from considering a firm’s unregulated activity in determining the appropriate risk channel. In view of the red flags associated with LCF,<sup>731</sup> as well as its highly unusual business model, the Investigation concludes that the Authorisations Division could and should have determined that the First VOP Application’s risk channel should not have been downgraded based on the risk posed by LCF’s unregulated bond business.<sup>732</sup>

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<sup>729</sup> *Ibid.*

<sup>730</sup> The FCA’s approach to the Perimeter is discussed in more detail in **Chapter 6** (The FCA’s Approach to the Perimeter) of this Report.

<sup>731</sup> See paragraph 6.11 of this Chapter.

<sup>732</sup> This is particularly the case given the information available to the Authorisations Division suggested that a number of the “*upward triggers*” referenced in the applicable risk appetite framework were engaged in connection with the First VOP Application. Based on this document, the Authorisations Division could have used the risks posed by LCF’s unregulated business to step outside the standard channelling and upgrade LCF’s risk rating to reflect its highly unusual and potentially

- (b) The FCA's process for risk assessing applications for Variation of Permission focused too much on the risks posed by LCF's regulated activity, resulting in the significant issues connected with LCF's unregulated activity not being appreciated and acted upon.<sup>733</sup> Responsibility for this weakness lies with: (i) the Executive Director of SRA given his remit at the time included being "[r]esponsible for establishing and overseeing processes for the authorisation of all firms, transactions and individuals";<sup>734</sup> and (ii) ExCo as a whole given its role in setting the FCA's attitude to the Perimeter.<sup>735</sup>

*Inadequate training of the relevant member of the Authorisations Division*

- 6.14 The second reason for the FCA's failures in the First VOP Application process was that the relevant member of the Authorisations Division was inadequately trained by the FCA to consider LCF's business holistically from reading its financial information.
- 6.15 In the course of reviewing the First VOP Application, the relevant member of the Authorisations Division did (commendably) notice a number of potentially troubling aspects of LCF's business. The relevant member of the Authorisations Division did not, however, question whether, holistically, there was something fundamentally wrong. For example:
- (a) There were questions as to whether LCF was able to meet its obligations as they fell due.<sup>736</sup> The relevant member of the Authorisations Division questioned LCF about this and LCF responded saying it intended to increase its loan-books<sup>737</sup> and,

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risky unregulated bond business. However, given the focus of the FCA's risk process on LCF's regulated activities it is perhaps unsurprising that he did not do so (see: New Authorisations Risk Appetite: VoPs, October 2016, at slide 17).

<sup>733</sup> The applicable risk appetite framework document does not expressly exclude a firm's unregulated activities from this assessment process (unregulated activities are not mentioned at all in the document), but the whole thrust is that the firm's unregulated activities are not part of the risk assessment. Unregulated activities are not included in the document's sector and conduct classifications and, by definition, do not feature in the calculation of the risk level of the firm's regulated activities (see: New Authorisations Risk Appetite: VoPs, October 2016).

<sup>734</sup> FCA Senior Managers Regime, Applying the SMR to the FCA, 2016, at page 46.

<sup>735</sup> This point is discussed further in **Chapter 6** (The FCA's approach to the Perimeter) of this Report.

<sup>736</sup> As explained in paragraph 6.4 of this Chapter and Section 4 of the StoneTurn Accountancy Report at **Appendix 11**.

<sup>737</sup> The relevant member of the Authorisations Division asked LCF the following on 3 April 2017: "[y]ou state that you are assuming 'Interest on the existing loan book will double over next 12 months (spread evenly)'. Please explain the basis for this assumption. Please also explain what assumptions are in place in relation to non payment of debts and the resulting financial figures (in terms of reduced income, written off assets and costs)." LCF's response dated 16 May 2017 stated: "Interest income doubling: We're expecting our loan book to double. Our demand far exceeds supply so we're working to



moreover, borrowers either rolled over their loans or the terms of the loans permitted LCF to request repayment of amounts owing.<sup>738</sup> As noted in paragraphs 6.6 to 6.13 of this Chapter, the relevant member of the Authorisations Division accepted these explanations following the transfer of the First VOP Application from the “*Enhanced*” to the “*Standard*” risk channel. The Investigation has concluded that this approach was inappropriate given the information that was available to the FCA at the time.

- (b) Similarly, LCF's unreliable profit projections did not concern the relevant member of the Authorisations Division because the FCA was “*used to receiving ambitious projections*”.<sup>739</sup>
- (c) A document suggesting that LCF's costs of funds was in the region of 25.5% did not concern the relevant member of the Authorisations Division (as it should have done), on the basis that such costs had a neutral effect on LCF's profitability because they were passed on to the lending side.<sup>740</sup> However, given the relevant member of the Authorisations Division accepted LCF's explanation for the costs of funds, this potential avenue for discovering the high rates of commission paid to Surge was not pursued.

6.16 The relevant member of the Authorisations Division did not appreciate that the totality of the information presented by LCF and the issues in paragraph 6.15 of this Chapter (above)

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*expand our bond book considerably. At present our funds are loaned out as soon as it is raised. We are currently working on 2 bonds to be listed of £100m each [details of bonds followed]... Non-payment of debts: Currently we are maintaining a beneficial loan-to-value ratio holding assets of c. £222 against loans of c. £65m. In the unlikely event of non-performance of a borrower, we would be able to liquidate said assets. We have intimate knowledge of the assets, our borrowers and their ability to repay”* (see: LCF Responses to Variation of Permission Queries, Fourth Series, 16 May 2017, at pages 8 to 9).

<sup>738</sup> For example, on 23 December 2016, the relevant member of the Authorisations Division asked: “[t]here appears to be a difference in the period over which the bonds will run and the period over which the loans these funded will be repaid. The balance sheet as at 30 April 2016 shows bonds due to be repaid within 1 year of £2,556,357 while the loans payments receivable in the same period appear to be £585,568. Please confirm how the applicant intends to fund (or has funded since 30 April) the repayment of bonds as they fall due”. LCF responded to this question by a document dated 30 April 2017 which stated: “[t]he loan agreement with clients has an agreement that, if bond holders do not wish to roll over (reinvest), LC&F can request payment of the loan amounts” (see: LCF Responses to Variation of Permission Queries, Third Series, 30 April 2017, at pages 9 to 10).

<sup>739</sup> Interview Transcript Z, see page 9.

<sup>740</sup> LCF Profit & Loss 2017 (provided to the FCA on 26 January 2017), at page 2; Interview Transcript Z, see page 21.

suggested there was something fundamentally wrong with LCF's business.<sup>741</sup> As a result, the relevant member of the Authorisations Division did not refer LCF to more specialist personnel within the FCA who had experience of reviewing company accounts and other financial information. Such personnel were available and could have probed LCF's financial information further.<sup>742</sup>

6.17 The failures in connection with the FCA's review of the First VOP Application appear to have occurred because of a lack of training provided by the FCA to the relevant member of the Authorisations Division to consider LCF's business holistically by assimilating its financial information. For example, the relevant member of the Authorisations Division in question was able and intelligent but had no accountancy or other business qualifications, which might have been relevant to assessing the financial information presented in LCF's accounts.<sup>743</sup> The relevant member of the Authorisations Division stated that training at the FCA in terms of reading company accounts was mainly "*on-the-job training*".<sup>744</sup>

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<sup>741</sup> Furthermore, the relevant member of the Authorisations Division acknowledged that the presence of significant related parties transactions referred to in LCF's accounts for the period ending 30 April 2016 did not come to his attention as a cause for concern (see: Interview Transcript X, at page 22). LCF's accounts for the period ending 30 April 2016 were lodged at Companies House on 31 October 2016 are available via the Companies House website (see: <https://find-and-update.company-information.service.gov.uk/company/08140312/filing-history> (accessed on 23 November 2020)). The "*Related Parties*" transactions are noted at item 18 on page 26 of those accounts.

<sup>742</sup> Interview Transcript Z at page 14. The FCA has also confirmed to the Investigation that more specialist staff were available. The FCA has confirmed that individuals in the Authorisations Division could contact the FCA's Prudential Specialist Division ("**PSD**") "*as and when necessary*" and the Authorisations Division could also consult "*someone who has the relevant accounting experience in the Authorisations department or Division, and experienced case officer or line manager before escalating to PSD*." The FCA has also told the Investigation that "[r]equests to PSD would not be routinely made". The questions asked would depend on the financial statements or the business model or changes as a result of a Variation of Permission. For example, an usual item in the firm's accounts, something unusual or unclear in the financial projections or a question about what would count as capital for regulatory capital purposes may be the subject of questions. The FCA has also told the Investigation that there are no specific policies or procedures in respect of when a member of the Authorisations Division should seek specialist expertise. Members of the Authorisations Division rely on "*a mixture of peer support, SMEs, buddies, experienced case officers and line managers for support and guidance*" (see: FCA response to information requests – Request 90 / LCF\_SEP\_\_003).

<sup>743</sup> Interview Transcript Z, at page 6.

<sup>744</sup> The relevant member of the Authorisations Divisions had attended an optional three-day internal training course for reviewing financial information in around 2010. The individual explained that staff discussed their training needs with their manager at the start of the year. The individual considered that the training course on financial information had not been ideal on the basis that it had more of a Supervision rather than an Authorisations focus. It may be that a staff member who had more background expertise in wholesale/corporate finance firms may have been more attuned to the risks associated with unregulated securities issues (Interview Transcript X, at pages 38 – 39; Interview Transcript Z, at pages 12 – 14).

- 6.18 The lack of training of the relevant member of the Authorisations Division contrasts with that of the FCA staff in the Listing Transactions Team and the Intelligence Team who, in late 2018, did eventually appreciate the risks which LCF posed. Those staff had backgrounds which were directly relevant to reading financial information in order to recognise circumstances suggesting fraud, financial crime or potential irregularities.<sup>745</sup>
- 6.19 There appears to have been similar weaknesses within the Supervision Division in interpreting financial information in order to recognise circumstances suggesting fraud, financial crime or potential irregularities.<sup>746</sup> Responsibility for inadequacies in the training framework for staff within the Authorisations Division (and the relevant staff within the Supervision Division) ultimately rests with the Executive Director for SRA. As noted above, the Executive Director's remit at the time included being "[r]esponsible for establishing and overseeing processes for the authorisation of all firms, transactions and individuals".<sup>747</sup> In the Investigation's view, this extends to responsibility for ensuring appropriate training so that the processes can operate effectively.
- 6.20 The FCA represented that: (i) members of the Authorisations Division are expected to have financial acumen, to ask pertinent question and to refer issues where appropriate; (ii) it would

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<sup>745</sup> The FCA's regulation of LCF in late 2018, including the detection by staff in the Listing Transactions and Intelligence teams of the FCA of the risk which LCF posed, is explained further in **Chapter 13** (Other matters of importance to the Investigation) of this Report. The staff member in the Listing Transactions Team who raised such concerns was a qualified accountant (see: Interview Transcript A, at page 4). The staff member in the Intelligence Team who detected such concerns came to the FCA from a previous role with an accreditation from a law enforcement agency which required him to maintain CPD requirements on a sixth-month basis (see: Interview Transcript B, at page 7).

<sup>746</sup> As discussed in **Chapter 10** (Adequacy of the FCA's supervision of LCF) of this Report. One individual in the Supervision Division stated in interview: "*I don't believe to the best of my knowledge that there is much training around how to identify financial crime. I think there are those – most people with intelligence teams have a good understanding of financial crime. But across the rest of the organisation I don't think the knowledge is there, frankly.*" (see: Interview Transcript AD, at page 7).

<sup>747</sup> Senior Managers Regime, Applying the SMR to the FCA, 2016, at page 46. The Executive Director of Supervision – Retail and Authorisations emphasised in interview that steps had been taken to improve financial literacy in both the Authorisations Division and the Supervision Division as part of the DES and DEA Programmes: see e.g. Interview with J Davidson, 15 June 2020 pages 16 to 18, 28 and 40. However, the Executive Director had identified "*people risks*" associated with the quality and training of staff (including in respect of Authorisations) as a "*top risk*" in both the Risks and Controls Self-Assessments dated 25 January 2016 (at page 2) and 13 January 2017. Despite this risk having been identified both before and during the First VOP Application, there appears to have been serious deficiencies in the training of the relevant member of the Authorisations Division responsible for that application. Indeed, much of the work in developing capability appears to have only started in 2018 (after the First VOP Application had concluded): see the ExCo Paper titled "*Developing Capability*" dated 19 June 2018. Accordingly, the steps taken to improve financial literacy after the First VOP Application do not excuse the Executive Director's responsibility for the deficient financial literacy of members of the Authorisations Division.

not be feasible for the FCA to train all employees to have expertise in financial analysis and that if it were to do so it would be costly; and (iii) if members of the Authorisations Division were expected to conduct a detailed review the financial accounts of every firm it would have significantly extended the time taken to review each authorisation application. The Investigation rejects the proposition that it would be necessary to for relevant members of the Authorisations Division to conduct a detailed review of *every* firm's accounts and that it would require a high standard of expertise in financial analysis for FCA employees to identify and act upon the red flags presented by LCF. As described above, the problems with LCF's accounts, and the red flags in LCF's business model, were sufficiently obvious such that they ought to have triggered further investigation during the various regulatory transactions. Most firms will not present such red flags which require further investigation.

6.21 The FCA also represented that the Investigation required the assistance of a forensic accountant to spot the issues with LCF's financial information. This is not correct. The Investigation Team identified a number of red flags in the financial information provided to the FCA by LCF (in particular the financial information provided as part of the First VOP Application) and then engaged a forensic accountant to confirm the team's original view. The relevant individual in the Authorisations Division, when reviewing the First VOP Application, should have done likewise; i.e. on identifying concerning red flags in LCF's financial information that individual should have sought assistance from someone with relevant expertise in reviewing financial information.

*FCA's approach to the Perimeter*

6.22 The FCA's approach to the Perimeter also contributed to the failures in the First VOP Application. As explained at paragraph 6.13(b) of this Chapter, the First VOP Application focused on regulated activity, with the result that the relevant member of the Authorisations Division failed properly to assess both the risks posed by LCF's business as a whole, and, in particular, by its unregulated bond business.

6.23 The FCA's approach to the Perimeter also appears to have contributed to the relevant member of the Authorisations Division's failure to appreciate the risk which LCF posed to consumers following an allegation of fraud made against LCF in early 2017. As noted at paragraph 6.11(c) of this Chapter, in January 2017, the FCA received the Anonymous Letter,

which alleged that LCF may have been engaged in fraud and other irregularities.<sup>748</sup> Although the relevant member of the Authorisations Division was copied on correspondence from the Supervision Division regarding the Anonymous Letter, no steps were taken to consider the issues in the letter, despite the Authorisations Division being in a position to do so in the context of the First VOP Application. Nor did the Authorisations Division (or any other team within the FCA) consider the allegations made in the Anonymous Letter in the light of the many other red flags, such as LCF's financial promotions breaches.<sup>749</sup> This is despite the fact that, very shortly before the FCA received the Anonymous Letter, the relevant member of the Authorisations Division had received financial crime training.<sup>750</sup>

6.24 The Investigation considers that the Authorisations Division's failure to consider LCF's business further in the light of the Anonymous Letter appears to have been attributable to the FCA's approach to the Perimeter. The relevant member of the Authorisations Division stated in interview that allegations of fraud would be "*principally a matter for the police*".<sup>751</sup>

6.25 In summary, the FCA's approach to the Perimeter contributed to failures in the First VOP Application. Despite LCF going through an authorisation process at the time, the FCA's Authorisations Division did not consider LCF's business in the light of the allegations of fraud in the Anonymous Letter of early 2017. This failure is particularly striking in the light of the FCA's public statements such as those set out Section 2 of this Chapter, that the FCA's

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<sup>748</sup> As explained in Section 4 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report, the FCA received the Anonymous Letter alleging fraud on the part of LCF in January 2017.

<sup>749</sup> See Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) for details of the various interactions between the Financial Promotions Team and LCF in 2016/2017. The FCA has confirmed that the relevant member of the Authorisations Division had access to the relevant case files/"*risk events*" on the case management system (see: FCA response to information request – LCF\_JUL\_006, at page 1). However, despite the First VOP Application running from October 2016 to June 2017, the relevant member of the Authorisations Division did not recall reviewing details of any financial promotions breaches (Interview Transcript X, at page 41; Interview Transcript Z, at pages 15 and 16). This is despite the fact that as part of its proposed corporate finance service, LCF was proposing to approve financial promotions of the companies to which it provided services (see: London Capital & Finance plc, Regulatory Business Plan, 4 October 2016, at page 2).

<sup>750</sup> LCF\_JUN\_06 – HR Records, at page 3.

<sup>751</sup> When pressed on where responsibility lay for responding to allegations regarding FCA-authorized firms, the relevant member of the Authorisations Division stated that responsibility would rest with the Supervision rather than the Authorisations Division (Interview Transcript X, at page 25). As explained in **Chapter 10** (Adequacy of the FCA's supervision of LCF) however, the Supervision Division also considered the matter primarily one for the police and also failed to properly consider LCF's business following receipt of the letter.

authorisation processes kept undesirable firms out of the market.<sup>752</sup> In reality, the FCA's scrutiny of firms in its authorisations process appears to have been severely constrained by its approach to the Perimeter, with the result that LCF's business was not properly scrutinised because its bond business fell outside the Perimeter. This was so even when allegations of fraud and other irregularities were made against the firm to the FCA while the First VOP Application was under review.

*Failure to consider the appropriateness of LCF's permissions on an ongoing basis*

6.26 The FCA also failed to consider whether the permissions which LCF had been granted as a result of the First VOP Application were appropriate on an on-going basis.

6.27 LCF does not appear to have been placed on any monitoring list for unusual and potentially concerning firms despite its unusual business model and the potential risks associated with its business set out above. Nor has the Investigation seen evidence that such a facility was available to the Authorisations Division to ensure that the appropriateness of LCF's permissions were kept under review.

## 7. Conclusion

7.1 As explained above, the Investigation has concluded that LCF's permissions were inappropriate for the business which it carried on for three reasons:

- (a) First, LCF may have carried on some regulated activities for which it did not have permission. However, the Investigation has concluded that the FCA was not at fault in not having identified that LCF may have been conducting regulated activities without permission. This issue is, therefore, of limited importance to the Investigation.
- (b) Second, and more importantly, the FCA appears to have granted LCF permissions for regulated activity which it did not carry on.

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<sup>752</sup> As further set out in **Chapter 13** (Other matters of importance to the Investigation), the FCA's attitude in respect of fraud needs to change. FCA staff must have greater awareness that protecting consumers from fraud committed by FCA-authorized firms is within remit of the FCA. This is particularly the case where a firm such as LCF is using its FCA-authorized status to attract investors to its non-FCA-authorized business.

- (c) Third, the Authorisations Division failed to appreciate the risks which LCF's business (albeit unregulated) posed to consumers and this resulted in the First VOP Application being approved when it should have been rejected or only approved subject to conditions or monitoring. Those failures occurred because: (i) LCF's approach to risk rating was overly focused on whether the firm had financial problems which could impact LCF's regulated business;<sup>753</sup> (ii) the relevant member of the Authorisations Division involved in the review of the First VOP Application was inadequately trained;<sup>754</sup> (iii) there were deficiencies in the FCA's approach to the Perimeter;<sup>755</sup> and (iv) there was no facility to make LCF's permissions subject to any conditions, or enhanced monitoring, to ensure that the appropriateness of those permissions was kept under review.<sup>756</sup>

7.2 The second and third failures in the FCA's authorisations process described in paragraphs 7.1(b) and (c) above are of particular importance because FCA-authorisation provided LCF with an imprimatur of respectability which was crucial in attracting investors to LCF's bond issues. That imprimatur was reinforced by the public statements made by the FCA which purported to provide reassurance that the FCA-authorisation process kept undesirable firms out of the market. In fact, however, such reassurances were unjustified and the imprimatur of respectability which LCF obtained from its FCA-authorisation was similarly unwarranted.

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<sup>753</sup> Paragraphs 6.6 to 6.13 of this Chapter.

<sup>754</sup> Paragraphs 6.14 to 6.19 of this Chapter.

<sup>755</sup> See paragraphs 6.20 to 6.23 of this Chapter. A wider discussion of the FCA's approach to the Perimeter is set out in **Chapter 6** (The FCA's approach to the Perimeter) of this Report.

<sup>756</sup> See paragraphs 6.24 to 6.25 of this Chapter.

## **CHAPTER 10: ADEQUACY OF THE FCA'S SUPERVISION OF LCF**

### **1. Introduction**

1.1 As set out in **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes) of this Report, ExCo was aware of the inadequacy of its supervision of flexible firms from late 2015 onwards<sup>757</sup> and the Board was aware from at least November 2016.<sup>758</sup> Those inadequacies meant there was no proactive supervision of LCF for the entirety of the Relevant Period. This Chapter does not repeat the inadequacies in the FCA's proactive supervision of flexible firms that were the genesis of the DES programme but considers more specifically the FCA's supervision of LCF.

1.2 Although the FCA had identified risks to consumers from mini-bonds, no thematic (or other) supervisory work was undertaken that resulted in a review of LCF's business before the intervention in late 2018.<sup>759</sup> Accordingly, the FCA's supervision of LCF throughout the Relevant Period was, in theory and under the regime in place, limited to reacting promptly and appropriately to risk events as and when they arose. Various red flags related to LCF were brought to the FCA's attention, including allegations of fraud and repeated breaches of the FCA's financial promotions rules. However, rather than assessing these red flags holistically to determine whether there were fundamental problems with LCF's business model or conduct which required early intervention or enforcement action, the FCA dealt with each issue regarding LCF in isolation. Further, any reactive supervision was also hampered by the supervisory model that applied before the implementation of the DES programme, which the Executive Director of the SIWS part of Supervision described as requiring supervisors to “*make a binary decision to act or not act based on a set of risk parameters that were largely quantitative*”.<sup>760</sup> Accordingly, the FCA's limited approach to

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<sup>757</sup> E.g. Risk and Controls Self-Assessment for the SIWS Division, Statement of Assurance (as at 31 December 2015), 22 January 2016, at page 1.

<sup>758</sup> Presentation to the FCA Board: Delivering effective supervision, 1 November 2016, at page 2.

<sup>759</sup> See **Chapter 7** (The FCA's awareness of mini-bonds and the related risks) for further detail on the risks to consumers posed by mini-bonds that the FCA identified during the Relevant Period and the limited work that was undertaken in response.

<sup>760</sup> Interview with M. Butler, 19 June 2020, at page 22.



supervising LCF did not prevent the risk of significant consumer harm from increasing and, ultimately, materialising.

1.3 In the circumstances, the Investigation concludes that, even in the limited area of reactive supervision, the FCA did not adequately supervise LCF's compliance with its rules and policies.

## **2. Public statements made by the FCA on supervision**

2.1 That the supervision of a firm such as LCF was limited was certainly not clear to consumers based on the public statements made by the FCA in connection with its approach to supervision during the Relevant Period.

2.2 The FCA's 2014/2015 Business Plan (published the day before the start of the Relevant Period) gave the following description of the FCA's approach to supervision:

*“Our supervision focuses on firms' culture, looking at their business models to ensure that consumers are at the heart of what they do and that remuneration practices do not incentivise employees to put quick profit first, at the expense of consumers getting products and services that meet their needs or of the integrity of the market...Our risk-based model enables us to find and deal with the root causes of issues in the markets to deliver a forward-looking approach that puts the interests of the consumer and market integrity at its heart. We carry out thematic work and market studies to investigate themes and specific products across the financial sectors and, where we find problems, we intervene early to prevent harm to consumers... If we find poor practice, we use our enforcement powers to ensure that firms and individuals that don't follow our rules do not damage consumer interests or the integrity of and confidence in our markets.”<sup>761</sup>*

2.3 The FCA's 2015/2016 Business Plan provided consumers with similar purported comfort regarding the scrutiny to which FCA-authorized firms would be subject by describing the FCA's approach to supervision as:

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<sup>761</sup> FCA Business Plan, 2014/2015, at page 6 (see: <https://www.fca.org.uk/publication/other/business-plan-2014-2015-interactive.pdf> (accessed on 23 November 2020)).

*“We look closely at firms’ business models and culture and use our judgement to assess whether they are sound and robust. We focus on the big issues and the causes of problems, as well as ensuring that there are accountable individuals in the firm if things go wrong. We have to be confident that if problems do arise, firms will be able to do the right thing for their customers and markets. Where we find poor practice we use our supervisory and enforcement tools to deter others, mitigate risks and secure redress for consumers where necessary.”*<sup>762</sup>

2.4 A slightly watered down version of that description was included in the FCA’s 2016/2017 Business Plan:

*“**Where necessary**, we look closely at firms’ business models and culture to assess whether they are sound and robust. We focus on the most significant issues and seek to ensure that firms identify and tackle the root causes of problems. We place a great emphasis on the responsibility of senior management within firms and expect individuals within firms to be accountable for their activities. We need to be confident that firms do the right thing for their customers and markets if problems occur. When we find poor practice we use our supervisory and enforcement tools to mitigate risks, deter others and secure redress for consumers where necessary”*<sup>763</sup> (emphasis added).

2.5 On a similar note, the FCA’s Mission document (published in April 2017) included a section describing what consumers could expect from the FCA and it stated:

*“However, it is the firms’ responsibility to follow our requirements. We do not operate a zero-failure regime. Some firms will fail financially and will sometimes fail to treat their customers fairly. Our rules include requirements for how firms handle complaints and provide redress.”*<sup>764</sup>

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<sup>762</sup> FCA Business Plan, 2015/2016, at page 63 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2015-16.pdf> (accessed on 23 November 2020)).

<sup>763</sup> FCA Business Plan, 2016/2017, at page 41 (see: <https://www.fca.org.uk/publication/corporate/business-plan-2016-17.pdf> (accessed on 23 November 2020)).

<sup>764</sup> FCA: Our Mission 2017, April 2017, at page 25 (see: <https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf> (accessed on 23 November 2020)).

2.6 The Supervision section of the Handbook (“**SUP**”) also explained that the FCA’s approach to supervision purportedly would be to “*adopt a pre-emptive approach which will be based on making forward-looking judgments about firms’ business models, product strategy and how they run their businesses, to enable the FCA to identify and intervene earlier to prevent problems crystallising*”.<sup>765</sup>

2.7 The FCA’s public statements on its approach to supervision have evolved over time. However, based on the public statements available throughout the Relevant Period, it would have been reasonable for any consumer to conclude that the FCA would be taking supervisory or enforcement action where it was aware of multiple red flags, including allegations of fraud or other misconduct and breaches of the FCA’s financial promotions rules. Such assumption, so far as any FCA action in relation to LCF was concerned, would have been misplaced.

### **3. Failure to appreciate the significance of red flags**

3.1 Despite the position set out in the FCA Handbook and in the FCA’s public statements, the FCA failed to ensure that it gave adequate consideration to LCF’s business as a whole in the light of all the evidence in the FCA’s possession. As a result, the Supervision Division failed to detect that a growing number of red flags signalled that LCF posed a significant and increasing risk to consumers. As detailed below, the FCA failed to detect the significance of:

- (a) express allegations from third parties that LCF was engaged in fraud or seriously irregular behaviour;
- (b) repeated breaches of the FCA’s financial promotions rules whereby LCF improperly used its FCA-authorized status to attract investors to its non-FCA-authorized bond business; LCF also repeatedly failed to give adequate risk warnings in its promotions for its bond issues;

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<sup>765</sup> See SUP 1A.3.1G.

- (c) regulatory returns and other information submitted by LCF to the FCA which showed that LCF was not conducting the regulated activities for which the FCA had granted it permission; and
- (d) LCF issuing mini-bonds, a product identified by the FCA during the Relevant Period as potentially being a vehicle for fraud and, in addition, the fact that the way in which LCF offered mini-bonds was unusual.<sup>766</sup>

*Allegations from third parties that LCF was engaged in possible fraud or irregularity*

3.2 The FCA received express allegations from third parties to the effect that LCF was engaged in possible fraud or serious irregularities.<sup>767</sup> However, the FCA failed to give adequate consideration to LCF's business as a whole in the light of this information.

3.3 For example, the FCA received multiple calls to its Contact Centre alleging that LCF was engaged in possible fraud or serious irregularity. The calls are summarised in **Appendix 6** below. The FCA received such calls on multiple occasions between 2016 and 2018, including repeated calls from Individual A.<sup>768</sup> The calls raised issues such as LCF's refusal to provide information to potential investors on the use of investors' capital, LCF's relationship with the trustee company, Global Security Trustees Limited,<sup>769</sup> the integrity of LCF's company structure and the rate of LCF's growth. One of Individual A's calls also raised allegations that LCF might be operating a "pyramid scam".<sup>770</sup> As set out in **Chapter 12** (Information provided by third parties) of this Report, such calls were often not referred from the Contact Centre to the Supervision Division or, even when they were referred, the allegations of possible fraud or serious irregularity were not pursued.

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<sup>766</sup> This point is not dealt with directly in this Chapter but is, instead, addressed in **Chapter 7** (The FCA's awareness of mini-bonds and the related risks).

<sup>767</sup> See **Chapter 12** (Information provided by third parties) and **Appendix 6** for further detail on the warnings that the FCA received from third parties.

<sup>768</sup> The Investigation has only reviewed a sample of the consumer calls the FCA's Customer Contact Centre received in respect of LCF as explained in **Appendix 6**. Section 4 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report provides an overview of the calls made by Individual A.

<sup>769</sup> Transcript of a call from Individual A to the FCA Contact Centre 22 July 2016, at page 7.

<sup>770</sup> Transcript of the first call from Individual A to the Customer Contact Centre 15 July 2017, at pages 5 to 11; Transcript of the second call from Individual A to the Customer Contact Centre 15 July 2017, at page 8.

3.4 A further example of the FCA failing to consider LCF's business as a whole following warnings by third parties arises in connection with the Anonymous Letter. As explained in more detail in Section 4 of **Chapter 3**, the Anonymous Letter was sent in January 2017 to a Detective Constable in the Metropolitan Police with a copy to an individual in the FCA's Unauthorised Business Department. The content of the Anonymous Letter was as follows:

*“Re.London Capital and Finance Group*

*I wrote a few back [sic] regarding the above company. Just by way of an update. They have raised £30m now and as far as I can see they have just “lent” the money to related companies controlled by the main players... [the letter then lists two individuals, neither of whom were obviously connected to LCF (i.e. they were not LCF's Approved Persons)].*

[The letter then includes a sentence alleging that one of the individuals had been making lavish purchases.]

*They trade on the fact that they are FCA regulated well they have a consumer credit license, they are not authorised for investment purposes or dealing with the general public re investment... the product is being heavily mis sold [...]*

*It crazy...*

*I have copied in [an FCA employee in the Unauthorised Business Department] at the FCA too... hopefully between you things will happen.”<sup>771</sup>*

3.5 In the event, the letter was forwarded on to the Supervision Division because the Unauthorised Business Division did not deal with FCA-authorised firms.<sup>772</sup>

3.6 The Supervision Division did not properly scrutinise LCF's business as a whole following receipt of the Anonymous Letter. Instead, the Supervision Division simply asked the Intelligence Team to contact the Detective Constable at the Metropolitan Police to whom the letter was addressed. Following contact between the Intelligence Team and the Detective Constable in the second half of February 2017, the Supervision Division closed the risk event on the basis the FCA did not believe that the entity referred to in the letter – “London Capital

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<sup>771</sup> Anonymous Letter addressed to a Detective Constable in the Metropolitan Police, undated.

<sup>772</sup> Interview Transcript C, at pages 7 to 11.

and Finance Group” – was the same entity as LCF and that the names and addresses of the individuals referred to in the letter did not match with those connected with LCF.<sup>773</sup> The FCA was unable to produce evidence to the Investigation of exactly what the Detective Constable at the Metropolitan Police told the individual in the Intelligence Team regarding the contents of this letter.<sup>774</sup> This of itself demonstrates a failing on the part of the FCA, as it should record, and be able to evidence, key decisions taken in response to allegations of fraud.

3.7 Despite allegations of fraud and other wrongdoing in the Anonymous Letter (including potential consumer detriment), no one in the FCA:

- (a) conducted a review of LCF's financial information to determine whether there were circumstances suggesting that LCF was engaged in possible fraud or serious irregularities; this is despite the fact that, as noted in **Chapter 9** (Appropriateness of LCF's permissions) above: (i) LCF was going through the First VOP Application when the Anonymous Letter was received; and (ii) the FCA had by this stage access to worrying financial information regarding LCF and received similarly concerning information during the FCA-authorisation process.
- (b) considered the Anonymous Letter in the light of other red flags; by early 2017, the FCA knew that LCF had been involved in at least two financial promotions breaches.<sup>775</sup> From around mid-2016, the FCA had also received a high-volume of consumer calls in respect of LCF.<sup>776</sup> Furthermore, as recorded in **Appendix 6**, by early 2017 the FCA had received (in calls to the Contact Centre on 18 July 2016 and 22 July 2016) at least three allegations that LCF was engaged in possible fraud

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<sup>773</sup> Case Detail (Document with Control Number 123434).

<sup>774</sup> Email from the FCA Investigation Liaison Team to the Investigation Team, 16 July 2020 at 10:19pm.

<sup>775</sup> See Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) of this Report.

<sup>776</sup> LCF from around mid-2016 featured increasingly prominently in a document which was produced monthly by the FCA which summarised calls received about firms titled “*Consumer Investment Products Emerging Themes*”. LCF was in the top 3 firms for June, July, August, September and October 2016. Such information indicates that the FCA was receiving an increased number of queries from consumers regarding LCF. (FCA Internal Document: *Consumer Investment Products Emerging Themes*, various dates)

or irregularity. However, the FCA did not consider these matters when looking at the Anonymous Letter.

- 3.8 In the event, despite the allegations in the Anonymous Letter, the FCA failed to appreciate the risk which LCF posed to consumers.
- 3.9 A further example of the FCA failing to consider LCF's business as a whole following allegations by third parties occurred in around March 2017. A member of the public raised a concern regarding one of LCF's financial promotions by email to the Financial Promotions Team.<sup>777</sup> The member of the public also stated regarding LCF, "*I feel this has to be a scam*" and gave various reasons for his suspicions.<sup>778</sup> As a result of this communication, the Financial Promotions Team contacted LCF regarding concerns to do with LCF's website<sup>779</sup> but did not investigate whether LCF was operating a scam by, for example, interrogating LCF's financial information. The Financial Promotions Team also did not refer the consumer concerns to any other team within Supervision or Authorisations. This is despite the fact that the First VOP Application was underway.
- 3.10 Consequently, for the reasons set out above, the Investigation has concluded that the FCA failed to give adequate consideration to LCF's business as a whole in the light of express allegations it received from third parties that LCF was engaged in possible fraud or serious irregularities.

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<sup>777</sup> Email Message 20 March 2017 (Document with Control Number 123602).

<sup>778</sup> The member of the public's email stated: "[t]his limited liability partnership is claiming to charge small businesses 10-20% interest on loans, and offers up to 8% interest for 3 year bonds of a minimum of A£5000, I feel that this has to be a scam. I checked the FCA register and the company has been registered since July last year – a big red flag in my opinion that they are such a new company. They are not covered by the FSCS and do not adhere to anti-money laundering regulations. They claim to offer asset backed securities that will give people the impression that the "bonds" they are buying are safe investments, yet a quick look at the risks they state at the bottom of their page reveal these are highly risky investments with no guarantees, no assets (or at least quality ones) to back them up so far as I can tell. My guess is that they will take peoples money and will go out of business before the bonds are redeemable. In addition, they also claim that to have a "withholding tax" on the interest paid of 20%, which also speaks for itself. There are red flags all over their literature" (*Ibid.*).

<sup>779</sup> Letter from the Financial Promotions Team to LCF, 5 April 2017 (Document with Control Number 112309).

*Repeated financial promotions breaches*

- 3.11 The FCA also failed to consider LCF's business as a whole despite its repeated breaches of the FCA's financial promotion rules.
- 3.12 For example, the Financial Promotions Team repeatedly contacted LCF and related parties in connection with LCF's financial promotions on the basis that LCF was improperly using its FCA-authorized status.<sup>780</sup> However, these financial promotions breaches did not result in a referral to the Supervision or Enforcement Divisions for further review.<sup>781</sup> Accordingly, no team within the FCA reviewed and assessed LCF's business as a whole in the light of these breaches. For example, despite LCF repeatedly using its FCA-authorized status improperly in its promotions, and despite the FCA having information that LCF was not conducting regulated activity, the FCA did not consider whether LCF had obtained, or was using, its FCA-authorized status for the purpose of attracting investors to its non-FCA authorized bond issues.
- 3.13 The Financial Promotions Team's correspondence with LCF and related parties regarding LCF's financial promotions also repeatedly noted that LCF failed to give adequate risk warnings in its promotions relating to its bond issues. However, the FCA never stepped back and analysed whether LCF was likely to be misleading consumers as to the risk of its products in its business and marketing more widely.
- 3.14 In addition, although LCF's breaches of the financial promotions rules triggered the Financial Promotions Team's "*repeat breacher*" policy,<sup>782</sup> this only resulted in the threat of a senior individual at LCF having to give an attestation. Despite the repeated breaches being indicative of, at a minimum, poor systems and controls, no steps were taken to assess LCF's

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<sup>780</sup> Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF) summarises the FCA's repeated correspondence regarding LCF's financial promotions.

<sup>781</sup> The Enforcement Division is primarily reliant on cases being referred from the Supervision Division. The Executive Director of Enforcement and Market Oversight explained: "*we don't run our own detective radar across Supervision. Supervision does that, and they refer matters to us*" (Interview with M. Steward, 12 June 2020, at pages 6 and 7). One member of the Financial Promotions Team noted in interview that it was extremely infrequent for a case to be referred from the Financial Promotions Team to the Enforcement Division: "[i]t's very unlikely or the message we've had from enforcement is that it's quite unlikely that a financial promotions case in itself would be accepted by Enforcement for enforcement action... it's certainly not an outcome that I have used in the four years that I've worked in the team" (Interview Transcript E, at page 21).

<sup>782</sup> See **Chapter 11** (FCA rules and policies relating to LCFs financial promotions).



systems and controls for financial promotions. The Investigation would have expected the FCA to have undertaken some proactive and ongoing monitoring of LCF's financial promotions in the light of the repeated breaches. No such monitoring occurred.

*Information showing LCF was not carrying out regulated activity*

- 3.15 The FCA also failed to consider LCF's business as a whole in the light of information showing that LCF was not carrying out any regulated activity for which it had obtained permissions.
- 3.16 LCF's regulatory returns submitted to the FCA showed that, despite the fact that it had consumer credit and then corporate finance permissions, it was not, in fact, using those permissions:
- (a) CCR007 regulatory return (*Consumer Credit Data: Key data for credit firms with limited permissions*) for the period 1 May 2016 to 30 April 2017 stated that its total revenue from credit-related regulated activities was £0 against a total revenue (including from activities other than credit-related regulated activities) of £6,678,685;<sup>783</sup>
  - (b) FSA030 regulatory returns (*Income Statement*) provided to the FCA on various dates from August 2017 (i.e. after LCF had become a full permission firm in June 2017) repeatedly stated that all LCF revenue fell into the "Other revenue" category (in other words, no revenue had accrued or was expected from the firm's regulated activities);<sup>784</sup> and
  - (c) FIN-A regulatory return (*Annual Report and Accounts*) for the reporting period ending on 30 April 2018 and submitted by LCF to the FCA in August 2018 similarly stated that the firm did not generate income from regulated activities during the accounting period.<sup>785</sup>

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<sup>783</sup> London Capital & Finance plc, CCR007 for the Reporting Period 1 May 2016 to 30 April 2017, submitted 6 June 2017.

<sup>784</sup> FCA Response to Information Request – LCF\_DEC11/12\_05.

<sup>785</sup> LCF's FIN-A Annual Report and Accounts for the period ending 30 April 2018, submitted 22 August 2018.

- 3.17 In relation to the FIN-A return, the FCA had amended its approach in January 2018, with the result that a return stating a firm did not generate income from regulated activities would have generated an automated alert. Because of the volume of automated alerts that were created as a result of this change in approach and what the FCA regarded as the limited perceived risks, the FCA implemented a further process change. This change meant that the alert arising from LCF's FIN-A return in August 2018 was closed without review but, according to the FCA, could have been considered in the event of subsequent alerts.<sup>786</sup>
- 3.18 The FCA has stated that these automated alerts "*do not necessarily signify a breach of our rules or prudential requirements*".<sup>787</sup> However, by this stage, the information from the FIN-A submission was another piece in the jigsaw which should have demonstrated to the FCA that there were serious concerns with LCF's business. For example, by August 2018, the FCA was aware that:
- (a) LCF had repeatedly breached financial promotions rules by using its FCA-authorized status improperly to attract investors to its non-FCA-authorized bond business.
  - (b) LCF's business model was highly unusual in that it had access to the "badge" of FCA-authorization by virtue of its corporate finance advice permission, but operated at a level of risk wholly different from the norm for corporate finance advisory firms. That was because LCF received money from investors in return for issuing its own securities to them. That money<sup>788</sup> was then effectively at risk in the event that LCF collapsed.
- 3.19 In addition, if the FCA had considered the FIN-A submission with the previous regulatory returns and the regulatory business plan submitted by LCF to the FCA during the course of the First VOP Application,<sup>789</sup> these would have demonstrated that LCF appeared to have

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<sup>786</sup> Response to information request – LCF\_JUN\_09, at page 1.

<sup>787</sup> *Ibid*, at page 2.

<sup>788</sup> The fact that, as previously noted, investors no longer retained a proprietary interest in funds subscribed was irrelevant to any analysis.

<sup>789</sup> London Capital & Finance plc – Regulatory Business Plan, 4 October 2016, at page 8.

generated zero revenue from its regulated business (either consumer credit or corporate finance) from at least 2015.

3.20 The Supervision Division's failure to address the fact that LCF was not using its permissions is a further failure in the supervision of LCF and this occurred despite the fact that the FCA had specific powers to alter or revoke firms' permissions, if they did not carry on regulated activity for which they had obtained permission.<sup>790</sup> Ultimately, this was yet another aspect of the FCA failing to give adequate consideration to LCF's business as a whole in the light of all the evidence in its possession. As a result, the Supervision Division failed to detect that a growing number of red flags signalled that LCF posed a significant, and increasing, risk to consumers.

#### **4. The FCA's approach to the Perimeter contributed to failures in supervising LCF**

4.1 The FCA's approach to the Perimeter contributed to failures in supervising LCF.<sup>791</sup>

4.2 The FCA's approach meant that the Supervision Division did not take adequate responsibility for supervising LCF because its core activity of issuing bonds fell outside the Perimeter:

- (a) for example, one of the reasons it appears the FCA did not respond adequately to the allegations in the Anonymous Letter was because FCA staff considered the letter primarily a matter for the police;<sup>792</sup> and

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<sup>790</sup> Provisions were in place under sections 55L and 55J of FSMA 2000 to vary or cancel firms' permissions. SUP 7.2.2G stated that "[t]he circumstances in which the FCA may vary a firm's Part 4A permission on its own initiative or impose a requirement on a firm under sections 55J or 55L of the Act include where it appears to the FCA that... (3) a firm has not carried out a regulated activity to which its Part 4A permission applies for a period of at least 12 months." Similar statements appeared in paragraph 8.1 of the Enforcement Guide.

<sup>791</sup> **Chapter 6** (The FCA's approach to the Perimeter) of this Report sets out further details of the FCA's general approach to the Perimeter.

<sup>792</sup> A member of the Authorisations Division with responsibility for the First VOP Application stated in interview "[i]f it is a matter of fraud, that would principally be a matter for the police or similar, rather than internally for the FCA" (Interview Transcript X, at page). A member of the FCA's Supervision Division stated in interview "[i]t would have been, let's see what the police have got and wait in the whole" (Interview Transcript AK, at page 20). Another member of the Supervision Division further stated in interview "[i]t was essentially to check with the police whether or not what they were looking at was the same details that we have for our firm" (Interview Transcript AF, at page 21). The FCA also appears not to have independently verified the police's conclusion that the Anonymous Letter did not refer to LCF (Interview Transcript G, at pages 23-24).

(b) interviews with FCA staff members also support the conclusion that the FCA's approach to the Perimeter contributed to failings in supervising LCF.<sup>793</sup>

4.3 In the absence of proactive supervision of LCF, the department with the most interaction with LCF during the Relevant Period appears to have been the Financial Promotions Team. This was because LCF's financial promotions, unlike its bond issues, fell within the Perimeter. However, for the reasons below, the Financial Promotions Team was not appropriately equipped to consider LCF's business as a whole.

4.4 First, the Financial Promotions Team was very small and consisted of around eight to ten people.<sup>794</sup> These staff members performed a wide range of functions including: (i) proactively reviewing financial promotions; (ii) reacting to consumer complaints about financial promotions; and (iii) providing specialist support to other areas of the FCA. Moreover, the team's staff numbers had declined over the years.<sup>795</sup> Accordingly, the Financial Promotions Team did not have sufficient resource to consider LCF's business as a whole.<sup>796</sup>

4.5 Second, the Financial Promotions Team was not adequately trained to consider LCF's business as a whole. The Financial Promotions Team operated under a very narrow remit

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<sup>793</sup> For example, the Executive Director of Enforcement & Market Oversight stated: "*I think there was a prevailing view within supervision that this was outside the perimeter and so their focus and their priority should be on things within the perimeter, not things that are outside the perimeter. Leaving aside the fact that this firm was regulated as a credit broker and then went on to get further permissions, the activity here wasn't within the perimeter by supervision's mindset and so it mattered less.*" (Interview with M. Steward, 12 June 2020, at page 36). The CEO also stated in interview that there was an attitude on his arrival at the FCA that the FCA should not concern itself with matters outside the Perimeter which he sought to change: "*the FCA took a very, pretty robust approach to the perimeter in terms of where it put its resources, prioritised its resources... I was very clear we have to shift the attitude to the perimeter because... a) it's very complicated, b) it's porous and c) stuff goes across it. To regard it as a sort of hard and fast "you're either in or you're out" is a problem.*" (Interview with A. Bailey, 17 June 2020, at page 13).

<sup>794</sup> See the FCA's Response to Document Request 92.

<sup>795</sup> When the FSA's financial promotions team was established in April 2004 it had approximately 30 staff (see *Financial Promotions: Taking Stock and Moving Forward*, FSA, February 2005, at page 5 ([https://webarchive.nationalarchives.gov.uk/20081112201535/http://www.fsa.gov.uk/pubs/other/promo\\_forward.pdf](https://webarchive.nationalarchives.gov.uk/20081112201535/http://www.fsa.gov.uk/pubs/other/promo_forward.pdf)) (accessed on 23 November 2020)). However, during the Relevant Period the team's average FTE headcount declined from 10.4 to 7.9 (see the FCA's Response to Document Request 92)). A relevant FCA employee stated that there had been pressure to reduce resources/headcount in the Financial Promotions Team.

<sup>796</sup> For example, the Financial Promotions Team was not adequately resourced to conduct preliminary reviews of LCF's financial information for suspicious or concerning entries. A relevant FCA employee stated in interview: "*eight to 10 people simply is not enough of a resource to do anything along the lines you suggest of further digging or gathering underlying material.*"

whereby its staff were expected to identify promotions which on their face were not fair or clear or were misleading.<sup>797</sup> The Financial Promotions Team was not trained, however, to consider businesses more broadly. For example, members of the team were not trained to read financial information to recognise unusual or suspicious entries or circumstances suggesting fraud or other irregularities.<sup>798</sup> This is a further reason why the Financial Promotions Team was not equipped to consider LCF's business as a whole. In the light of the above, it was particularly important that there was an alternative team in Supervision that was equipped to consider LCF's business as a whole in light of the financial promotions breaches.

## 5. Inadequate training of individuals in the Supervision Division

5.1 The FCA's failures in supervision are also partially attributable to its staff being inadequately trained to consider a firm's business as a whole.

5.2 For example, in the case of the Anonymous Letter, there was no policy which required the Supervision Division to interrogate a firm's financials for indicative entries following an allegation of fraud being made against a firm. Staff were instead encouraged to adopt a "common sense" approach.<sup>799</sup> In the event, however, LCF's financial information was not interrogated by the Supervision Division despite the allegations made in the Anonymous Letter. Similarly, in the case of the allegation that LCF was engaged in possible fraud which was made to the Financial Promotions Team in March 2017, there was no policy which required the Financial Promotions Team or any other team within the Supervision Division to interrogate LCF's financials for evidence of irregularity. In the event the FCA did not do so.

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<sup>797</sup> A relevant FCA employee stated in interview "[t]he fin prom's team role is really focused on when a consumer gets a financial promotions on the face of it is it clear, fair and not misleading".

<sup>798</sup> One FCA employee was asked in interview "do you receive in the financial promotions team any training on how to read company accounts to determine if a company is a risky or potentially fraudulent company?" To which the employee responded "[n]o." (Interview Transcript AA, at page 3).

<sup>799</sup> In interview, a relevant member of Supervision Division was asked "[a]nd is there a specific policy or procedure that tells you what to do in situations when you get these anonymous letters, or these sorts of cases?" The FCA employee responded "...I can't recall it and don't remember their being one. It was more of a case-by-case basis and just let common sense prevail and speak to the relevant people at the time. There may have been something, but I couldn't recall if there was" (Interview Transcript G, at page 24).

5.3 There were weaknesses in training within the Supervision Division (and the FCA as a whole) in how to read company financial statements to recognise circumstances suggesting financial crime or serious irregularities. This meant that even if LCF's financials had been interrogated by the Supervision Division, the FCA may still not have appreciated the risk which LCF posed.<sup>800</sup>

5.4 It is crucial, in the Investigation's view, that FCA staff are trained to assess a firm's business as a whole, including being able to read financial information for indicators of financial crime or serious irregularity and to recognise circumstances such matters. As explained in elsewhere in this Report, the FCA staff in the Listing Transactions Team and the Intelligence Team who, in late 2018, did eventually appreciate the risks which LCF posed, had backgrounds which were directly relevant to reading financial information for indicia of irregularities and possible fraud.<sup>801</sup>

## 6. Failure to consider LCF's marketing strategy

6.1 The FCA also failed to take any further steps to consider LCF's marketing activities following LCF's repeated financial promotions breaches. The Financial Promotions Team dealt with LCF on a purely reactive basis and neither it, nor any other unit in the Supervision Division, took any steps to look at LCF's marketing activities in more detail.

6.2 LCF used a wide range of marketing techniques. For example:

- (a) LCF used price comparison websites. Although the Investigation did not investigate this independently, being outside of its remit, Bondholders have submitted that LCF used a comparison website connected with Surge which charged LCF extremely high rates of commission for its services. Bondholders

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<sup>800</sup> One supervisor stated: "*I don't believe to the best of my knowledge that there is much training around how to identify financial crime. So that's something that I have provided some training on to colleagues in our department myself, fairly recently in fact but in terms of their being a good grounding, I think the experience that you have that that you tend to apply more than receiving training in that respect*" (Interview Transcript AD, at pages 7 to 8). The interviewee explained that this statement applied across the FCA and was not limited to Supervision: "[y]es, it would apply to the organisation generally. I think there are those – most people with intelligence teams have a good understanding of financial crime. But across the rest of the organisation I don't think the knowledge is there, frankly" (*Ibid*, at pages 27 to 28).

<sup>801</sup> The staff member in the Listing Transactions Team was a qualified accountant (Interview Transcript A, pages 3 to 4). The staff member in the Intelligence Team came to the FCA from a previous role with an accreditation from a law enforcement agency (Interview Transcript B, at pages 7 to 8). The FCA's regulation of LCF in late 2018 is considered further in **Chapter 13** (Other matters of importance to the Investigation).

have also alleged that LCF's products were unfairly presented on such sites as comparable with safer investments while offering higher returns, meaning that LCF was often ranked first on such sites.

- (b) LCF produced marketing documents including brochures connected with specific bond issuances. Those brochures made assertions about LCF's FCA-authorized status,<sup>802</sup> the security which LCF held over loans made to the business to which it lent,<sup>803</sup> the suitability of business to which it lent,<sup>804</sup> and alleged an added layer of protection was provided to investors by virtue of LCF granting a charge over its assets to an independent security trustee who held the charge on trust for the benefit of investors.<sup>805</sup> It has since emerged there were serious questions which should have been asked at the time as to whether such statements were misleading.<sup>806</sup>

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<sup>802</sup> For example see the brochure titled: "3-year 8.0% Income Bonds: A simple and transparent investment Series 10, LCF". See the "Disclaimer" section which stated "LCF is authorised and regulated by the FCA. This statement did not reveal, however, that LCF's bond issuance was not a regulated activity (Exhibit to Judicial Review Statement of Fact, at page 322).

<sup>803</sup> See for example the brochure titled: "2-year 6.5% Income Bonds: A simple and transparent investment Series 4, LCF" (Exhibit to Judicial Review Statement of Fact) which stated: "[o]nce a potential Borrowing SME has been assessed as creditworthy and its business plan viable, agreed security in the form of a charge over other property and/or other assets of the Borrowing SME is taken at no more than 75% loan to value. So, for example, for a loan of £750,000, the value of the charged assets of the Borrowing SME would need to be at least £1 million." (Ibid, at page 293).

<sup>804</sup> See for example the brochure titled: "2-year 6.5% Income Bonds: A simple and transparent investment Series 4, LCF" (Exhibit to Judicial Review Statement of Fact) which stated LCF adopted "[s]trong risk controls" and stated "[i]n addition to the physical security charged, [LCF] has controls in place to monitor the Borrowing SME and alert it to any potential repayment issues early on. By adding these additional layers of control and monitoring, [LCF] has endeavoured to create multiple layers of security and safeguards to protect Bond Holders' capital" (Ibid).

<sup>805</sup> See for example the brochure titled: "2-year 6.5% Income Bonds: A simple and transparent investment Series 4, LCF" (Exhibit to Judicial Review Statement of Fact) which stated under the heading "Security Trustee" that "[LCF] has granted the Security Trustee a charge over all of its assets, which includes the value of security [LCF] takes over the Borrowing SMEs' assets. The Security Trustee holds this charge over [LCF's] assets in trust for the benefit of all Bond Holders" (Ibid.).

<sup>806</sup> The administrator's report of 25 March 2019 estimated a return to investors as low as 20% of their investment and noted a "number of highly suspicious transactions involving a small group of connected people which have led to large sums of the Bondholders' money ending up in their personal possession or control." (Joint Administrators' Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 Insolvency Act 1986, 25 March 2019, at page 4 (see: <https://smithandwilliamson.com/media/3772/lcf-joint-administrators-proposals.pdf> (accessed on 23 November 2020))). This calls into question both (1) the adequacy of LCF's security and (2) the suitability of the parties to which LCF was lending. As already stated, there are also serious questions as to whether the security trustee was independent from LCF. The High Court, Chancery Division has granted an application to remove the trustee (see *London Capital & Finance Plc (in Administration) v Global Security Trustees Ltd* [2019] EWHC 3339 (Ch)).

- 6.3 The FCA, however, never considered LCF's marketing as a whole and how that reflected on LCF's business or the risk it posed to consumers. For example, the Investigation has seen no consideration by the FCA of LCF's approach to using price comparison sites nor of it reviewing LCF's marketing brochures.<sup>807</sup>
- 6.4 The FCA did not have the resources, and could not have been expected, to consider the marketing strategy of every flexible firm in this level of detail. However, in LCF's case, there were enough red flags to have triggered an enhanced level of monitoring. The FCA's failure to look in more detail at LCF's marketing activities following its contact with the Financial Promotions Team occurred in a context where:
- (a) The FCA had access to documents showing that LCF was achieving very high rates of growth for its business, indicating that its marketing was highly effective. For example, LCF's publicly filed accounts stated that: (i) (for the period ended 30 April 2016) there were "*bond additions*" of approximately £9.2 million,<sup>808</sup> and (ii) (for the period ended 30 April 2017) "*the company issued bonds with an aggregate par value of £53,397,157*".<sup>809</sup> LCF's projected growth rates which it submitted to the FCA as part of its variation of permission application also predicted similarly exponential growth rates.<sup>810</sup>
  - (b) The FCA was aware that LCF had repeatedly breached its financial promotions rules. LCF's breaches included using its FCA-authorized status improperly to attract investors to its bond issues and failing to provide adequate risk warnings in respect of its bond issues.
  - (c) The FCA was aware of other red flags such as allegations from third parties that LCF was engaged in possible fraud or serious irregularity as well as high volumes of calls to the FCA's Contact Centre regarding LCF. Indeed, in the allegations from a member of the public in March 2017, the member of the public expressly

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<sup>807</sup> Interview Transcript AA, at pages 9 to 10.

<sup>808</sup> LCF Annual Report and Financial Statements for the Year Ended 30 April 2016, available at Companies House.

<sup>809</sup> LCF Annual Report and Financial Statements for the Year Ended 30 April 2017, available at Companies House.

<sup>810</sup> See e.g. LCF's Forecasted Statement 30 November 2017 submitted to the FCA on 8 May 2017.



stated that “[t]here are red flags all over LCF’s literature”.<sup>811</sup> The FCA also had information showing that LCF was not conducting regulated activity.

- (d) The FCA was aware that mini-bonds carried particular risks for consumers.
- (e) The FCA was aware of the unusual way that LCF was using mini-bonds.

6.5 The FCA’s failure to consider LCF’s marketing as a whole, and how this reflected on LCF’s business and the risk it posed to consumers, occurred because no team was expected to consider this issue. The Financial Promotions Team operated within a narrow remit and was not expected to consider LCF’s marketing as a whole. Nor was any other team within the FCA expected to consider this issue either.

## 7. Conclusion

7.1 Even though the FCA only supervised LCF on a very limited reactive basis, that limited supervision was still inadequate. The FCA:

- (a) failed to appreciate the significance of multiple red flags (including allegations from third parties of fraud and other irregularities) and the repeated financial promotions breaches; the Supervision Division did not take any steps to review LCF’s financial information or otherwise engage with LCF to understand and assess its business;
- (b) was hampered by its organisation-wide approach, which meant that supervisors did not take adequate responsibility for supervising LCF because its core activity of issuing bonds fell outside the Perimeter;
- (c) failed to train staff adequately so that they could assess and react appropriately to allegations of fraud or other irregularity; and
- (d) failed to consider LCF’s marketing strategy despite multiple red flags.

7.2 For the reasons above, the FCA did not adequately supervise LCF’s compliance with its rules and policies.

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<sup>811</sup> Email Message 20 March 2017 (Document with Control Number 123602).

## **CHAPTER 11: FCA RULES AND POLICIES RELATING TO LCF'S FINANCIAL PROMOTIONS**

### **1. Introduction**

- 1.1 As provided in paragraph 3(1)(b) of the Direction, this Chapter considers whether the FCA had in place appropriate rules and policies relating to LCF's communication of financial promotions. The meaning that the Investigation ascribes to the terms "*rules*" and "*policies*" was explained in Section 4 of **Chapter 1** (Introduction and background). The Investigation considers that the "appropriateness" of FCA's rules and policies should be judged by reference to whether they enabled the FCA effectively to fulfil its statutory objectives.
- 1.2 In summary, the Investigation has concluded that the FCA had in place appropriate *rules*. However, the FCA did not have in place appropriate *policies*. The FCA made improvements to its financial promotions policies in the second half of 2017, but those changes had no impact on the FCA's regulation of LCF as the last interaction between the Financial Promotions Team and LCF occurred shortly before the changes were made (albeit the relevant members of the Financial Promotions Team were aware of the incoming changes at the time of that last interaction and they did not change their approach).
- 1.3 As explained in more detail in this Chapter, the FCA had in place appropriate rules relating to the communication of LCF's financial promotions for the following reasons:
- (a) The FCA's rule in COBS 4.2.1R required that LCF's financial promotions be fair, clear and not misleading. This was appropriate. Had LCF complied with this rule, it could not have issued promotions which mislead investors as to the risks associated with investing in its bonds.<sup>812</sup> Other FCA rules and guidance complemented the fair, clear and not misleading rule.<sup>813</sup>

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<sup>812</sup> The misleading nature of LCF's financial promotions is further described in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>813</sup> See paragraphs 2.6 and 2.7 of this Chapter.

*Chapter 11: FCA rules and policies relating to LCFs financial promotions*

- (b) The FCA also had appropriate “powers”<sup>814</sup> to monitor LCF’s financial promotions and to intervene in the event that LCF breached the FCA’s rules.<sup>815</sup>
- (c) The Investigation’s conclusion that the FCA had in place appropriate rules relating to the communication of financial promotions<sup>816</sup> by LCF is reinforced by the fact that no legislative changes were required for the FCA’s intervention against LCF in late 2018. Indeed, the FCA’s intervention was based on some of the rules referred to in this Chapter. This suggests that the FCA’s failures in regulating LCF were not owing to a lack of appropriate rules.

1.4 However, the FCA, and in particular the Supervision Division, did not have in place appropriate *policies* relating to LCF’s financial promotions. Thus, as explained below:

- (a) The Supervision Division’s policies for monitoring LCF’s financial promotions were deficient for the reasons set out in Sections 3 and 6 of **Chapter 10** (Adequacy of the FCA’s supervision of LCF) and paragraphs 3.6 to 3.11 of this Chapter. In particular, the FCA did not have policies in place which required any team in the Supervision Division<sup>817</sup> to consider: (i) LCF’s marketing activities in the light of red flags that the FCA was aware of, or (ii) LCF’s business as a whole in the light of its repeated financial promotions breaches. This resulted in the FCA failing to appreciate that, in the light of LCF’s breaches of the financial promotions rules, it posed a significant risk to consumers.
- (b) The Supervision Division’s policies regarding intervention in response to LCF’s financial promotions breaches were also deficient. The FCA’s policies in this regard were too cautious. For example, the “*repeat offenders*” policy only required action by the FCA if there were three or more financial promotions breaches by a

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<sup>814</sup> As explained in Section 4 of **Chapter 1** (Introduction and background), the term “rules” in the meaning ascribed by the Investigation includes “*guidance set out in the FCA Handbook and other legislation, rules and regulation contained in or made under [FSMA]*”. As such, the term “rules” encompasses the statutory powers described in this Chapter.

<sup>815</sup> Paragraphs 3.2 to 3.5 and paragraphs 4.3 to 4.13 of this Chapter.

<sup>816</sup> The FCA’s powers of intervention were not limited to LCF’s financial promotions. As explained in Section 2 of **Chapter 6** (The FCA’s Approach to the Perimeter), the FCA also had the power to intervene in respect of the unregulated activities of a regulated firm.

<sup>817</sup> As explained below, no policy required the Financial Promotions Team to consider these issues, nor was any other team in the Supervision Division required to consider them either.

firm within a 12-month rolling period.<sup>818</sup> At a more general level, the FCA's policies did not facilitate any consideration of whether seemingly technical breaches could be symptomatic of wider or more serious problems.

(c) Together, the deficiencies described in sub-paragraphs (a) and (b) above contributed to the FCA's failure to respond appropriately to LCF's multiple breaches of the financial promotions rules.<sup>819</sup>

1.5 Finally, the Investigation is aware that the financial promotions regime has been the subject of recent reform.<sup>820</sup> It is not within the Investigation's remit to consider the merits or otherwise of such reforms since they occurred outside the Relevant Period. Furthermore, consultations in respect of proposed changes to the financial promotions regime are ongoing as at the date of this Report.

## **2. The FCA's rules in respect of LCF's financial promotions were appropriate if complied with**

2.1 The FCA's rules in respect of LCF's financial promotions were appropriate if complied with. As explained below, the fair, clear and not misleading rule and associated guidance was appropriate. Furthermore, the fair, clear and not misleading rule was complemented by further appropriate rules and guidance.

*The 'fair, clear and not misleading' rule was appropriate if complied with*

2.2 COBS 4.2.1R required a firm to ensure that a financial promotion was fair, clear and not misleading. This requirement was appropriate. Had LCF complied with this rule, it could not have issued promotions which mislead investors as to the risks associated with investing in its bonds.<sup>821</sup> The rule was drafted in appropriately broad terms which captured the misleading nature of LCF's promotions.

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<sup>818</sup> Other deficiencies in FCA's policies regarding intervention in respect of financial promotions related to its use of the power under section 137 of FSMA (paragraphs 4.19 to 4.23 below) and its binary approach to escalation of cases to Enforcement (see paragraph 3.10 below).

<sup>819</sup> See paragraphs 4.24 to 4.26 of this Chapter.

<sup>820</sup> See **Appendix 9** to this Report.

<sup>821</sup> The misleading nature of LCF's financial promotions is further described in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

- 2.3 The fair, clear and not misleading rule was also supplemented by appropriate guidance as to the meaning and operation of the rule. This guidance increased the likelihood that the fair, clear and not misleading rule could be used by the FCA to target LCF's misleading promotions.
- 2.4 For example, COBS 4.2.4G stated that a firm should ensure that a financial promotion "*that names the FCA... as its regulator and refers to matters not regulated by... the FCA... makes clear that those matters are not regulated by the FCA...*" This guidance clarified that the fair, clear and not misleading rule extended to LCF's inappropriate use of its FCA-authorized status to promote its unregulated bond business.<sup>822</sup>
- 2.5 Similarly, COBS 4.2.5G provided that "[a] *communication or a financial promotion should not describe a product or service as "guaranteed", "protected" or "secure", or use a similar term unless: (1) that term is capable of being a fair, clear and not misleading description of it; and (2) the firm communicates all of the information necessary and presents that information with sufficient clarity and prominence, to make the use of that term fair, clear and not misleading.*" Thus, the fair, clear and not misleading rule captured misleading statements in LCF's promotions regarding the security which bondholders had in respect of their investments.<sup>823</sup>

*Further rules and guidance*

- 2.6 Furthermore, other appropriate rules and guidance complemented the fair, clear and not misleading rule.
- 2.7 For example, the FCA Handbook provided appropriate rules and guidance to protect retail clients in respect of financial promotions. COBS 4.5.2R(2) provided that information must not "*emphasise any potential benefits of relevant business or a relevant investment without also giving a fair and prominent indication of the risks*". COBS 4.5.2R(3) provided that information must be "*presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received.*" COBS

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<sup>822</sup> Furthermore, as set out in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF), the FCA intervened with regards to LCF's misleading use of its FCA-authorized status in its promotions on a number of occasions.

<sup>823</sup> See, for example, LCF's claims as to the security which LCF held over loans made to the business to which it lent described in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

4.5.2R(4) further provided that information must not “*disguise, diminish or obscure important items, statements or warnings.*”<sup>824</sup> These rules meant that LCF was not allowed to issue financial promotions which failed to provide risk warnings or give adequate prominence to risk warnings.<sup>825</sup> Had these further rules been complied with, they would also have prevented LCF’s misleading promotions.

### 3. Monitoring LCF’s financial promotions

3.1 As set out below, the FCA had appropriate powers for monitoring LCF’s financial promotions.<sup>826</sup> However, the FCA did not have in place appropriate policies.<sup>827</sup>

*The FCA had in place appropriate powers for monitoring LCF’s financial promotions*

3.2 The FCA Handbook made clear that the FCA could use a range of methods for information gathering such as: (i) desk-based reviews; (ii) requesting documents by telephone, at meetings or in writing, including by electronic communication; (iii) visiting firms; or (iv) seeking meetings at the FCA’s offices.<sup>828</sup>

3.3 The FCA monitored financial promotions each week using an external monitoring service, which provided the FCA with promotions across various media including television, press,

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<sup>824</sup> These provisions were accompanied by guidance including: (i) COBS 4.5.4G: “[i]n deciding whether, and how to communicate information to a particular target audience, a firm should take into account the nature of the product or business, the risks involved, the client’s commitment, the likely information needs of the average recipient, and the role of the information in the sales process”; and (ii) COBS 4.5.5G “[w]hen communicating information, a firm should consider whether omission of any relevant fact will result in information being insufficient, unclear, unfair or misleading.”

<sup>825</sup> As set out in **Chapter 3** (Key events in the FCA’s regulation of LCF), the FCA intervened in respect of LCF’s inappropriate use of risk warnings on a number of occasions.

Separately, COBS 4.7.7R and 4.7.8R contained rules on direct offer financial promotions which limited when a person’s “*direct-offer*” financial promotion relating to a non-readily realisable security could be made. However, many of LCF’s financial promotions appear not to have been “*direct offer*” promotions because they did not “[*specify*] the manner or response or [*include*] a form by which any response may be made” limiting the importance of these provisions for the Investigation.

<sup>826</sup> Paragraphs 3.2 to 3.5 of this Chapter.

<sup>827</sup> Paragraphs 3.6 to 3.11 of this Chapter.

<sup>828</sup> FCA Handbook, at SUP 1A.4.5G and SUP 2.3.1G (see: <https://www.handbook.fca.org.uk/handbook/SUP> (accessed on 23 November 2020)).

*Chapter 11: FCA rules and policies relating to LCFs financial promotions*

radio, cinema, outdoor (i.e. billboards and posters on trains and buses), internet banners, direct mail, door drops and email.<sup>829</sup>

3.4 The FCA also had extensive investigatory powers under sections 165, 167 and 168 of FSMA.<sup>830</sup> Indeed, the FCA used its section 165 power in its unannounced site visit on 10 December 2018 to require an officer of LCF to produce a range of information including “[d]etails of all financial promotions used to market the bonds and ISAs, including: a. Copies / content of financial promotions; b. Agreements with any third party and/or agent used to conduct financial promotions; and c. Details of payments made to third parties and/or agents, including commissions.”<sup>831</sup>

3.5 In short, the FCA had extensive and appropriate powers which could be used to monitor LCF’s financial promotions. However, as explained below, the FCA did not have in place appropriate policies.

*The FCA did not have in place appropriate policies for monitoring LCF’s financial promotions*

3.6 As explained in Section 6 of **Chapter 10** (Adequacy of LCF’s permissions), the FCA did not take any steps to consider LCF’s marketing beyond the limited and purely reactive contact with the Financial Promotions Team. This was notwithstanding LCF’s repeated financial promotions breaches and other red flags such as: (i) LCF’s high rates of growth; (ii) warnings from third parties that LCF was engaged in fraud or serious irregularity;<sup>832</sup> (iii)

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<sup>829</sup> Financial Promotions Memorandum of Understanding, undated (although the FCA informed the Investigation it was dated 4 September 2014), at paragraph 1.

<sup>830</sup> Section 165 of FSMA provided the FCA with a power to require an authorised person to provide specified information or documents or information or documents of a specified description. Section 167 of FSMA provided the FCA with a power to appoint persons to conduct a general investigation on its behalf into the business of an authorised person. Section 168 of FSMA provided the FCA with a power to appoint persons to carry out investigations in particular cases, which included where the FCA considered that there were circumstances suggesting that a person may have contravened a rule made by the FCA (section 168(4) and (5) of FSMA) or where an offence under sections 89-90 of the FSA 2012 (section 168(2) and (3)) had been committed.

<sup>831</sup> Letter from the Supervision Division to LCF’s CEO, 10 December 2018.

<sup>832</sup> As referred to in **Chapter 6** (The FCA’s approach to the Perimeter) and **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks) above, one of these warnings (in March 2017) was made directly from a member of the public to the Financial Promotions Team. Not only did the communication state that the member of the public considered that LCF “has to be a scam”, the member of the public also stated “[t]here are red flags all over their literature” (see: Email Message Detail 20 March 2017 (Document with Control Number 123602)).

awareness that mini-bonds carried particular risks for consumers; and (iv) awareness of the unusual way in which LCF was using mini-bonds.

3.7 The failure to consider LCF's marketing more substantively occurred because the FCA did not have any policy in place which required the Supervision Division to do so. As explained in **Chapter 10** (Adequacy of the FCA's supervision of LCF), the Financial Promotions Team was not expected to consider this issue in the light of the narrow remit within which it operated,<sup>833</sup> nor was any other team in the Supervision Division expected to consider this issue.

3.8 As also explained in Section 3 of **Chapter 10** (Adequacy of the FCA's supervision of LCF), the FCA never considered LCF's business as a whole, including in the light of its repeated financial promotions breaches. For example, the FCA repeatedly intervened with respect to LCF improperly using its FCA-authorized status to attract investors to its non-regulated bond business. The FCA addressed this issue in correspondence with LCF dated 2 September 2016,<sup>834</sup> 8 September 2016,<sup>835</sup> 5 April 2017,<sup>836</sup> 1 June 2017<sup>837</sup> and 18 August 2017.<sup>838</sup> However, the FCA did not consider whether LCF's breaches might be symptomatic of a more serious problem and in particular whether LCF might have obtained, or used, FCA-authorized status for the purpose of attracting investors to its unregulated bond issues.<sup>839</sup>

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<sup>833</sup> As explained in **Chapter 10** (Adequacy of the FCA's supervision of LCF), the Financial Promotions Team operated under a very narrow remit whereby they were expected to identify promotions which on their face were fair, clear and not misleading.

<sup>834</sup> Letter from FCA Financial Promotions to Sentient Capital London Limited, 2 September 2016 (Document with Control Number 214183).

<sup>835</sup> Email from FCA Financial Promotions to LCF's CEO, 8 September 2016 at 2:36pm (Document with Control Number 219461); Letter from FCA Financial Promotions to LCF's CEO, undated (Document with Control Number 219462).

<sup>836</sup> Letter from FCA Financial Promotions to LCF's CEO, 5 April 2017.

<sup>837</sup> Letter from FCA Financial Promotions to LCF's CEO, 1 June 2017.

<sup>838</sup> Letter from FCA Financial Promotions to LCF's CEO, 18 August 2017 (Document with Control Number 219458).

<sup>839</sup> The FCA's Financial Promotions Team dealt with LCF on a number of isolated instances as described in Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF). However, these never resulted in the FCA appreciating that LCF's breaches of the financial promotions rules indicated that LCF posed a significant risk for consumers. This is particularly surprising since, during the Relevant Period, the Financial Promotions Team consisted of only around eight to ten people. Thus, the members of the Financial Promotions Team are likely to have had multiple interactions with LCF (see, for example, paragraph 4.25 of this Chapter).



3.9 Again, no policy required any team in the Supervision Division to consider holistically how LCF's repeated financial promotions breaches reflected on the firm's business. The Financial Promotions Team was not expected to do so owing to the narrow remit within which it operated. Nor was any other team in the Supervision Division expected to consider this issue. As explained in Section 6 of **Chapter 9** (Appropriateness of LCF's permissions), the lack of connectivity between the Financial Promotions Team and the Authorisations Division had led to LCF's First VOP Application being processed and approved without reference to its breaches of the financial promotion rules.

3.10 Another deficiency in the FCA's policies in respect of LCF's financial promotions related to the Supervision Division's binary approach (as to which see Section 3 of **Chapter 8** (The "Delivering Effective Supervision" and "Delivering Effective Authorisations" Programmes)). This meant that, unless concerns by the Financial Promotions Team were sufficiently serious to be passed on to Enforcement, they were closed as being within risk tolerance. The result was that, in practice, it was not easy for the Financial Promotions Team to escalate matters. As a member of the Financial Promotions Team told the Investigation in interview:

*"It's very unlikely or the message we've had from enforcement is that it's quite unlikely that a financial promotion case in itself would be accepted by enforcement for enforcement action.... it's certainly not an outcome that I have used in the four years that I've worked in the team."*<sup>840</sup>

3.11 The FCA represented to the Investigation that the approach of the Financial Promotions Team was to engage broadly with the Supervision Division on matters outside of its remit. In support of this, the FCA stated:

(a) *"Throughout the Relevant Period [the Financial Promotions Team] referred cases to other parts of the FCA (e.g., Supervision, Unauthorised Business Department) where it had identified issues that went beyond how financial promotions were presented to consumers (the remit of the [Financial Promotions Team])"*.

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<sup>840</sup> Interview Transcript E, at page 21.

- (b) “From October 2017, with the introduction of the [p]rotocol,<sup>841</sup> the team would engage with the relevant firm Supervision team before the [Financial Promotions Team] contacted the firm in all cases relating to non-standard investments”.
- (c) “From June 2018, with the allocation of firms to portfolios under the [DES programme], the [Financial Promotions Team] amended its process to always engage with the relevant portfolio team before contacting a firm about its financial promotions”.<sup>842</sup>

3.12 The Investigation considers the “protocol” referred to in paragraph 3.11(b) above to be an improvement because of the requirement for the Financial Promotions Team to work more closely with the Supervision Division. However, the Investigation did not see any evidence that this protocol had any impact on the FCA’s supervision of LCF during the Relevant Period. To some extent that was because the Financial Promotions Team opened its last case in relation to LCF in August 2017 and the protocol only appears to have come into force formally in September/October 2017. As discussed in more detail in Section 2 of **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks), the Investigation considers that it is surprising that the new protocol was not followed in August 2017 (i.e. a referral from the Financial Promotions Team to the Supervision Division should have been made), given that the individual in the Financial Promotions Team who wrote the letter to LCF in August 2017 attended the July 2017 meeting at which the change of procedure was agreed.<sup>843</sup>

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<sup>841</sup>Section 2 of **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks) explains that a July 2017 meeting produced an action item for the Financial Promotions Team to amend its policies so that it would refer promotions approved by authorised firms for certain investments (including mini-bonds) to the relevant team within the Supervision Division. The FCA has represented that the resultant protocol “was produced setting out how Financial Promotions would work with the Retail Investments and Investment Management departments in SIWS in relation to firms approving financial promotions for non-standard investments, including mini-bonds. Under the [p]rotocol, any firms approving financial promotions for mini-bonds would be referred from the Financial Promotions team to the SIWS team. Further, this Protocol extended across all areas of Supervision (i.e. if it was identified that in-scope firms were supervised by other parts of Supervision, information would be passed to the relevant area to consider what action was required)...As a result, more firm supervisors became involved in joint contact with firms in relation to financial promotions cases relating to non-standard investments (including mini-bonds), with firm supervisors determining what, if any, action to take in addition to any action taken by the Financial Promotions team.”

<sup>842</sup> FCA representations, at paragraph 9.12.

<sup>843</sup> See, in particular, paragraphs 2.11 to 2.16 of **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks).

3.13 The responsibility for the policy deficiencies identified in paragraphs 3.6 to 3.10 of this Chapter rests with Mr Davidson, who had overall responsibility for FCA’s policies in respect of financial promotions in his role as Executive Director of the SRA (albeit he did not have direct oversight of those policies).

#### **4. Intervening in respect of LCF’s financial promotions**

4.1 The FCA had appropriate powers to intervene in respect of LCF’s financial promotions in the event there was a breach.<sup>844</sup>

4.2 However, the FCA did not have in place appropriate policies. The FCA’s policies, and, in particular, those of the Supervision Division, were too cautious in respect of intervention following financial promotions breaches. This, together with the deficiencies described in paragraphs 3.6 to 3.10, contributed to the FCA’s failure to respond appropriately to LCF’s multiple breaches of the financial promotions rules.<sup>845</sup>

##### *Summary of the FCA’s powers under section 137S of FSMA*

4.3 Section 137S of FSMA provided the FCA with powers to intervene in respect of breaches of the financial promotion rules by LCF:<sup>846</sup>

- (a) The FCA could give a direction if: (i) an authorised person had made, or proposed to make, a communication or had approved, or proposed to approve, another person’s communication; and (ii) the FCA considered that there had been, or was likely to be, a contravention of financial promotion rules in respect of the communication or approval.<sup>847</sup>
- (b) Such a direction could require the authorised person to: (i) withdraw the communication or approval; (ii) refrain from making the communication or giving the approval (whether or not it has previously been made or given); (iii) publish

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<sup>844</sup> Paragraphs 4.3 to 4.13 of this Chapter.

<sup>845</sup> Paragraphs 4.14 to 4.26 of this Chapter.

<sup>846</sup> Section 137S of FSMA was part of a suite of powers introduced by section 24 of the FSA 2012. The FSA 2012 was a significant piece of legislation which sought to overhaul the UK’s financial regulatory framework in the light of the global financial crisis. Among other changes, the powers of the previous key financial regulator (the FSA) were transferred to successor bodies which included the FCA.

<sup>847</sup> Pursuant to section 137S(1) of FSMA.

details of the direction; or (iv) do anything else specified in the direction in relation to the communication or approval.<sup>848</sup>

- (c) A direction under section 137S of FSMA to refrain from making or approving a communication included a requirement to refrain from making or approving another communication where: (i) the other communication was in all material respects the same as, or substantially the same as, the communication to which the direction related; and (ii) in all the circumstances a reasonable person would think that another direction would be given under this section in relation to the other communication.<sup>849</sup>
- (d) Section 137S(5) – (12) of FSMA contained provisions regarding the circumstances in which the FCA should provide notice of its direction and provide the recipient of the direction with the opportunity to make representations regarding the direction.<sup>850</sup>

4.4 Section 137S of FSMA is one reason why the Investigation has concluded that LCF had appropriate powers to intervene in the event that LCF breached the financial promotions rules. In the event, the FCA exercised this power in the case of LCF in its First Supervisory Notice dated 10 December 2018<sup>851</sup> and in its Second Supervisory Notice dated 17 January 2019.<sup>852</sup>

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<sup>848</sup> Pursuant to section 137S(2) of FSMA.

<sup>849</sup> Pursuant to section 137S(3) of FSMA.

<sup>850</sup> Pursuant to section 137S(5) – (12) of FSMA.

<sup>851</sup> FCA, First Supervisory Notice against London Capital & Finance plc, 10 December 2018 (Document with Control Number 207810).

<sup>852</sup> FCA, Second Supervisory Notice against London Capital & Finance plc, 17 January 2019 (see: <https://www.fca.org.uk/publication/supervisory-notices/second-supervisory-notice-london-capital-and-finance-plc-2019.pdf> (accessed on 23 November 2020)).

*Summary of the FCA's powers under sections 55J and 55L of FSMA*

- 4.5 Other powers pursuant to which the FCA could have intervened if LCF breached its financial promotions rules were provided by sections 55J and 55L of FSMA. The FCA had:
- (a) a power under section 55J of FSMA to vary or cancel an authorised person's permissions; and
  - (b) a power under section 55L of FSMA to impose requirements including prohibiting or restricting the disposal of an authorised person's assets.
- 4.6 These powers complemented the FCA's powers under section 137S of FSMA and are a further reason the Investigation has concluded that the FCA had appropriate powers to intervene if LCF breached the financial promotions rules. In the event the FCA exercised the power under section 55L of FSMA in respect of LCF. Shortly after the FCA's unannounced site visit in December 2018, LCF applied for a "*voluntary application for imposition of requirement*" under section 55L of FSMA. This resulted in various restrictions on LCF's ability to deal with its assets, conducting regulated activity and communicate or approve financial promotions.<sup>853</sup>

*Further powers*

- 4.7 The FCA had a range of further powers to intervene in the event that LCF breached its financial promotions rules. The Investigation provides a non-exhaustive summary of such powers below.
- 4.8 Under section 380 of FSMA, the FCA had the power to apply to the Court for various forms of injunction in respect of a breach or potential breach of a "*relevant requirement*" which included breach of the FCA's rules on financial promotion.<sup>854</sup>

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<sup>853</sup> Voluntary Application for Imposition of Requirement, 13 December 2018, at paragraph 4 which provided "*LCF may not communicate or approve any invitation or inducement to engage in investment activity (i.e. financial promotion).*"

<sup>854</sup> The rules are a requirement imposed under FSMA pursuant to the FCA's rule making powers in section 137R and so fall within the definition of a "*relevant requirement*" in sections 380, 382 and 384 of FSMA: McMeel and Virgo, *Financial Advice and Financial Products* (3<sup>rd</sup> Ed.) (Oxford University Press, 2014) paragraph 18.229: "*breaches of an FCA rule or principle will trigger jurisdiction...*"

The forms of injunctions available included injunctions: (1) directed to restraining contraventions under section 380(1). Such an order could be made if the Court was satisfied either that (a) there was a reasonable likelihood that any person would contravene a relevant requirement; or (b) that any person had contravened a relevant requirement and that there was

4.9 Section 382 of FSMA provided the FCA with a power to seek restitution orders from the Court in the event that its financial promotion rules in COBS 4 were breached. The Court could make an order under section 382 of FSMA, upon the application of the FCA, if it was satisfied that a person had contravened a “*relevant requirement*”, which included the FCA’s financial promotion rules, or been knowingly concerned in such contravention and that:

- (a) profits had accrued to him as a result of the contravention (section 382(1)(a) of FSMA); or
- (b) one or more persons had suffered loss or been otherwise adversely affected as a result of the contravention (section 382(1)(b) of FSMA).<sup>855</sup>

4.10 Section 384 of FSMA provided the FCA with a power to require restitution.<sup>856</sup> The FCA was entitled to exercise the power under section 384(5) of FSMA if it was satisfied that an authorised person has contravened a relevant requirement, which included the FCA’s financial promotion rules, or been knowingly concerned in the contravention of such a requirement and that:

- (a) profits had accrued to him as a result of the contravention (section 384(1)(a) of FSMA); or

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a reasonable likelihood that the contravention would continue or be repeated; (2) directed to remedying contraventions under section 380(2). Such an order could be made if the Court was satisfied (a) that any person had contravened a relevant requirement and (b) that there were steps which could be taken for remedying the contravention. Such an order could be directed at the person which had committed the contravention “*and any other person who appears to have been knowingly concerned in the contravention*” and (3) freezing assets under section 380(3). Such an order could be made if the Court was satisfied that any person may have contravened a relevant requirement or had been knowingly concerned in the contravention of such a requirement in respect of assets which the Court was satisfied the person was reasonably likely to dispose or deal with. The Court also had a power to grant interim freezing relief pursuant to its inherent jurisdiction (the FCA’s Enforcement Guide paragraph 10.4 and 10.5).

<sup>855</sup> Under section 382(2) of FSMA the Court could order the person concerned to pay to the FCA such sum as appeared to the Court to be just having regard to: (1) in a case within section 382(1)(a), the profits appearing to the Court to have accrued; (2) in a case within section 382(2)(b), the extent of the loss or other adverse effect; and (3) in a case within both section 382(1)(a) and (b), the profits appearing to the Court to have been accrued and to the extent of the loss or other adverse effect. Section 382(3) of FSMA contained a provision for the Court to direct the FCA to then pay the relevant victims compensation from the sums it received.

<sup>856</sup> The FCA’s power under section 384(5) was to require the person concerned to pay to the FCA or to distribute among the appropriate persons such amount as appeared to the FCA to be just having regard to: (1) in a case within section 384(1)(a), the profits appearing to the FCA to have accrued; (2) in a case within section 384(1)(b), the extent of the loss or other adverse effect; and (3) in a case within section 384(1)(a) and (b), the profits appearing to the FCA to have accrued and to the extent of the loss or other adverse effect.

- (b) one or more persons had suffered loss or been otherwise adversely affected as a result of the contravention (section 384(1)(b) of FSMA).

4.11 The FCA would first consider using its powers under section 384 of FSMA before considering Court action under section 382 of FSMA.<sup>857</sup>

4.12 Further powers which were of potential relevance to the FCA intervening in the event of a breach of COBS 4 by LCF included:

- (a) If the FCA considered that an authorised person had contravened a relevant requirement imposed on the person, it could publish a statement to that effect under section 205 of FSMA.

- (b) Furthermore, if the FCA considered that an authorised person had contravened a relevant requirement it could impose a penalty in respect of the contravention in such amount as it considered appropriate under section 206 of FSMA which was payable to the FCA.<sup>858</sup>

4.13 Accordingly, for the reasons set out above, the Investigation has concluded that the FCA had a wide range of appropriate powers which it could have used in the event that LCF breached the financial promotions rules.

*The FCA did not have appropriate policies in place in respect of intervening*

4.14 However, while the FCA had appropriate powers, the FCA did not have appropriate policies in place in respect of intervening with regards to LCF's financial promotions breaches. In the Investigation's view, the FCA's policies were too cautious.

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<sup>857</sup> Enforcement Guide paragraph 11.4. Section 382 Court action might be appropriate where, for example, the FCA considered that there was "*danger that the assets of the firm may be dissipated; in those cases, the FCA may wish to combine an application to the court for an order for restitution with an application for an asset-freezing injunction*" (Enforcement Guide, paragraph 11.5).

<sup>858</sup> Separately, sections 89 and 90 of the FSA 2012 created offences in respect of misleading statements and misleading impressions. The FCA also had a range of powers it could take against individuals such as those contained in section 66 of FSMA. A useful summary of the FCA's powers to impose sanctions is provided in Blair, Walker and Purves, *Financial Services Law* (4<sup>th</sup> Ed.) (Oxford University Press, 2018) paragraph 9.05.

*The “repeat offenders” policy was too cautious*

- 4.15 The FCA had a “repeat offenders” policy. The FCA considered a firm a “repeat offender” if it had breached financial promotions rules three times or more within a rolling 12-month period.<sup>859</sup>
- 4.16 The FCA followed a two-tiered response to repeat offenders. In respect of Level 1 repeat offenders,<sup>860</sup> the FCA would send a letter to the firm instructing the firm to amend or withdraw the non-compliant promotion and, where applicable, take remedial action. The FCA would advise the firm that it was a repeat offender. More serious Level 2 repeat offenders were also required to amend or withdraw the promotion and take remedial action where applicable. In addition, Level 2 repeat offenders were asked to arrange for an attestation by a person with a significant influence function that they were content that the firm’s procedures are sufficient and their staff were adequately trained to sign off promotions.
- 4.17 The Investigation considers that the FCA’s “repeat offenders” policy was unsatisfactory:
- (a) The “repeat offenders” policy was not sufficiently robust. The definition of “repeat offender” meant that three breaches had to accumulate in a 12-month period before the FCA would take further action.
  - (b) The FCA’s “repeat offenders” policy was a limited one in that the attestation procedure was the only intervention that it provided for. Indeed, there were doubts within the FCA as to whether attestations were enforceable.<sup>861</sup>
  - (c) The “repeat offenders” process did not trigger any proactive monitoring by the FCA. For example, no special attention was paid to financial promotions by a firm which had accumulated, say, two breaches in two months.

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<sup>859</sup> FCA Policy of Repeat Offenders.

<sup>860</sup> Defined as including “those firms who have had promotions that contained breaches but not pursued on a risk based approach”.

<sup>861</sup> Email between the FCA Financial Promotions team, 4 December 2018.



4.18 The “repeat offenders” process was eventually abandoned around early 2018 in favour of using “the most appropriate supervisory tool to fit the circumstances of a particular case.”<sup>862</sup> By this stage, however, LCF had already breached the FCA’s financial promotions rules on five occasions as set out in Section 3 of **Chapter 3** (Key events in the FCA’s regulation of LCF).

*Policies during the Relevant Period regarding the FCA’s use of section 137S of FSMA were too cautious*

4.19 Similarly, the Supervision Division’s policies in respect of its use of section 137S of FSMA were too cautious. Around the time section 137S was introduced into FSMA by the FSA 2012, the explanatory notes to the Act, as well as FSA and FCA public statements, envisaged that the power to ban promotions would be used swiftly and publicly for the protection of consumers.<sup>863</sup>

4.20 However, in the event, the FCA did not use the section 137S power at all in the years between its introduction in 2012 and the FCA’s intervention against LCF in late 2018. The lack of

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<sup>862</sup> *Ibid.*

<sup>863</sup> For example, the Explanatory Notes to section 137S stated “[t]his provision is intended to enable the FCA to take swift action to minimise consumer detriment. It includes the power to take action in relation to a financial promotion, if it was made or approved by an authorised person. The FCA can direct the firm to refrain from making a promotion, withdraw a promotion, to publish details of it, or to do anything else the FCA directs it to do in relation to the promotion. It is envisaged this might include, for example, contacting consumers who have acted upon the promotion.”

Similarly, an FSA paper titled “*Journey to the FCA*” dated October 2012 stated that the section 137S powers were to be used: (1) swiftly to remove harm without going through the enforcement process; (2) transparently and publicly so that other firms would “benefit from a more transparent process” and to “give a clear message to firms that are thinking of doing something similar”; (3) in such a way as to “raise standards in a particular area, such as for new products or relatively new channels like social media”; (4) not only for the worst cases: “[t]he promotions where we use the power will not only be the worst cases, and we will not always measure harm to consumers in terms of actual or potential financial loss. We will also consider promotions that adversely affect consumers’ ability to make informed choices and secure the best deal for themselves.” (see: <https://www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf> (accessed on 23 November 2020)).

Furthermore, the FCA’s Business Plan for 2013/2014 stated: “*The FCA has a new power to ban financial promotions and publish the details relating to it. Using this power will deliver a number of benefits. In particular and most importantly, it allows us to take swift action to protect consumers in a transparent and visible way. Publishing a ban will inform and warn consumers of the misleading promotion and encourage a broader understanding of how promotions can be unfair, unclear and misleading. For firms it will allow them to see real and varied examples of where they fall short of our requirements and allow them to proactively improve their own financial promotions. We hope this power will deter firms from misleading consumers. Where this is not the case, we are ready to use this power.*

*We will also adopt a more streamlined and robust approach to firms that consistently produce promotions that can mislead, confuse or be unfair to consumers. This may involve greater use of our supervisory and enforcement powers.*” (see: <https://www.fca.org.uk/publication/business-plans/bp-2013-14.pdf> (accessed on 23 November 2020)).

the FCA's use of its section 137S power before its intervention in LCF in late 2018 was owing to the FCA adopting a process whereby it would issue "*minded to ban*" letters to firms prior to invoking section 137S. If the firm cured the breach, as firms often did, the FCA would not exercise its power to issue a direction under section 137S.<sup>864</sup>

4.21 This issue was addressed by the Joint SRA / SIWS Risk Committee meeting on 9 July 2018 which amended the policy so that the FCA would proceed to issuing a banning notice under section 137S of FSMA, without first issuing "*minded to ban*" letters "*in cases where we've had issues with the firm in the past*". The committee determined that a pilot should be run to test the new process.<sup>865</sup> Since the events of LCF, the FCA has used its powers under section 137S of FSMA on other occasions indicating that the frequency with which the FCA uses this power has increased.<sup>866</sup>

4.22 The FCA's caution in respect of the use of its section 137S power arose, in part, owing to what was regarded as difficult legal questions in respect of the circumstances in which the section 137S powers could be exercised and their purpose. The FCA received varying legal advice from different counsel on this issue over the course of 2013 and late 2015<sup>867</sup> and these questions were under active consideration by the FCA during this period.<sup>868</sup>

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<sup>864</sup> A July 2018 "*Joint RiskCo Summary Paper*" titled "*Financial Promotions Transparency – Banning Power and Other Options*" recorded that "[d]espite having had this statutory banning power for five years, we have not used it". The paper attributed the non-use of the section 137S power to the "*minded to ban*" process by which the FCA would engage with a firm before invoking its section 137S power. As a result of this process "*the firms have either revoked or amended their adverts without us needing to invoke the s137S banning power. It is also worth noting that most firms address our concerns before we even reach the stage of issuing a "minded to ban" letter.*" The Joint RiskCo paper recommended that the FCA continue to seek to use the section 137S power in appropriate cases but that the process be amended so that the FCA no longer issue minded to ban letters before issuing a section 137S notice.

<sup>865</sup> Joint SRA / SIWS RiskCo Committee Minutes, 9 July 2018.

<sup>866</sup> FCA Use of Banning Power (see: FCA Response to Information Request LCF\_DEC11/12\_03).

<sup>867</sup> The legal advice which the FCA received in 2013/2014 indicated that it could not exercise its power to issue a direction under section 137S if it was fully satisfied that the steps which would be required by the direction have or will be taken. Moreover, the advice indicated that the FCA could not use the s137S power purely for the purposes of achieving transparency (see: Legal Advice written for the FCA, 16 July 2013, at paragraph 3e; Legal Advice written for the FCA, 13 June 2014 at paragraph 5). Later advice from 2015, however, suggested that the FCA could revise its policy so that it could exercise its s137S powers in appropriate cases (i.e. where it has formed a reasonable view based on a proper factual basis that there has been a contravention) without first giving the firm a chance voluntarily to address the problem (see: Legal Advice written for the FCA, 20 October 2015, at paragraph 119).

<sup>868</sup> For example, in one instance there was a period of over 1 year between the issuing of instructions by the FCA and the receipt of advice by Counsel. An employee in GCD stated that "[w]hat had happened was there was a lot of back and forth during that period." Interview Transcript W, at page 24.

4.23 Ultimately, however, there appears to have been a gap of around two years between the receipt of legal advice in late 2015 and the FCA altering its approach to using its section 137S powers in July 2018. Responsibility for this delay rests with FCA’s Senior Management in Supervision. This is because it was ultimately the Supervision Division that was most likely to use the section 137S power.<sup>869</sup> As such, questions as to whether the power was being underutilised rest most obviously with the Supervision Division.<sup>870</sup>

*Consequences of the deficient FCA policies in respect of intervention*

4.24 The FCA’s overly cautious policies in respect of intervening, combined with the failures described in paragraphs 7.1 to 7.5 of **Chapter 10** (Adequacy of the FCA’s supervision of LCF) above for monitoring LCF’s financial promotions, meant that the FCA failed to take appropriate action in response to LCF’s financial promotions breaches. As explained in paragraph 3.1 of **Chapter 3** (Key events in the FCA’s regulation of LCF), LCF breached the FCA’s financial promotions rules on multiple occasions. However, while the FCA repeatedly wrote to LCF requiring it to cure the breaches identified, the FCA did not take any further action.

4.25 Even on the fifth occasion of LCF’s breach of financial promotions rules, the Financial Promotions Team only warned LCF by letter dated 17 August 2017 that on the *next* occasion of a breach it would seek a “*formal attestation*” by a person with a significant influence function within LCF that there were adequate systems and controls in place for the approval of compliant financial promotions.<sup>871</sup> This is despite the fact that the staff-member who wrote the letter on behalf of the FCA: (i) had dealt with previous financial promotions breaches by LCF; and (ii) was present at the SIWS Risk Committee meeting on 26 July 2017 which had identified that mini-bonds posed particular risks to consumers and agreed changes to the procedures of the Financial Promotions Team to require referral of financial

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<sup>869</sup> As noted above, the notices issued pursuant to section 137S were “*supervisory*” notices.

<sup>870</sup> One member of the Supervision Division’s senior management, Ms Butler, stated in interview regarding the FCA’s change of approach to its section 137S powers “*I think we could have considered that shift in practice earlier.*” (see: Interview with M. Butler, 19 June 2020, at page 12). However, when asked in second interview as to where responsibility lay for failing to consider the shift in practice earlier, Ms Butler would not say where such responsibility lay.

<sup>871</sup> Letter from FCA Financial Promotions to LCF’s CEO, 18 August 2017.

promotions cases involving authorised firms and mini-bonds to the relevant team within the Supervision Division.<sup>872</sup>

4.26 The Investigation’s conclusion that the FCA failed to take appropriate action in respect of LCF’s financial promotions is reinforced by the fact that internal FCA documents also suggest that the FCA was sensitive as to its past inadequate response to LCF’s financial promotions’ breaches. For example:

(a) when drafting the first supervisory notice in respect of LCF, the FCA considered putting in a section entitled “*Past indication of concerns by the FCA*”. A comment on a draft version of First Supervisory Notice stated:

*“I am inclined not to include details of why we [are] issuing this without giving the firm the chance to amend its advert i.e. the past interactions with Finproms. Arguably it is more complete to include this detail but I don’t think we are required to put it in the Notice and it would provide fuel for those who want to argue the FCA has missed a trick and should have shut the marketing down a long time ago”*<sup>873</sup> (emphasis added).

(b) An internal FCA email dated 11 January 2019 commenting on the draft second supervisory notice stated that “*it was previously considered to include the 4 pursued [financial promotions] cases as a reason for issuing the direction. However, they decided not to include it because of the potential for reputational risk to the FCA, as there could be criticism that we did not resolve the issues with the firm sooner. Apparently, this was also discussed with Megan [Butler] during the approval of the Notice and she agreed to leave this information out.*”<sup>874</sup>

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<sup>872</sup> See further details of the July 2017 paper in paragraphs 2.5 to 2.17 of **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks).

<sup>873</sup> Draft Supervisory Notice to LCF, FCA: Supervision and Enforcement, 4 December 2018, (214467). In interview, the FCA employee who had drafted this comment explained that this was not necessarily a legitimate criticism of the actions of the Financial Promotions Team, but the individual was conscious at the time of the *potential* for the FCA to be criticised in hindsight for failing to detect wider risks to consumers associated with LCF’s business (Interview Transcript V, at pages 17 and 18).

<sup>874</sup> Email from FCA Financial Promotions Team to Supervision Division, 11 January 2019, at 10.07am (Document with Control Number 207852).

**5. Conclusion**

5.1 As explained above, the FCA had in place appropriate rules relating to the communication of financial promotions by LCF. However, the FCA's policies, and in particular those of the Supervision Division, were deficient for the reasons set out above. These deficiencies led to failures in the appropriate regulation of LCF.

## **CHAPTER 12: INFORMATION PROVIDED BY THIRD PARTIES**

### **1. Introduction**

1.1 The Direction asked the following questions in respect of information provided to the FCA by third parties: (i) whether the FCA had established appropriate policies for responding to information provided by third parties regarding the conduct of LCF (the “**Existence of Policies Question**”); (ii) whether the FCA received such information during the Relevant Period (the “**Receipt of Information Question**”); and (iii) whether those policies were properly applied (the “**Application of Policies Question**”).<sup>875</sup> Each of these questions are addressed in this Chapter.

1.2 The Investigation considers that some of the FCA’s failures described in this Chapter are egregious. In particular, the FCA repeatedly received allegations from third parties that LCF might be engaged in fraud or irregularity but failed to respond. These warnings included at least 15 calls from a single individual (as noted in Section 4 of **Chapter 3** (Key events in the FCA’s regulation of LCF), this individual is referred to as “Individual A” in this Report) between 15 July 2016 and 22 February 2018. In the calls, Individual A made detailed allegations that LCF might be engaged in fraud or irregularity. The detail of such calls is summarised in **Appendix 6**<sup>876</sup> which, in the Investigation’s view, merits careful scrutiny by readers of this Report. Also summarised in **Appendix 6** is the FCA’s repeated failures to respond to those warnings.

### **2. Existence of Policies Question**

2.1 In the Investigation’s view, the FCA did not establish appropriate policies<sup>877</sup> for responding to information provided by third parties. The FCA’s policies, in particular those of the Supervision Division, were seriously inappropriate for three reasons.

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<sup>875</sup> Paragraph 3(c) of the Direction.

<sup>876</sup> See especially Section 3 of **Appendix 6** which provides a detailed summary of calls to the FCA which alleged that LCF may have been engaged in fraud or serious irregularity.

<sup>877</sup> The Investigation’s consideration of how the term “policies” should be understood for the purposes of the Direction has been explained in **Chapter 1** (Introduction and background).

- 2.2 First, the Supervision Division's policies were unclear in how to respond to information provided by third parties. In particular:
- (a) Contact Centre<sup>878</sup> policy documents were unclear in respect of whether call-handlers should refer allegations of fraud or serious irregularity regarding the unregulated activity of FCA-authorized firms more widely within the Supervision Division. As a result, call-handlers did not refer allegations against LCF on a number of occasions.
  - (b) Supervision Division policy documents were also unclear as to how allegations of fraud or serious irregularity regarding the unregulated activity of FCA-authorized firms should be pursued. This meant that even when such allegations reached the wider Supervision Division, they were not pursued or the allegations were not considered in the light of other relevant information.
  - (c) The responsibility for the policy failures set out above is identified in the relevant paragraphs below.
- 2.3 Second, Contact Centre policies failed to state clearly that call-handlers should not reassure callers in respect of a firm's unregulated activities based on its FCA-authorized status.
- 2.4 As a result, call-handlers sometimes reassured callers as to the reputability of LCF's bond issues based on its FCA-authorization. That was wholly inappropriate. As described elsewhere in this Report, the FCA's regulation of activities outside its Perimeter was in many respects deficient. FCA policy should have been clear that call-handlers were not to reassure callers in respect of a firm's unregulated activities based on its FCA-authorized status.<sup>879</sup> The responsibility for the above policy failing is set out in paragraph 2.32 below.
- 2.5 Third, Contact Centre policy documents were insufficiently clear that LCF's bond issues did not benefit from FSCS protection. As a result, in a limited number of instances call-handlers incorrectly advised that LCF's bond issues benefited from FSCS protection.<sup>880</sup>

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<sup>878</sup> As explained in **Appendix 6** the Contact Centre sits within the FCA's Supervision Division. An explanation of the Contact Centre's functions appears at paragraphs 2.2 to 2.6 of **Appendix 6**.

<sup>879</sup> See paragraphs 2.28 to 2.32 below.

<sup>880</sup> See paragraphs 2.34 to 2.36 below.

*Inappropriate policies for the handling of fraud allegations by the Customer Contact Centre*

- 2.6 Contact Centre policy documents were unclear in respect of whether call-handlers should refer allegations of fraud or serious irregularity regarding the unregulated activity of FCA-authorized firms more widely within the Supervision Division.
- 2.7 Some documents suggested that call-handlers did not need to refer such concerns. For example, the 2015 “*Contact Centre Scams*” induction booklet stated that a training course objective was to “[k]now when and who to inform about consumer scam queries.”<sup>881</sup>
- 2.8 However, Contact Centre call-handlers were only told to refer scams to the wider Supervision Division if they concerned regulated activities. The booklet provided a decision tree which stated, in text above the tree, “**If the scam is about a regulated activity, you will need to inform other FCA team’s about it**” (emphasis added). The tree then showed that “[s]cams about regulated activities” involving an authorised firm should be referred to the Supervision Division.<sup>882</sup> The decision tree did not explain to call-handlers when or where to refer concerns regarding potential scams regarding unregulated activity conducted by authorised firms.
- 2.9 The 2017 “*Contact Centre Scams*” induction booklet was in similar terms.<sup>883</sup>
- 2.10 Other documents made broader statements. For example, a document titled “*Supervision Referral Process*” stated in respect of “*financial crime...create a referral to supervisor*”.<sup>884</sup> Similarly, the FCA’s Contact Centre induction pack from 2017 stated, under the heading

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<sup>881</sup> Contact Centre Scams Induction Booklet, 2015, at page 2.

<sup>882</sup> *Ibid.*, at page 13. The decision tree also stated that scams involving regulated activity by unauthorised firms should be referred to the Intelligence Team or the FCA’s Unauthorised Business Department.

<sup>883</sup> Contact Centre Scams Induction Booklet, 2017, at page 13. Further the training materials contained statements that suggested that scams concerning unregulated activities were outside the remit of the FCA. For example, the 2015 and 2017 “*Contact Centre Scams*” induction booklets stated on pages 7 and 12: “[i]f a scam is a regulated activity then it is within the remit of the FCA... If a scam is not about a regulated activity it is out of scope for the FCA. However, as you will see in this Section, it is not out of scope for the CCC: you will still respond to all scam queries and explain the next steps to the consumer”. When explaining the advice to give to consumers the booklets stated: “[i]f it is a regulated activity, inform them their query will be forwarded to the relevant FCA team.”

<sup>884</sup> FCA Contact Centre, Supervision Referral Process, 24 October 2016. However, earlier versions of this document in use between 12 August 2016 and 23 October 2016 did not contain an entry relating to financial crime (see: FCA Contact Centre, Supervision Referral Process, 17 August 2016 to 8 September 2016; and FCA Contact Centre, Supervision Referral Process, 9 September 2016 to 23 October 2016).



“Criteria for when to refer a Risk Event to Event Supervision”, that “[a] Risk Event should be referred where there are concerns around financial crime”.<sup>885</sup> However, these documents did not state clearly that allegations regarding an FCA-authorized firm’s unregulated activity should also be referred to a supervisor. In the light of documents such as the training booklets referred to above, it was unclear whether call-handlers should refer allegations of fraud or serious irregularity regarding the unregulated activity of FCA-authorized firms.<sup>886</sup>

2.11 The unclear nature of FCA policies undermined the transmission of information from the Contact Centre to the wider Supervision Division. This is despite the fact that facilitating the transmission of such information had been a reason for bringing the Contact Centre’s services in-house.<sup>887</sup>

2.12 The Investigation has concluded that these policy failures reflected broader problems with the FCA’s approach to the Perimeter described elsewhere in this Report. The FCA recognised at Senior Management level that it was entitled to act in respect of authorized firms which conducted unregulated activity beyond the Perimeter, and that there were problems with the FCA’s approach to such activity.<sup>888</sup> However, this recognition did not result in change at lower, operational levels of the organisation to prevent the failures of regulation which occurred in respect of LCF. The unclear Contact Centre policy documents described above are an example of this broader deficiency in relation to the FCA’s approach to its Perimeter and of the failure to ensure appropriate operational change at lower levels of the organisation (in this instance, the Contact Centre). Responsibility for the failure in respect of the FCA’s approach to its Perimeter rests with ExCo and Mr Bailey.<sup>889</sup>

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<sup>885</sup> FCA presentation titled “Contact Centre Intelligence Referrals”.

<sup>886</sup> In paragraph 8.4 of the FCA’s representations, the FCA pointed out by reference to slide 18 of the “Contact Centre Intelligence Referrals” presentation that a number of cases of “Scams”, “Financial crime”, “Unknown or lapsed firms doing unauthorized business” and “Regulated firms doing additional activities without permission” were escalated by the Contact Centre to Enforcement. None of these are identified as cases of fraud regarding the unregulated activities of authorized firms. Accordingly, the Investigation does not consider that they detract from the conclusions set out in paragraphs 2.6 to 2.10.

<sup>887</sup> As described in **Appendix 6**, at paragraph 2.4.

<sup>888</sup> As described in **Chapter 6** (The FCA’s approach to the Perimeter).

<sup>889</sup> As identified in **Chapter 6** (The FCA’s approach to the Perimeter).

## Chapter 12: Information provided by third parties

- 2.13 However, responsibility for this policy failure is not solely attributable to the FCA's attitude to its Perimeter. Responsibility also rests with management of the Supervision Division, in particular with those elements of management responsible for the Contact Centre, for the reasons explained below.
- 2.14 Similar failings to those described in paragraphs 2.6 to 2.13 above had been identified in an FCA Internal Audit Final Report dated 13 November 2015.<sup>890</sup> In this respect, the report made a number of findings, the most relevant of which was that "*intelligence from unprompted consumer contact is not utilised effectively.*"<sup>891</sup> The report noted the importance of the Contact Centre to the FCA in receiving intelligence but also noted that such intelligence was not always passed on.<sup>892</sup> The report identified a number of action items to remedy these problems including "[refreshing] *all [Contact Centre] training materials to capture criteria for identifying, gathering and passing on consumer intelligence to internal stakeholders*" and "[rolling] *out refresher training to all Contact Centre employees*".<sup>893</sup>
- 2.15 Despite the concerns expressed in the Internal Audit Final Report, Contact Centre training materials remained deficient as explained above. Mr Davidson expressed the view that, while he did not have any role in the commissioning of the Internal Audit, he would have had a role in responding to it.<sup>894</sup> In the light of the above, the Investigation has concluded

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<sup>890</sup> FCA Internal Audit Final Report, The identification and use of unprompted consumer intelligence about regulated firms, 13 November 2015.

<sup>891</sup> *Ibid.*, at page 8.

<sup>892</sup> *Ibid.*, at page 8. The report stated: "[t]he Contact Centre is the main point of entry for consumers into the FCA and is the key supplier of intelligence from unprompted contact to internal stakeholders. The Contact Centre does not have its own criteria for what intelligence will be passed on to internal stakeholders. However, management of the Contact Centre acknowledges that in practice staff in the Contact Centre do not refer all contacts received every month to internal stakeholders.

*Staff in the Contact Centre filter intelligence before forwarding it to internal stakeholders and therefore, the FCA's ability to identify and use intelligence from unprompted contact is reliant on the judgment of individuals. Sample testing identified in instances where similar queries were treated differently by different staff in the Contact Centre resulting in some intelligence not being referred to the Supervision Division. While each separate piece of intelligence may not be actionable, if the Supervision Division had been able to review all intelligence at the same time, then collectively they might have concluded that the intelligence was useful.*

*The Contact Centre requires more support and guidance from internal stakeholders who receive intelligence from unprompted contact about improvements required to ensure that this intelligence can be used and also on distinguishing intelligence from consumer questions."*

<sup>893</sup> *Ibid.*, at page 10.

<sup>894</sup> Interview with J. Davidson, 15 June 2020, at pages 24 and 25.

that responsibility for the above failings rests with Mr Davidson solely by virtue that oversight of the Contact Centre falls within his remit.<sup>895</sup>

2.16 As a result of this unclear policy, Contact Centre call-handlers on various occasions failed to refer allegations of fraud or serious irregularity regarding LCF's (unregulated)<sup>896</sup> bond business to the wider Supervision Division.

2.17 Sometimes Contact Centre call-handlers failed to refer a case to Supervision in respect of such calls at all. This occurred in respect of three calls on 22 July 2016<sup>897</sup> and another on 10 July 2017.<sup>898</sup> The calls raised detailed allegations regarding LCF and the failure to refer them is, in the Investigation's view, inexplicable.<sup>899</sup> To provide just one example of many, in one call the on 22 July 2016 the caller stated in respect of LCF:

*"...what they say they're doing is they're lending out to SMEs to pay back the interest for the bonds. But I don't think they are, in my opinion... there's absolutely no evidence whatsoever of them doing that either in the past or in the present. There's only been one occasion where they've lent money out, and that was to another company, which was just a shell company, and that was last year on their accounts where they lent, how was it, about £20,000 out to another company, which, and the Director of that company, the debtor, was also the Director who obviously provided loans to the creditor. So that doesn't count,*

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<sup>895</sup> The Investigation has reached this conclusion because Mr Davidson is part of the management of the Supervision Division and the Contact Centre sits within Mr Davidson's remit (see: Interview with J. Davidson, 15 June 2020, at page 21). The Investigation is also aware that Mr Davidson appears to have been conscious of, and referred in interview to, difficulties in how calls were recorded during the Relevant Period (see: Interview with J. Davidson, 28 August 2020, at pages 21 to 25). Furthermore, the Contact Centre on multiple occasions failed to refer allegations of fraud or irregularity regarding LCF from the Contact Centre to the wider Supervision Division and in those circumstances some attribution of responsibility to Executive Director-level is, the Investigation considers, appropriate. Nonetheless, the Investigation has concluded that in reality someone with the broad portfolio and seniority of Mr Davidson is unlikely to have been aware of the points of detail described above such as deficiencies in training materials. Section 11 of **Chapter 1** (Introduction and background) sets out what is meant by individual responsibility in this Report.

<sup>896</sup> As explained in **Chapter 9** (Appropriateness of LCF's permissions) above and **Appendix 5** below, the Investigation's view is that LCF's business of issuing bonds did not constitute regulated activity. Accordingly, LCF's issuing bonds, which was the main activity LCF undertook, was outside the Perimeter. The Investigation is, however, aware that judicial review proceedings are ongoing which raise the question whether LCF's issuing bonds constituted regulated activity. The Investigation's view is not binding or legally determinative of this issue which can ultimately only be resolved by the Courts rather than this Investigation.

<sup>897</sup> As discussed in paragraphs 3.6 to 3.14 of **Appendix 6**.

<sup>898</sup> As discussed in paragraphs 3.21 to 3.23 of **Appendix 6**.

<sup>899</sup> As already stated, the reader is encouraged to refer to **Appendix 6** to familiarise themselves with the detail of these calls.

*basically, if he's lending to himself. So they haven't basically lent money out to anyone, so I don't know what they're doing. But what they say they're doing, they're not doing."*

- 2.18 On other occasions, the call-handlers referred a case in respect of such calls. However, the call-handlers' notes failed to record that the caller had alleged fraud or irregularity. The notes instead focused on issues such as whether LCF's issuing bonds were within the Perimeter. This occurred in respect of a call on 15 July 2016<sup>900</sup>, 18 July 2016<sup>901</sup> and 21 June 2017.<sup>902</sup> This potentially meant that the supervisors would not realise the callers had raised allegations of fraud or serious irregularity. This is because supervisors relied on Contact Centre staff to identify the points in the call for potential further investigation.<sup>903</sup>
- 2.19 Again, in the Investigation's view, the failure of call-handlers to refer calls is simply inexplicable. To take but one example,<sup>904</sup> on the 18 July 2016 call the caller alleged that there were various irregularities in respect of LCF. For example, the caller alleged that LCF's recent rate of growth was suspicious.<sup>905</sup> The caller also made other allegations of irregularity against LCF on the call.<sup>906</sup>

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<sup>900</sup> As discussed in paragraphs 3.2 to 3.5 of **Appendix 6**.

<sup>901</sup> As discussed in paragraphs 3.6 to 3.10 of **Appendix 6**.

<sup>902</sup> As discussed in paragraphs 3.20 to 3.22 of **Appendix 6**.

<sup>903</sup> Interview Transcript O, at page 31.

<sup>904</sup> Further examples are provided in **Appendix 6**.

<sup>905</sup> The caller stated: "[t]hey're claiming that they have 160 SMEs which they lend money to and they've invested £30 million with them so far since the beginning of the new published financial year. Now I did a company search on them and they have no assets, their amount of money in the bank is £8 and it goes on basically... So they had – during that year, their income was £14,000 and the lending was to one person only and that person was another company of which the director of the company was the same director as the lending company... So basically what I'm trying to find out is how on earth can they suddenly get 160 customers that they lend to when they only had one last year and that was someone basically who was the director of their own company" (see: Transcript of call from Individual A to the FCA Contact Centre 18 July 2016, at pages 4 and 5).

<sup>906</sup> For example, at one point in the call, the caller stated: "[a]nd they're saying they've got charges on their property, security on them, assets on their property, of course they don't have any assets. It's all horrendous really, the whole thing" (see: *Ibid.*, at page 15). Individual A also raised the issue of what should happen if a (hypothetical) company were illegally paying interest from Bondholder money (see: *Ibid.*, at page 13). The call-handler stated that the caller could go to the police or seek legal advice.

2.20 The Contact Centre call-handler stated that LCF's lending business did not "*fall within our remit as to what we would regulate*".<sup>907</sup> Nonetheless, the call-handler raised a risk event so that the call would be considered within the wider Supervision Division. However, the call-handler's notes on the FCA's case management system summarised the call as one which focused on whether LCF had the correct FCA permissions for its business.<sup>908</sup> The call-handler's notes made no mention of the fact that the caller had alleged that there were various irregularities in respect of LCF as summarised in paragraph 2.19 above.

*Inappropriate policies for the handling of fraud allegations by the Supervision Division*

2.21 Supervision policy documents were also deficient as to how such allegations of fraud or serious irregularity should be pursued. This meant that, even if such allegations reached the wider Supervision Division, they were not pursued or the allegations were not considered in the light of other relevant information. The policy documents were deficient for two reasons.

2.22 First, and as explained in **Chapter 10** (Adequacy of the FCA's supervision of LCF) above, there was no policy which required the FCA's supervision staff to interrogate a firm's financial information following an allegation of fraud or serious irregularity being made against a firm. Staff were instead encouraged to adopt a "*common sense*" approach.<sup>909</sup>

2.23 In the event, however, the FCA's Supervision Division did not interrogate LCF's financial information, despite the allegations of fraud or irregularity made by third parties. This occurred, for example, in the case of the Anonymous Letter sent to the FCA in early 2017<sup>910</sup> and also in respect of the allegation that LCF was a scam made to the Financial Promotions

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<sup>907</sup> *Ibid.* at page 5. Later in the call after the caller had alleged further irregularities, the call-handler reiterated that "[s]o far as the bonds are concerned that falls outside what we would regulate, that's not something that would be forwarded on because it's not anything that we would have rules against..." (see: *Ibid.*, at page 16).

<sup>908</sup> The Contact Centre call-handler's notes summarised the call as a "[q]uery as to whether the firm has correct permissions". The notes also stated "*consumer called to query the permissions of [LCF] as he explained the website states the firm is regulated by us for consumer credit lending*" (see: Case Detail 18 July 2016 (Document with Control Number 122276)).

<sup>909</sup> Interview transcript G, at page 24.

<sup>910</sup> As defined in Section 4 of **Chapter 3** (Key events in the FCA's regulation of LCF).

## Chapter 12: Information provided by third parties

Team in March 2017.<sup>911</sup> It also occurred in respect of cases referred from the Contact Centre (see: (i) the 18 July 2016 call;<sup>912</sup> (ii) the 21 June 2017 call;<sup>913</sup> and (iii) 20 July 2018 call).<sup>914</sup>

2.24 Responsibility for these policy failings rests with the Senior Management of the Supervision Division.<sup>915</sup>

2.25 Second, FCA policies were unclear that allegations of fraud or serious irregularity should be pursued by the Supervision Division, where those allegations concerned the unregulated activities of FCA-authorized firms. The Investigation is not aware of policy statements which required staff within the Supervision Division to pursue allegations of fraud or irregularity in respect of the unregulated activities of FCA-authorized firms. This reflected broader problems with the FCA's approach to the Perimeter described elsewhere in this Report.

2.26 These unclear policies in respect of how allegations of fraud or serious irregularity should be pursued or escalated, also led to failures in the regulation of LCF. Supervision staff failed to consider allegations made in the Anonymous Letter in part because they considered it a matter primarily for the police.<sup>916</sup> Similarly, the allegations made in the communication from the member of the public to the Financial Promotions Team in March 2017, to the effect that that LCF was operating a scam, were also not pursued by the Financial Promotions Team or any other team in the Supervision Division. Furthermore, the Supervision Division did not pursue allegations of fraud or illegality referred from the Contact Centre, because they concerned unregulated activity. For example, the supervisor's notes to the 20 July 2018 call<sup>917</sup> stated: "[c]oncerns relate to firm's unregulated activities. Reg history checked. Considered as within risk tolerance."<sup>918</sup> The supervisor had not, however, taken steps such as interrogating LCF's financial information for evidence of irregularity.

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<sup>911</sup> See Section 3 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>912</sup> See paragraphs 3.6 to 3.10 of **Appendix 6**.

<sup>913</sup> See paragraphs 3.20 to 3.22 of **Appendix 6**.

<sup>914</sup> See paragraphs 3.26 to 3.28 of **Appendix 6**.

<sup>915</sup> As described in **Chapter 10** (Adequacy of the FCA's supervision of LCF).

<sup>916</sup> As described in **Chapter 10** (Adequacy of the FCA's supervision of LCF).

<sup>917</sup> See paragraph 7.3 of **Appendix 6**.

<sup>918</sup> Case Detail 20 July 2018 (Document with Control Number 125069).

2.27 Accordingly, even when allegations of fraud or irregularity relating to LCF came before the FCA's Supervision Division, deficiencies in FCA policies meant that staff were inadequately prepared as to how such allegations should be pursued.

*Failure to establish appropriate policies in respect of reassuring callers as to reputability of LCF's bond issues*

2.28 Contact Centre policies and documents also failed to state clearly that Contact Centre call-handlers should not reassure callers in respect of an FCA-authorized firm's unregulated activities based on its FCA-authorized status. As a result, call-handlers sometimes reassured callers that LCF's bond issues were reputable, simply, and erroneously, based on LCF's FCA-authorized status.

2.29 For example, one document titled "*Using the Register Flowchart*" recommended that callers should be advised to complete final checks to satisfy themselves that they fully understood how a firm was using its permissions. The document also stated "[b]e risk averse and put the final onus on the consumer to reduce their risk of dealing with clone or scam firms" and "[e]xplain that the consumer should check with the firm that the activity they're doing is a regulated activity and ask the firm to confirm which of their permissions allows them to do this." The document did not, however, state that call-handlers should avoid reassuring callers in respect of a firm's unregulated activities based on a firm's FCA-authorized status.<sup>919</sup>

2.30 Similarly, the "*Contact Centre Scams*" training booklets for 2015 and 2017 recommended that Contact Centre call-handlers should advise consumers "*if they have not yet invested, recommend that they only deal with authorised firms and should exercise extreme caution if they deal with a firm that is not authorised by the FCA.*"<sup>920</sup> However, the booklets did not go on to advise exercising similar caution when dealing with the unregulated activities of an FCA-authorized firm.

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<sup>919</sup> Knowledge article 5130, *Using the Register Flowchart*, 5 October 2017 to 30 July 2018; and Knowledge article 5130, *Using the Register Flowchart*, 31 July 2018 to 22 October 2019.

<sup>920</sup> *Contact Centre Scams Induction Booklet*, 2015, at page 12 and *Contact Centre Scams Induction Booklet*, 2017, at page 12.

## Chapter 12: Information provided by third parties

- 2.31 As a result of the unclear policy, Contact Centre call-handlers sometimes<sup>921</sup> reassured callers that LCF's bond issues were reputable based on LCF's FCA-authorized status. This occurred in respect of calls on 23 January 2017<sup>922</sup> and 6 March 2017.<sup>923</sup>
- 2.32 For example, in the course of explaining what an "asset-backed bond" was on the 6 March 2017 call, a Contact Centre call-handler stated "[s]o you're effectively investing in a business and you're going to see a return. Now, **the business appears to be regulated, so it doesn't appear from the information you've given to me and the information that I've found, it doesn't appear to be a scam or anything along those lines, so it may actually have a cancellation or cooling-off period with regards to the money**" (emphasis added).<sup>924</sup>
- 2.33 Such reassurance was inappropriate. As described elsewhere in this Report, the FCA's regulation of activities outside its Perimeter was in many respects deficient. Such reassurance reinforced LCF's ability to abuse the imprimatur of respectability and integrity which it had obtained from FCA-authorization in order to attract investors to its non-FCA-authorized bond business, as described elsewhere in this Report.<sup>925</sup> FCA policy should have been clear that call-handlers were not to reassure callers in respect of a firm's unregulated activities based on its FCA-authorized status. Thus policy documents failed to ensure Contact Centre staff appreciated the significance of the Perimeter in respect of the advice it was appropriate for them to give.

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<sup>921</sup> As explained in **Appendix 6**, there are contrary examples where Contact Centre call-handlers recommended that callers exercise caution in respect of investing in LCF.

<sup>922</sup> See paragraph 4.2 of **Appendix 6**.

<sup>923</sup> See paragraphs 4.3 to 4.4 of **Appendix 6**.

<sup>924</sup> Transcript of a call to the FCA Contact Centre 6 March 2017, at page 12. The Contact Centre call-handler also made similar statements elsewhere on the call: (1) "*the good news is, **it doesn't appear to be a scam, so it doesn't appear that you've lost your money from what you've said to me so far, and the information that I hold on the business***" at page 12; (2) "*some asset-back bonds aren't regulated and it's very unclear right now as to the type of asset-backed bond your [relative] may have invested in but the **key thing here to remember is that the business is, indeed, regulated, okay? So, you haven't lost your money to a scam. However, if you want to find out about the cancellation side of things, you would need to contact the business***" at page 13; and (3) "*Yeah, I mean, **if there's any good bit of news from what this is, right now it doesn't appear the money has been lost to a scam, okay, but the next steps available for you would be to get in contact... with the company on the number I've provided, okay, to find out if there is any cooling-off period***" (emphasis added) (see: *Ibid.*, at page 16).

<sup>925</sup> Furthermore, as already explained in **Chapter 9** (Appropriateness of LCF's permissions), FCA public documents represented to the public that its authorization processes were robust. The statements provided a false degree of reassurance to the public that FCA-authorized firms such as LCF had been adequately scrutinised. The reassurance provided by call-handlers further contributed to the false degree of reassurance provided to the public in respect of FCA-authorization.



*Failure to establish appropriate policies as to whether LCF's bond issues benefited from FSCS protection*

- 2.34 Contact Centre policy documents also failed to state with sufficient clarity that LCF's bond issues did not benefit from FSCS protection. For example, an FCA employee created an internal knowledge document explaining how Contact Centre call-handlers should deal with permissions queries regarding LCF.<sup>926</sup> This document arose out of a number of allegations which had been made to the FCA that LCF was engaging in unauthorised investment activities. The knowledge document was in use from 6 June 2016 to 8 July 2016.
- 2.35 The document stated that the FCA's General Counsel's Division had "*advised that the firm did not need to be regulated for its investment activity as the issued bonds in this case relate to an investment in the firm itself, rather than the firm dealing in investments on behalf of another.*" However, the document did not expressly go on to state that LCF's bond issues did not benefit from FSCS protection. It appears that knowledge documents which expressly stated that LCF's bonds (and mini-bonds in general) did not benefit from FSCS protection only appeared from around late 2018.<sup>927</sup>
- 2.36 The result was that, in a limited number of instances, FCA call handlers incorrectly<sup>928</sup> advised callers that LCF's bonds benefited from FSCS protection.<sup>929</sup> For instance, in a call on 24 June 2016 a caller stated they were looking to invest in a fixed three-year income bond at 8% per annum. The caller stated "[i]t does sound too good to be true doesn't it" to which the FCA call handler replied "[l]et's have a look". The call handler then stated "[LCF]... So that's coming up as authorised and regulated, so that's absolutely fine. That means if you

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<sup>926</sup> Knowledge Article 4102, London Capital & Finance plc, 6 June 2016 to 8 July 2016.

<sup>927</sup> See for example Knowledge Article 5675, What is a mini-bond? Are they regulated by the FCA?, 27 December 2018; and Knowledge Article 5648, London Capital & Finance plc, 28 December 2018 to 1 January 2019.

<sup>928</sup> As already explained above, the Investigation's view is that LCF's issuing bonds did not constitute regulated activity. Accordingly, LCF's issuing bonds, which was the main activity LCF undertook, was outside the FCA's perimeter. The Investigation is, however, aware that judicial review proceedings are ongoing which raise the question whether LCF's issuing bonds constituted regulated activity. The Investigation's view is not binding or legally determinative of this issue which can ultimately only be resolved by the Courts rather than this Investigation.

<sup>929</sup> As stated in paragraphs 6.2 to 6.6 of **Appendix 6**, the Investigation has seen only limited instances of FCA call handlers offering such incorrect advice. In other instances, FCA call-handlers advised that LCF's bonds did not benefit from FSCS protection.

wanted to invest with them, you'd be protected by up to £50,000 by the Financial Compensation Scheme.”<sup>930</sup> Further detail of such calls is provided in **Appendix 6**.

*Conclusion on the Existence of Policies Question*

- 2.37 For the reasons set out above, the FCA, and in particular the Supervision Division, did not establish appropriate policies regarding information provided by third parties in respect of LCF. This led to failures in respect of the regulation of LCF.
- 2.38 First, the Supervision Division's policies were unclear as to how to respond to information provided by third parties. This led to highly significant failings because: (i) repeated and detailed allegations of fraud or serious irregularity were not referred from the Contact Centre for further investigation; or (ii) when such allegations were referred they were not pursued either at all or in the light of other relevant information.
- 2.39 Second, Contact Centre policies also failed to state clearly that Contact Centre call-handlers should not reassure callers in respect of an FCA-authorized firm's unregulated activities based on its FCA-authorized status. These failures in policy meant that the Contact Centre provided inappropriate reassurance to callers in respect of LCF's bond business based on LCF's FCA-authorized status.
- 2.40 Third, Contact Centre policy documents were insufficiently clear that LCF's bond issues did not benefit from FSCS protection. As a result, in a limited number of instances call-centre handlers incorrectly advised that LCF's bond issues benefited from FSCS protection.

**3. Receipt of Information Question**

- 3.1 The FCA received multiple items of information from third parties including (among others): (i) specific and repeated allegations that LCF was engaged in fraud or serious irregularity; (ii) enquiries as to whether LCF was operating a scam; and (iii) enquiries about LCF's permissions. A detailed summary of such information is set out in **Appendix 6**. As already stated, the Investigation considers that Appendix merits careful scrutiny by readers of this Report.

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<sup>930</sup> Transcript of a call to the FCA Contact Centre 24 June 2016, at pages 2 and 3.

#### 4. Application of Policies Question

4.1 For the reasons set out above, the failures in respect of the FCA’s response to information provided by third parties regarding LCF occurred because of deficiencies in FCA policies. Accordingly, it is the policies themselves, rather than failures by FCA staff in applying those policies, which explain the failures in regulation set out in this Chapter.

4.2 With particular focus on the multiple allegations of fraud or irregularity to which the FCA failed to respond, the consistency of the FCA’s failure to respond suggests that the cause of these failures was the policy deficiencies described above. The fact that so many call-handlers and other FCA supervision staff failed so consistently to respond to such warnings indicates that the problem was one at policy level, as opposed to instances of staff failing to apply those policies.

#### 5. FCA’s representations as to third-party information

5.1 This section addresses two observations made by the FCA in its representations to the Investigation.

5.2 First, the FCA stated that it was not “*fair to generalise from the examples in this case... that there was a systemic issue with the handling of calls in the Customer Contact Centre during the Relevant Period.*”<sup>931</sup> The FCA represented that of the 8,767 consumer contacts that were quality assured by the FCA’s Consumer Team between May 2015 and September 2020, there were 225 instances (2.5%) in which consumers were given incorrect advice. Of these, only 115 (1.3%) had the potential to lead to consumer detriment.<sup>932</sup> The FCA also informed the Investigation about four matters unrelated to LCF where, it was said, the FCA “*acted decisively on the basis of third-party intelligence*”.<sup>933</sup>

5.3 As stated in paragraph 3(c)(i) of the Direction, the relevant question that the Investigation has to consider is whether “*the FCA had established appropriate policies for responding to information provided by third parties regarding the conduct of LCF*” (emphasis added). Accordingly, the Investigation has only considered the FCA’s handling of third-party

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<sup>931</sup> FCA representations, paragraph 8.6.

<sup>932</sup> FCA representations, paragraph 8.6.

<sup>933</sup> FCA representations, paragraph 8.7.

information regarding LCF. It does not express any view on whether, in other instances, the FCA advised consumers correctly or whether the FCA acted appropriately on the basis of third party information.

- 5.4 Nonetheless, the Investigation considers that in the light of the continued and repeated failures in respect of LCF outlined above, which occurred over a sustained period of time, it *is* fair for the Investigation to draw the conclusions which it has regarding systemic issues with the FCA’s handling of calls during the Relevant Period. Indeed, not to draw any broader conclusions as to why there were continued and repeated failures of in the call-handling of LCF during the Relevant Period would be perverse.
- 5.5 Second, the FCA stated that, although the Report refers to FCA’s whistleblowing policies in the context of the DES and DEA Programmes,<sup>934</sup> they are not recognised in the context of the FCA’s policies regarding information provided by third parties. It was said that, during the Relevant Period, the FCA’s policy was to assess every report from a whistle-blower to determine whether action was appropriate. The Investigation was informed that there were 165 whistleblowing disclosures that led to “*action*” or “*significant action*”<sup>935</sup> action in this way during the Relevant Period.<sup>936</sup>
- 5.6 As explained above, the relevant question for the Investigation is whether the FCA had established appropriate policies for responding to information provided by third parties “*regarding the conduct of LCF*”. The Investigation has not seen evidence of any whistle-blowers providing information to the FCA regarding LCF.

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<sup>934</sup> See paragraphs 8.20 to 8.22 of **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes).

<sup>935</sup> In this context, “*significant action*” means: (i) intelligence assessed by the Supervision identifying significant harm, referred to and accepted by enforcement; (ii) intelligence being deemed relevant to and/or assisted with an existing Enforcement case; and (iii) intelligence leading to, or contributing to “*significant outcomes*” such as a penalty, censure, warning, redress scheme, change in business model, variation/removal of permissions, enhanced supervisory oversight of a firm, change in firm culture or refusal of application.

<sup>936</sup> FCA’s representation, paragraph 8.12.

5.7 The Investigation recognises that the definition of the term “*whistle-blower*” in the FCA’s policies during the Relevant Period was broader than what was required by the Public Interest Disclosure Act 1998.<sup>937</sup> Thus, the FCA’s glossary defines a “*whistle-blower*” as:

“*any person that has disclosed, or intends to disclose, a reportable concern:*

*(a) to a firm; or*

*(b) to the FCA or the PRA; or*

*(c) in accordance with Part 4A (Protected Disclosures) of the Employment Rights Act 1996.*

*A person is not necessarily a whistleblower if they use a channel other than the internal arrangements set out in SYSC 18.3.”*<sup>938</sup>

5.8 According to this definition, it was possible for the FCA to treat Individual A<sup>939</sup> as a whistleblower even though Individual A may not have been a current or previous employee of LCF. The FCA’s documents from the Relevant Period suggest that the FCA assessed whether someone is a whistle-blower by reference to a number of factors including whether the information provided was sensitive, whether it concerned misconduct, malpractice or financial crime, whether the informant sought confidentiality, whether the offer of information was “*out of the blue*” and whether the informant was tasked with obtaining the information in a covert manner.<sup>940</sup> If the information was treated as being provided by a whistle-blower, the FCA’s policy was to refer it to the Whistleblowing Team.<sup>941</sup> The Investigation has not seen any evidence of Individual A being treated as a whistle-blower. Accordingly, the Investigation considers that the FCA’s policies regarding whistle-blowers are of limited relevance to the question which it is asked to answer.

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<sup>937</sup> FCA, ‘How we handle disclosures from whistleblowers’ (February 2015) (see: <https://www.fca.org.uk/publication/corporate/how-we-handle-disclosures-from-whistleblowers.pdf> (accessed on 23 November 2020)).

<sup>938</sup> The “*arrangements set out in SYSC 18.3*” are the “*appropriate and effective*” internal whistleblowing arrangements that a firm must “*establish, implement and maintain*”.

<sup>939</sup> As explained in paragraph 1.2 above, Individual A made 15 calls to the FCA between 15 July 2016 and 22 February 2018 making detailed allegations about LCF.

<sup>940</sup> Exco paper titled ‘Revised whistleblowing intelligence strategy’, 7 February 2017.

<sup>941</sup> FCA, ‘How we handle disclosures from whistleblowers’ (February 2015).

**6. Conclusion**

- 6.1 This Chapter has explained that the FCA, and in particular the Supervision Division, failed to establish appropriate policies for responding to information provided by third parties regarding LCF. It has also explained that the failure to establish appropriate policies in turn led to other failures in the FCA's regulation of LCF.
- 6.2 In some instances, despite clear allegations that LCF was engaged in fraud or serious irregularity, Contact Centre call-handlers failed to refer allegations onwards to the wider Supervision Division for further investigation. In other instances, even when such allegations were referred, the Supervision Division failed to pursue such allegations or consider them in the light of other relevant information.
- 6.3 In other cases still, Contact Centre call-handlers reassured callers that LCF was unlikely to be operating fraudulently based on the firm's FCA-authorized status or that investments in LCF's bond issues benefited from FSCS protection. This again was inappropriate for reasons explained above.

## **CHAPTER 13: OTHER MATTERS OF IMPORTANCE TO THE INVESTIGATION**

### **1. Introduction**

1.1 The Investigation considers that there are other matters relevant to the question of whether the FCA discharged its functions in respect of LCF in a manner which enabled it effectively to fulfil its statutory objectives.<sup>942</sup>

1.2 In summary:

- (a) The fact that LCF's bonds were advertised on the basis that they could be acquired in an ISA wrapper was crucial in attracting investors. Bondholders have informed the Investigation that they were reassured by the ISA status of LCF's products.<sup>943</sup> However, neither the FCA nor HMRC considered apparent flaws in the ISA status of LCF's products, owing to a lacuna in the way in which ISAs were regulated. The sense of reassurance this generated among Bondholders was therefore misplaced.<sup>944</sup> This compounded the false reassurance provided by LCF's FCA-authorized status.
- (b) The FCA's failure appropriately to regulate LCF is not excused or mitigated by the risk associated with LCF's products.

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<sup>942</sup> This responds to paragraph 3(2) of the Direction which provides: "[t]he Investigator may also consider any other matters which they deem relevant to the question of whether the FCA discharged its functions in a manner which enabled it to effectively fulfil its statutory objectives."

<sup>943</sup> See paragraph 9.4(d) of **Chapter 1** (Introduction and background) of this Report.

<sup>944</sup> As explained below, the Investigation's criticism of the FCA in respect of this ISA issue is limited. As a result of the regulatory lacuna, the FCA was not required to consider in all cases whether products such as LCF's ISAs complied with legislative requirements. Accordingly, the Investigation does not criticise the FCA for not ensuring that it checked the compliance of LCF's ISAs, in the absence of other worrying information relevant to LCF's business.

However, the Investigation's view is that, if the FCA had appreciated the significance of the other red flags detailed in this Report, it would have been appropriate for the FCA also to consider whether LCF's ISA products complied with legislative requirements. This would have been as part of a wider exercise of considering LCF's business as a whole in the light of red flags of which the FCA was aware (as explained elsewhere in this Report, the FCA repeatedly failed to conduct such an holistic assessment of LCF's business prior to late 2018 in the lead up to the unannounced visit).

- (c) The Register and similar FCA resources aimed at members of the public were of limited use and do not excuse or mitigate the FCA’s failures identified elsewhere in this Report.
- (d) The fact that LCF’s accounts contained the Auditors’ Statement<sup>945</sup> does not excuse or mitigate the FCA’s failures.
- (e) The FCA needs to raise awareness among its staff of the important role it plays in combatting fraud.
- (f) The FCA’s intervention against LCF in late 2018 demonstrated positive behaviour in the way the risks were identified by individuals in the Intelligence and Listing Transactions Teams. However, there were also delays in addressing the risks once they had been identified.

## 2. Non-regulation of LCF’s ISA products

### *Introduction*

2.1 The fact that LCF’s bonds were advertised on the basis that they could be acquired in an ISA wrapper was crucial in attracting investment:

- (a) Bondholders have informed the Investigation that they believed the ISA status indicated LCF’s products were subject to an additional level of regulatory scrutiny and assurance;<sup>946</sup> and
- (b) once LCF obtained approval to act as an ISA manager in November 2017 and marketed its bonds as ISA eligible, its sales significantly increased.<sup>947</sup>

2.2 However, the regulation of LCF’s ISA products was flawed. LCF utilised a new ISA structure, which was introduced in 2016, to promote its bonds; the innovative finance ISA (“**IFISA**”). For the reasons explained below, the Investigation’s view is that LCF’s bonds

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<sup>945</sup> As defined in paragraph 5.1 of this Chapter.

<sup>946</sup> See paragraph 9.4(d) of **Chapter 1** (Introduction and background) of this Report.

<sup>947</sup> Joint administrators’ Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 Insolvency Act 1986, 25 March 2019, table 7.1, at page 9 (see: <https://smithandwilliamson.com/media/3772/lcf-joint-administrators-proposals.pdf> (accessed on 23 November 2020)).



did not comply with the legislative requirements applicable to such structures.<sup>948</sup> Neither the FCA nor HMRC (in the context of their regulatory functions) addressed this issue of non-compliance during the course of their respective dealings with LCF owing to a lacuna in the way in which ISAs were regulated.<sup>949</sup> As a result, the reassurance which many investors felt based on the ISA status of LCF's bonds was misplaced.

*Non-compliance in the regulation of ISA products*

- 2.3 For the reasons below, the Investigation's view is that LCF's bonds did not comply with legislation applicable to IFISAs.<sup>950</sup>
- 2.4 First, the relevant legislation required that LCF's IFISA products be transferable. Regulation 8A(4)(a)<sup>951</sup> of the Individual Savings Account Regulations 1998/1870 (the "**ISA Regulations**") provided in respect of IFISAs that "*debentures*" had to be a "*transferable security*".
- 2.5 LCF's ISA products did not comply with this requirement because they were non-transferable. For example, the front cover of LCF's information memorandum for its Series 3 ISA bond contained the words "*Non-transferable Securities*" immediately underneath the product's title.<sup>952</sup>
- 2.6 Second, regulation 8A(4)(b) of the ISA Regulations also provided in respect of IFISAs that "*the investment in the debenture is facilitated by a person carrying on an activity of the kind*

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<sup>948</sup> Complex legal issues have been raised in the judicial review proceedings against the FSCS in Claim No. CO/1176/2020 as to whether clauses which do not comply with ISA legislation should be struck down. For example, see the Claimant investors' Amended Detailed Statement of Facts and Grounds, 24 April 2020, at paragraph 5(c)(ii) (see: <https://shearman.sharefile.com/share/view/s13a21097cc041508> (accessed on 23 November 2020)). The Investigation does not comment on such issues which can only be resolved by the Courts rather than this Investigation. Furthermore, the Investigation's view that LCF's products did not comply with legislative requirements is not legally binding and these issues can also only ultimately be determined by the Courts rather than this Investigation.

<sup>949</sup> As explained above, the Investigation's criticism of the FCA in respect of the ISA issue in the light of this regulatory lacuna is limited.

<sup>950</sup> See above in respect of the complex legal issues which have been raised in the judicial review proceedings.

<sup>951</sup> Regulation 8A applied to IFISAs. The provision was added by amendment to the ISA Regulations on the introduction of IFISAs in 2016.

<sup>952</sup> DSGF Exhibit Part 2, at page 482 (LCF Information Memorandum, 30 May 2018, at page 1) (see: <https://shearman.sharefile.com/share/view/s13a21097cc041508> (accessed on 23 November 2020)).

*specified in article 25 of the Regulated Activities Order 2001 through an electronic system operated by that person in an EEA State for such purpose.”*

2.7 LCF’s ISA products did not comply with this requirement:

- (a) LCF did not conduct the activity specified in Article 25 of the RAO, namely *“making arrangements for another person (whether as principal or agent to buy... a particular investment... which is... a security”*.
- (b) This is because Article 34 of the RAO excluded *“arrangements made a by a company for the purposes of issuing its own shares.”* LCF’s issuing of its own bonds were caught by this exclusion such that it was not carrying out the activity described in Article 25 of the RAO.<sup>953</sup> Accordingly, its products did not comply with Regulation 8A(4)(b) of the ISA Regulations.
- (c) Nor does it appear there was any third party which was making arrangements for investors to invest in LCF’s ISA products either.

2.8 Third, regulation 8A(4)(c) of the ISA Regulations provided that the person who carried on the activity specified in Article 25 of the RAO or another, acting under an arrangement with that person or at that person’s direction, *“in respect of the investment treats the account investor as its client and undertakes on behalf of the account investor to – (i) receive payments in respect of the debenture; (ii) make payments when due, in respect of the debenture to the account investor; and (iii) exercise, or facilitate the exercise of rights in respect of the debenture”*.

2.9 LCF’s products also did not comply with this requirement because LCF was not carrying out the activity specified in Article 25 of the RAO for the reasons set out above. Nor does it appear any third party was making arrangements for investors to invest in LCF’s ISA products within the meaning of Article 25 of the RAO either.

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<sup>953</sup> See paragraph 5.14 of **Appendix 5**. Although as also noted in paragraph 4.10 of **Appendix 5** in certain limited instances it appears that LCF did conduct the activity in Article 25. Where LCF sent transfer instructions to a Bondholder’s existing ISA manager, instructing the ISA manager to sell the Bondholder’s existing holdings in a stocks and shares ISA, it appears LCF’s activity fell within the scope of regulated arranging. This is because, by arranging the disposal, LCF was *“making arrangements for”* another person (the investor) to *“sell”* their existing investment in the stocks and shares ISA within the meaning of Article 25(1) of the RAO in order to facilitate their investment in the LCF bonds.

*Lacuna in the regulation of ISAs*

- 2.10 Neither the FCA nor HMRC considered the apparent non-compliance of LCF's IFISA products with the ISA Regulations prior to late 2018, when significant adverse intelligence resulted in the FCA conducting an unannounced visit to LCF's place of business. This was owing to a lacuna in the way in which ISAs were regulated which meant that neither the FCA nor HMRC:
- (a) identified the risk of non-compliant IFISAs being promoted; or
  - (b) checked that LCF's products complied with the relevant legislation applicable to IFISAs.
- 2.11 The Investigation has not considered HMRC's remit. Nor has the Investigation considered whether it had any statutory function or obligation to check that products which market participants (such as LCF) claimed were ISA products complied with legislative requirements. However, HMRC has indicated to the Investigation that, in HMRC's view, this was not within its function.
- 2.12 HMRC told the Investigation that once a firm was approved as an ISA manager, it was the firm's responsibility to ensure that it complied with the ISA regulations,<sup>954</sup> and although HMRC would take action when it became aware of actual breaches of the ISA Rules, it would only do so on a reactive basis.<sup>955</sup> HMRC did not approve individual products as compliant with ISA regulations. Its approval process involved certain limited checks on the

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<sup>954</sup> See Regulation 4(5) of the ISA Regulations, which provides that “[a]n account must at all times be managed in accordance with these Regulations by an account manager and under terms agreed in a recorded form between the account manager and the account investor”.

<sup>955</sup> HMRC wrote a letter to the Investigation stating: “[c]ompliance with an ISA manager's obligations is treated in a similar way to taxpayers' compliance with other tax legislation, such as Self-Assessment which relies initially on a self-assessment by the taxpayer. In seeking HMRC approval to act as an ISA manager, the ISA manager undertakes to comply with the ISA Regulations in their entirety. HMRC publishes detailed guidance for ISA managers on the GOV.uk website that explains how they should fully comply with the requirements of the ISA Regulations. However...when we become aware of non-compliance with the tax rules, we have a range of powers including carrying out inspections, withdrawing approval to act as an ISA manager and reclaiming any incorrectly paid tax relief” (HMRC Letter to the Investigation, 31 July 2020, at page 2).

*Chapter 13: Other matters of importance to the Investigation*

applicant itself and HMRC did not engage with the FCA.<sup>956</sup> Nor did HMRC carry out any regular monitoring to ensure that LCF's products complied with the ISA regulations.

2.13 As regards the FCA, it was not within the FCA's remit to consider, as a matter of course, whether an LCF bond complied with legislation applicable to IFISAs in circumstances where: (i) LCF's issuing of bonds did not constitute regulated activity<sup>957</sup> and (ii) the fact that LCF claimed to place some of its bonds in a tax wrapper did not change this fact.<sup>958</sup>

2.14 In the light of the lacuna described above, the FCA was not required to consider in all cases whether products such as LCF's ISAs complied with legislative requirements. Accordingly, the Investigation does not criticise the FCA for not ensuring that it checked the compliance of LCF's ISAs, in the absence of other worrying details relevant to LCF's business.

2.15 However, the Investigation's view is that if the FCA had appreciated the significance of the other red flags detailed in this Report, it would have been appropriate for the FCA also to have considered whether LCF's ISA products complied with legislative requirements. As explained in paragraph 2.13 above, the Investigation recognises that, in the normal course, it was not within the FCA's remit to consider whether LCF's ISA products complied with the legislative requirements. However, in view of the concerns of fraud or serious irregularity, the FCA should have done so as part of the wider exercise of considering LCF's business as a whole in the light of red flags of which the FCA was aware (as explained

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<sup>956</sup> The letter stated that: "[at the time of LCF's application] a prospective manager was asked to confirm their Financial Conduct Authority (FCA) approval number on their application form. This number was then cross checked against the Financial Services Register to check if the manager was in fact authorised, and had the regulatory permissions required for the type of Individual Savings Account (ISA) they were applying to manage. In addition, prospective managers were also asked as part of the application process to certify that they were authorised to manage the ISA components they were offering and attach evidence of the permissions they held. We would not engage with the FCA at this stage other than checking their Financial Services Register" (HMRC Letter to the Investigation, 31 July 2020, at pages 1 – 2).

<sup>957</sup> As explained in **Chapter 9** (Appropriateness of LCF's permissions) above and **Appendix 5** below, the Investigation's view is that LCF's business of issuing bonds did not constitute regulated activity. Accordingly, LCF's issuing bonds, which was the main activity LCF undertook, was outside the Perimeter. The Investigation is, however, aware that judicial review proceedings are ongoing which raise the question whether LCF's issuing bonds constituted regulated activity. The Investigation's view is not binding or legally determinative of this issue which can ultimately only be resolved by the Courts rather than this Investigation.

<sup>958</sup> The FCA's response to the Investigation Team's information request on this issue stated: "[p]erforming the role of an ISA manager is not a regulated activity. There is no requirement for firms to notify the FCA when they carry out such activity, and the FCA does not monitor for when firms elect to do so. Therefore, in general, there is no change to our supervisory approach if a firm becomes an ISA manager, as this is not something the FCA would be aware of" (FCA Response to Information Request regarding ISA Manager status, Request 56).

elsewhere in this Report, the FCA repeatedly failed to conduct such a holistic assessment of LCF's business during the Relevant Period). Indeed, once the significant adverse intelligence identified by the Intelligence Team triggered the joint work in respect of LCF in late 2018, the FCA did review LCF's business and identified the issue with LCF's ISA products which led it to engage with HMRC.

*Consequence of the non-regulation of ISAs*

- 2.16 As a result of the lacuna in the regulation of ISA products described above, Bondholders' reassurance based on the ISA status of LCF's bonds was misplaced. Far from ISA status indicating an additional level of regulatory scrutiny and assurance in respect of LCF's products as many investors believed, the ISA regime in fact allowed LCF to represent to the market that its products complied with the ISA Regulations, with no regulatory scrutiny as to whether such representations were accurate. The system for regulating ISAs was, accordingly, open to abuse. ISA status did not denote an additional level of regulatory scrutiny and assurance as many investors believed.<sup>959</sup>
- 2.17 The false reassurance provided to investors in respect of the ISA status of LCF's products unfortunately compounded the false reassurance arising out of LCF's FCA-authorized status.<sup>960</sup> As explained elsewhere in this Report, LCF's FCA-authorized status was crucial in attracting investors because, as Bondholders have informed the Investigation, it provided LCF with a badge of apparent integrity. That apparent integrity belied a firm whose business was financially unsustainable and which was not adequately regulated by the FCA.
- 2.18 Furthermore, owing to the non-compliance of LCF's products with ISA legislation, Bondholders' possible claims to the FSCS may be unavailable or have been cast into doubt:

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<sup>959</sup> In its representations to the Investigation, HMRC pointed out that the list of authorised ISA managers on the Government website is accompanied by a warning that "*HMRC has not approved any ISA that the ISA manager may offer*" (see: <https://www.gov.uk/government/publications/list-of-authorised-isa-managers/isas-authorised-managers> (accessed on 23 November 2020)). It appears that a similar warning was present on the Government website at (at least) various points during the Relevant Period (see: [https://web.archive.org/web/20160415000000\\*/https://www.gov.uk/government/publications/list-of-authorised-isa-managers/isas-authorised-managers](https://web.archive.org/web/20160415000000*/https://www.gov.uk/government/publications/list-of-authorised-isa-managers/isas-authorised-managers) (accessed on 14 November 2020)).

<sup>960</sup> See paragraph 9.4(d) of **Chapter 1** (Introduction and background) of this Report.

- (a) If LCF's products had complied with the ISA Regulations, then some hypothetical third party may have conducted the regulated activity under Article 25 of the RAO of arranging investors' investments in LCF's ISA products. Bondholders would then potentially have had the benefit of claims to the FSCS against this third party had there been deficiencies in that party's carrying out of the regulated activity. This is because the FSCS compensates in respect of regulated activities.<sup>961</sup> As set out above, however, owing to the non-compliance of LCF's ISA products, no third party conducted the regulated activity set out in Article 25 of the RAO. As a result claims to the FSCS arising out of the possible conduct of such a third party may be unavailable.
- (b) Furthermore, other possible claims arising out of the actions of LCF itself have been cast into doubt. There are now ongoing judicial review proceedings brought by investors against the FSCS' decision that LCF did not conduct regulated activity. Such proceedings raise complex questions as to whether the non-transferability clauses in LCF's ISA products should be struck down, given its non-compliance with the ISA Regulations, and the effect this would have (if any) on the issue whether LCF conducted regulated activity after 3 January 2018.<sup>962</sup> The Investigation does not comment on such complex legal questions which can only be resolved by the Courts. However, the existence of these proceedings shows that the non-compliant way in which LCF's ISA products were sold, has placed investors in a complex legal position in relation to recovery from the FSCS.

### **3. The FCA's failure appropriately to regulate LCF is not excused or mitigated by the risk associated with LCF's products**

- 3.1 The Investigation has considered whether the FCA's failures of regulation are excused or mitigated by the risk associated with LCF's products, including the high rates of return LCF

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<sup>961</sup> FSCS website (see: <https://www.fscs.org.uk/how-we-work/eligibility-rules/> (accessed on 23 November 2020)).

<sup>962</sup> Claimant investors' Amended Detailed Statement of Facts and Grounds, 24 April 2020, at paragraph 3. January 2018 is the date when alterations to the regulatory regime provided by MiFID II came into force. The introduction of MiFID II raises complex issues as to whether LCF conducted regulated activity after 3 January 2018 as set out in **Appendix 5**.

Chapter 13: Other matters of importance to the Investigation

offered. The Investigation concludes that the FCA's failures are not so excused or mitigated for the reasons below.

- 3.2 LCF's products offered rates of return of between 3.9% and 11% with many of LCF's products offering returns at the higher end of that range (6.5% or higher).<sup>963</sup> The Investigation has not sought to determine how high such returns were compared with other broadly comparable products during the Relevant Period, but it is clear that such returns were generally favourable given market conditions at the time. For example, the Bank of England base-rate over the Relevant Period fluctuated between 0.25% and 0.75%.<sup>964</sup> Furthermore, the visit plan for the FCA's unannounced site visit to LCF's offices in late 2018 recorded that LCF used price comparison websites which presented LCF as offering market-leading rates of return.<sup>965</sup>
- 3.3 It also appears to have been clear to at least some Bondholders, or potential Bondholders, that LCF's high rates of return indicated a degree of risk connected with LCF's products. For instance, the Investigation has seen examples of callers contacting the FCA with concerns that LCF's products seemed "*too good to be true.*"<sup>966</sup>
- 3.4 It is thus clear that LCF's products offered high rates of return and at least some Bondholders appreciated that a level of risk came with such rates of return. However, this does not excuse or mitigate the FCA's failures of regulation as explained below.
- 3.5 Despite LCF's high rates of return, and as explained elsewhere in this Report, FCA-authorisation provided LCF with an imprimatur of respectability which attracted

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<sup>963</sup> Joint administrators' Report and Statement of Proposals pursuant to Paragraph 49 of Schedule B1 of Insolvency Act 1986, 25 March 2019, table 7.1, at page 9.

<sup>964</sup> The base-rate for the Relevant Period can be found online (see: <https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp> (accessed on 23 November 2020)).

<sup>965</sup> FCA Enforcement Memo, Unannounced visit to offices of London Capital & Finance Plc (PRN: 722603), 13 November 2018, at paragraphs 17 and 18 (Document with Control Number 112751).

<sup>966</sup> See for example: (1) FCA Contact Centre Transcript 204253670, 1 July 2016 (Document Request 43 – Contact Centre Call Transcripts); (2) FCA Contact Centre Transcript 204244616, 24 June 2016, at pages 2 to 3; (3) FCA Contact Centre Transcript 204246434, 27 June 2016, at page 3; (4) FCA Contact Centre Transcript 204897310, 8 September 2017, (Document Request 43 – Contact Centre Call Transcripts) at page 4; and (5) FCA Contact Centre Call Transcript 203866614, 18 December 2018 (Document Request 43 – Contact Centre Call Transcripts) at page 3.

investors.<sup>967</sup> Furthermore, the FCA failed to appreciate the risk LCF posed to consumers, despite the FCA having had access to a range of red flags which suggested irregularities in respect of LCF (including express allegations of possible fraud or serious irregularity). Bondholders could not have known from the high rates of return that LCF's business was potentially irregular, but the red flags to which the FCA had access should have demonstrated this fact. Accordingly, the fact that LCF offered high rates of return and that LCF's products carried a degree of associated risk does not excuse or mitigate the failures of regulation referred to in this Report. This is particularly so in circumstances where the FCA had access to a range of information suggesting that LCF carried a degree of risk to consumers beyond that which was demonstrated by the high rates of return, and where FCA-authorisation provided LCF with an imprimatur of respectability.

#### **4. The FCA Register and initiatives to inform the public of the risk of fraud**

4.1 The FCA has pointed to the Financial Services Register and ScamSmart website as tools that were designed to inform members of the public of a number of matters, including potential risks which they might face in respect of their investments.

4.2 For the reasons below, the Investigation concludes that the above resources do not excuse or mitigate the FCA's failures identified elsewhere in this Report. The Investigation has not located evidence that either the Register or the ScamSmart website dissuaded investors from investing in LCF's products. Indeed, these resources contributed to certain investors' belief that LCF had a badge of respectability based on its FCA-authorisation. LCF was then able to abuse that badge to attract investment in its unregulated bond business.

##### *The FCA Register*

4.3 For the reasons below, the Register was deficient during the Relevant Period. Paragraphs 4.4 to 4.5 below describe the Register while paragraphs 4.6 to 4.12 describe its deficiencies.

##### *Description of the Register*

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<sup>967</sup> Indeed, as explained in **Appendix 6**, in certain instances FCA call-handlers reassured investors based on LCF's FCA-authorised status.



## Chapter 13: Other matters of importance to the Investigation

4.4 The Register was a public record of the financial services firms, individuals and other bodies that were, or had been, regulated by the FCA and the Prudential Regulation Authority. The FCA had a statutory duty to maintain such a record.<sup>968</sup>

4.5 The Register was designed to inform the public as to whether they were dealing with an FCA-authorized firm and the permissions which such a firm held. For example, an FCA internal document recorded “[t]he FCA website (last updated 9/11/16) advises consumers to check the Register to see if the firm or individual is authorised by us, or registered, to avoid scams and unauthorised [firms].”<sup>969</sup> Similarly, the “Using the Register Flowchart” document encouraged Contact Centre call handlers to explain to callers “what the Register shows about the firm status and the permissions held.”<sup>970</sup> The Register was, accordingly, a public document which purported to provide members of the public with information regarding firms with which they dealt.

### *The Register was deficient*

4.6 During the Relevant Period, the Register was, however, deficient in two respects: (i) it failed adequately to warn consumers of the risk of unregulated products sold by authorised firms; (ii) it failed adequately to present information in a manner intelligible to the public.

### *Unregulated products sold by regulated firms*

4.7 Bondholders have informed the Investigation that LCF’s appearance on the Register contributed to investors’ belief that LCF had a badge of respectability deriving from its authorised status, including in respect of its unregulated bond business. For example, at the Bondholders’ Meeting, one investor said that the Register showed that LCF was FCA-registered which led the investor to conclude “therefore they’re FCA approved, therefore we are safe.”<sup>971</sup> The investor then invested in an LCF ISA product. Similarly, a Contact Centre

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<sup>968</sup> Such statutory duty arises from section 347 of FSMA. The current version of the Register is available here: <https://register.fca.org.uk/> (accessed on 23 November 2020).

<sup>969</sup> ExCo Paper, Delivering Effective Authorisations: Improving the FS Register, 11 September 2017, at page 3.

<sup>970</sup> See Internal FCA Article, Using the Register Flowchart v1, at page 1, and Internal FCA Article, Using the Register Flowchart v2, at page 1.

<sup>971</sup> The investor also said “...[s]o when we looked at the FCA stuff [online], we looked and it said “FCA approved” and so we on the website, saw that there was approval there for the company – didn’t question it because they’re FCA and they’re

call handler reassured a caller after checking the Register.<sup>972</sup> The risk to consumers arising from the Register's failure to warn about unregulated products sold by authorised firms was also raised by other individuals and groups who engaged with the Investigation.

- 4.8 The Investigation has not seen evidence of the FCA warning the public that LCF's FCA-authorised status as presented on the Register indicated little, or no, assurance of regulatory protection in respect of its non-FCA regulated bond business. As such, LCF's presence on the Register contributed to the badge of respectability which LCF acquired through its FCA-authorisation. The Register, accordingly, reinforced LCF's ability to abuse its FCA-authorised status to attract investors to its unregulated bond business as explained elsewhere in this Report.

*The Register failed to present information in an intelligible manner*

- 4.9 This deficiency was acknowledged in an internal FCA ExCo paper dated 11 September 2017. The paper stated that the "*Register does not give potential users, particularly consumers, an intelligible service*" and quoted from a January 2015 study which had concluded that "*consumers are largely baffled by the Register's language.*"<sup>973</sup> The paper went on to state that if the Register was maintained as it was "[c]onsumers will continue to find it difficult to understand the language used in the Register which is likely to result in harm."<sup>974</sup> The paper also recorded that the FCA had held workshops with staff from all areas of the FCA and that "[t]here was a general view that the Register as constructed is not a suitable vehicle for conveying information directly to consumers."<sup>975</sup>
- 4.10 The minutes of the ExCo board meeting dated 11 September 2017, for which the paper was prepared, recorded that "*ExCo [recognised] the significant problems with the register data*

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*important people, so we went ahead with our initial investment*" (Transcript of Bondholder Meeting, 23 January 2020, at page 31).

<sup>972</sup> See **Appendix 6**, at paragraph 4.2.

<sup>973</sup> ExCo Paper, Delivering Effective Authorisations: Improving the FS Register, 11 September 2017, at pages 3 and 4, paragraphs 1.5 and 1.6.

<sup>974</sup> *Ibid.*, at page 8, paragraph 4.1.

<sup>975</sup> *Ibid.*, at page 9, paragraph 4.11.

*as currently presented e.g. poor search functionality, confusing and inconsistent use of terms.*<sup>976</sup>

4.11 Interviews with current or former FCA staff also confirmed that there were deficiencies in the Register, particularly in respect of the intelligibility of information.<sup>977</sup> For example, Mr Bailey said:

*“...it became clear to me that the register was a problem, quite a big problem... In actual fact, the register is, to characterise what you said, it is not user-friendly. It’s also got errors in it as well... we’ve had a major investment programme to rebuild it... [the] register was a backwater in my view in the FCA, and at the FSA as well. And yet here you are operating a very big database which is in fact the sort of journal of record, as you were saying, to which increasingly you’re referring consumers as a port of reference, as you like. Yet the thing is not user friendly and it’s actually not that accurate either, it turns out... [The Register] was just not in the state it needed to be. If you’re going to say to consumers, “You go to the FCA register to find out the information you need on firms”, it’s got to be in a form where they can actually do it, hopefully. That’s why it’s being rebuilt.”*<sup>978</sup>

4.12 As part of the DEA programme, referred to in more detail in **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” Programmes) above, the FCA undertook a project to improve the accessibility of the Register. An examination of whether the DEA programme cured the deficiencies of the Register is outside the scope of the Investigation. For the purposes of the Investigation, however, the relevant point is that the Register was deficient during the Relevant Period in that it was unintelligible to the public. In any event, the changes implemented pursuant to the DEA programme did not address the Register’s failure to warn consumers of the risk that not all products sold by an authorised firm are regulated by the FCA.

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<sup>976</sup> Minutes of ExCo Meeting, 11 September 2017, at page 6.

<sup>977</sup> Interview with A. Bailey, 17 June 2020, at pages 14 and 15. Similarly, a former member of the FCA’s Contact Centre team stated in interview that a “*skill of the call hander*” was to turn what the register said into “*simpler terms*”. The staff member stated: “...*the information on a register can be quite difficult to understand for anyone who isn’t involved in financial services or hasn’t seen this information before...*” (Interview Transcript M at page 14).

<sup>978</sup> Interview with A. Bailey, 17 June 2020, at page 15.

*The ScamSmart website*

- 4.13 Likewise, the ScamSmart website does not appear to have dissuaded investors from investing in LCF's products.
- 4.14 The ScamSmart website was part of a wider FCA ScamSmart campaign which operated across television, print, radio and digital advertisements. The campaign was a joint initiative by the Enforcement and Communications Divisions of the FCA to provide information, knowledge and tools to “*at-risk consumers*” so as to prevent them from falling victim to fraud. The FCA decided that the campaign would focus on investment and pension scams based on, among other things, the significant financial harm to consumers resulting from these activities. The campaign was launched in October 2014.<sup>979</sup>
- 4.15 The ScamSmart website was at the heart of the campaign. The FCA has told the Investigation that:
- “All ScamSmart communications activity point to the ScamSmart website, which gives consumers tips on how to spot the techniques used by fraudsters and hosts the FCA Warning List. This is a tool that helps users find out more about the risks of an investment or pension opportunity and search a list of firms that we know are operating without our authorisation.”*<sup>980</sup>
- 4.16 The FCA estimates that between October 2014 and August 2019, over 1.2 million people visited the ScamSmart website and that over 19,500 people were warned about an unauthorised firm after using the Warning List tool.<sup>981</sup> In a speech in September 2019, the Chair of the FCA said that the ScamSmart campaign had “*potentially stopped hundreds of millions of pounds from falling into the wrong hands*”.<sup>982</sup> For the avoidance of doubt, the effectiveness of the ScamSmart campaign as a whole is not within the scope of the

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<sup>979</sup> FCA Document, ScamSmart approach, at page 1.

<sup>980</sup> *Ibid*, at page 1.

<sup>981</sup> The FCA's response to the Treasury Select Committee's Report entitled “*The work of the Financial Conduct Authority: the perimeter of regulation*”, available online (see: <https://publications.parliament.uk/pa/cm201919/cmselect/cmtreasy/132/13202.htm> (accessed on 23 November 2020)).

<sup>982</sup> Speech delivered at the Cambridge Economic Crime Symposium on 5 September 2019 (see: <https://www.fca.org.uk/news/speeches/fight-against-skimmers-and-scammers> (accessed on 23 November 2020)).

Investigation. Accordingly, it is not necessary for the Investigation to express a view, and the Investigation does not express any view, on the accuracy of the statements set out in this paragraph.

4.17 As explained below, based on feedback from Bondholders, the ScamSmart website does not appear to have dissuaded investors from investing in LCF's products.

4.18 LCF was not identified on the FCA Warning List during the Relevant Period. Nor did the ScamSmart website warn consumers about the risk of mini-bonds during the Relevant Period.<sup>983</sup> Furthermore, no individual has indicated to the Investigation that the ScamSmart website dissuaded him from investing.

4.19 Indeed, when potential investors checked the ScamSmart website, they did not see any mention of LCF. As one investor stated at the Bondholders' Meeting:

*"So, in terms of my due diligence the documentation provided by LCF had the FCA logo all over it, as did their website. I went on and checked ScamSmart. They weren't allocated in any kind of way on there. When you click on authorisation to see what LCF were FCA authorised to do, the only exception they had was they were not allowed to hold client moneys..."*<sup>984</sup>

*General warnings on the ScamSmart website*

4.20 The Investigation has considered whether the general warnings provided on the ScamSmart website during the Relevant Period would have dissuaded investors from investing in LCF's products.

4.21 During the Relevant Period, the ScamSmart website warned consumers that, even though a firm was not on the Warning List, it might be a scam.<sup>985</sup> The fact that this warning was on

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<sup>983</sup> FCA Document: *ScamSmart approach*: A description of the ScamSmart campaign provided to the Investigation by the FCA does not indicate that mini-bonds were identified as an area of risk for consumers during the Relevant Period. As already explained in **Chapter 7** (The FCA's awareness of mini-bonds and the related risks) above, the FCA had identified mini-bonds as an area of risk for consumers.

<sup>984</sup> Transcript of Bondholder Meeting, 23 January 2020, at page 32.

<sup>985</sup> An individual participant in the representations process pointed out that, since 3 October 2014, the ScamSmart website has warned investors against "*tempting returns that sound too good to be true, for example, offer[ing] much better interest rates than those offered elsewhere*". As explained in paragraph 3.1 to 3.5 above, potential investors could not have known from the high rates of return that LCF's business was potentially irregular, but the red flags to which the FCA had access

the website does not detract from the Investigation's conclusion that the ScamSmart campaign did not dissuade investors from investing in LCF. First, it does not excuse the campaign's failure to alert consumers to the risks associated with mini-bonds during the Relevant Period. As explained in elsewhere in this Report, the FCA was aware of such risks.<sup>986</sup> Second, the warning was followed immediately by a statement that referred consumers to the Register. Since August 2017, the warning on the webpage for the Warning List has read as follows:

*“Even if a firm isn't on the Warning List, it might still be a scam.*

*You should check it's an authorised firm on the [Financial Services Register](#).”<sup>987</sup>*

4.22 In order for this warning to have dissuaded consumers from investing in LCF, therefore, the Register would have had to have warned them of the risks associated with unregulated products sold by authorised firms. As explained in paragraphs 4.7 and 4.8 above, it did not do so.

4.23 Since August 2017, the ScamSmart website has also contained the following warning under the heading “*unregulated investment scams*”:

*“If you use an **authorised firm**, access to the Financial Ombudsman Service and FSCS protection will depend on the investment you are making and the service the firm is providing. Even if an authorised firm is involved, our rules generally apply only to products designed for the general public, rather than ‘niche’ investments, which may be completely unregulated”* (emphasis in original).

4.24 The Investigation does not consider that this warning would have dissuaded investors from investing in LCF either. The warning does not explain the distinction between “*products designed for the general public*” and “*niche investments*”. It is likely, therefore, that an

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should have demonstrated this fact. In these circumstances, the Investigation does not consider that this warning excuses or mitigates the FCA's failures of regulation identified in this Report.

<sup>986</sup> A description of the ScamSmart campaign provided to the Investigation by the FCA does not indicate that mini-bonds were identified as an area of risk for consumers during the Relevant Period. As already explained in **Chapter 7** (The FCA's awareness of mini-bonds and the related risks) above, the FCA had identified mini-bonds as an area of risk for consumers.

<sup>987</sup> See: <https://www.fca.org.uk/scamsmart/about-fca-warning-list> (accessed on 23 November 2020).

average potential investor would have considered LCF bonds to be “*products designed for the general public*” marketed by an “*authorised firm*”.

4.25 In short, the ScamSmart website does not appear to have diminished the effect of LCF’s authorisation, specifically that LCF acquired a badge of respectability through its FCA-authorisation which it then abused to attract investors to its non-FCA regulated bond business. Accordingly, the ScamSmart website does not excuse or mitigate the FCA’s failures of regulation identified elsewhere in this Report.

4.26 *Conclusion regarding the FCA Register and ScamSmart tools*

4.27 For the reasons set out above, the Register and the ScamSmart website do not excuse or mitigate the FCA’s failures set out in this Report. Such resources did not dissuade investors from investing in LCF.

## 5. **The Auditors’ Statement on LCF’s accounts did not excuse or mitigate the FCA’s failures**

5.1 LCF’s accounts for the financial years ending 2015, 2016 and 2017 each contained similar statements from LCF’s auditors<sup>988</sup> that, in the auditor’s opinion, the accounts gave a true and fair view of the state of LCF’s affairs as at the relevant date and of LCF’s profit for the relevant year (the “**Auditors’ Statement**”)<sup>989</sup>. The Auditors’ Statement was provided in accordance with Chapter 3, of Part 16 of the Companies Act 2006 (“**CA 2006**”).<sup>990</sup>

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<sup>988</sup> LCF used different auditors (from different accountancy firms) for each of its 2015, 2016 and 2017 accounts.

<sup>989</sup> For completeness, in respect of the financial year ending 2016 the Auditors’ Statement also said that LCF’s accounts gave a true and fair reflection of LCF’s cash flow for that financial year.

<sup>990</sup> Within Chapter 3 of Part 16 of the CA 2006 sections 495 and 496 governed the requirements of the Auditors’ Statement. Section 495(3) provided: “[t]he report must state clearly whether, in the auditor’s opinion, the annual accounts— (a) give a true and fair view— (i) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year, (ii) in the case of an individual profit and loss account, of the profit or loss of the company for the financial year, (iii) in the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company; (b) have been properly prepared in accordance with the relevant financial reporting framework; and (c) have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).” Section 496 provided (from 17 June 2016, for completeness it is noted there were amendments to this provision during the Relevant Period): “(1) In his report on the company’s annual accounts, the auditor must (a) state whether, in his opinion, based on the work undertaken in the course of the audit— (i) the information given in the strategic report (if any) and the directors’ report for the financial year for which the accounts are prepared is consistent with those accounts, and (ii) any such strategic report and the directors’ report have been prepared in accordance with applicable legal requirements, (b) state whether, in the light of the knowledge and understanding of the company and its environment

- 5.2 In its representations, the FCA submitted that the Investigation “*ought to consider whether the [Auditors’ Statements] on LCF were a factor in the events and circumstances surrounding the failure of LCF*”.<sup>991</sup> The FCA represented that they “*plainly were*” a factor. The FCA also pointed out that, pursuant to section 342(5) of FSMA and the Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001, auditors were required to inform the FCA if they reasonably believed that there was or may have been (among other circumstances) the contravention of a relevant regulatory requirement.<sup>992</sup> The FCA also observed that, under section 344 of FSMA, auditors were required to notify the FCA if they resigned before the expiry of their term or they were not re-appointed by an authorised person.<sup>993</sup> In these circumstances, the FCA said that “*the auditors act as a source of information for the FCA in its supervision of the firm*”.
- 5.3 The Investigation agrees with that general proposition. However, the relevant question for the present purposes is whether the presence of the Auditors’ Statements excuse or mitigate the FCA’s failures of regulation in respect of LCF. For the reasons set out below, the Investigation has concluded that they do not do so, because the FCA’s position was fundamentally different from that of the auditors.
- 5.4 First, unlike LCF’s auditors, the FCA was responsible for regulating LCF in accordance with FCA’s rules. For example:
- (a) The FCA was responsible for authorising LCF. The level of worrying information in LCF’s financial information has led the Investigation to conclude that the FCA still should have detected that LCF’s business model was financially unsustainable, irrespective of the Auditors’ Statement.

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*obtained in the course of the audit, he has identified material misstatements in the strategic report (if any) and the directors’ report, and (c) if applicable, give an indication of the nature of each of the misstatements referred to in paragraph (b) (2) Where more than one person is appointed as auditor, the report must include a statement as to whether all the persons appointed agree on the statements and indications given under subsection (1) and, if they cannot agree on those statements and indications, the report must include the opinions of each person appointed and give reasons for the disagreement.”*

<sup>991</sup> See paragraph 9.2.

<sup>992</sup> See paragraph 9.3.

<sup>993</sup> See paragraph 9.5.



- (b) The FCA failed to respond to red flags in its supervision of LCF such as LCF's: (i) failure to conduct regulated activity; and (ii) breach of FCA rules. The fact that LCF's accounts contained the Auditors' Statement does not excuse the FCA's failures to respond to such red flags because its auditors were unlikely<sup>994</sup> to have considered such issues. In any event it was the FCA's responsibility to consider such matters when regulating LCF.

5.5 Second, the FCA had access to clear warnings that LCF was engaged in fraud or serious irregularities. Such warnings included the Anonymous Letter, which was sent to the FCA in early 2017, and the multiple calls to the Contact Centre which alleged that LCF was engaged in possible fraud or serious irregularity. This is a further reason why the FCA's position was fundamentally different from that of LCF's auditors who are unlikely to have received such information.

5.6 Third, the Investigation has seen no evidence that anyone within the FCA relied on the Auditors' Statement when assessing LCF's business (to the extent that any such assessment occurred during the Relevant Period).

5.7 Accordingly, the Investigation concludes that the FCA's failures of regulation are not excused or mitigated by the Auditors' Statement.

## **6. FCA staff must have a greater awareness of the FCA's role in combatting fraud**

6.1 The Investigation has identified a number of instances where it was not clear that FCA staff appreciated the FCA's important role in combatting fraud. For example:

- (a) The handling of the Anonymous Letter, which contained clear allegations of fraud and other misconduct, demonstrated that multiple employees considered the allegations to be a matter for other law enforcement agencies. This was the case even though, at the time of receiving the Anonymous Letter, the Authorisations Division were reviewing the First VOP Application.<sup>995</sup>

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<sup>994</sup> The Investigation has not investigated the work of LCF's respective auditors or the circumstances in which such auditors signed the Auditors' Statement.

<sup>995</sup> See Section 6 of **Chapter 9** (Appropriateness of LCF's permissions) for further information on the FCA's failure to act on the contents of the Anonymous Letter in the context of the First VOP Application. See paragraphs 3.4 to 3.7 of **Chapter**

- (b) As detailed in **Chapter 12** (Information provided by third parties) and **Appendix 6**, the FCA received, from third parties, multiple allegations that LCF was potentially engaged in fraud or other misconduct. However, none of these allegations resulted in a detailed review of LCF’s business. The intervention in late 2018 was triggered by adverse intelligence that the Intelligence Team “*stumbled upon*”.<sup>996</sup>
- (c) In an email exchange between Mr Bailey and the Executive Director of Enforcement and Market Oversight in January 2019 regarding the FCA’s approach to cases involving possible fraud and other alleged misconduct (including the LCF case), the Executive Director of Enforcement and Market Oversight appeared to acknowledge the need to change the mindset within the FCA: “[t]he organisational history of risk tolerance still haunts the way these cases are tackled or not tackled as has often been the case. The mindset is very risk averse and resilient but it is changing”.<sup>997</sup>

6.2 The Investigation notes that there have been suggestions that tackling fraud is a difficult issue for law enforcement agencies generally.<sup>998</sup> However, regardless of these possible difficulties,<sup>999</sup> the Investigation concludes there needs to be a change in mindset at the FCA in respect of fraud. FCA staff must have greater awareness that protecting consumers from fraud committed by FCA-authorized firms is within the remit of the FCA, particularly when

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**10** (Adequacy of the FCA’s supervision of LCF) for details of the Supervision Division’s failure to investigate the allegations in the Anonymous Letter.

<sup>996</sup> See Section 7 of this Chapter.

<sup>997</sup> Email from the Executive Director of Enforcement and Market Oversight to the CEO, 26 January 2019, at 7:07pm (Document with Control Number 300444).

<sup>998</sup> Interview with A. Bailey, 17 June 2020, at pages 31 and 32. Mr Bailey also raised this point at a hearing before the Treasury Select Committee on 25 June 2019. At that appearance, he stated: “[f]irst, one of the issues that we are also facing here, though fortunately LC&F has been taken on by the Serious Fraud Office, is the lack of capacity in the broader system for tackling fraud. If you have not seen it, there has been a recent report by the Inspectorate of Constabulary on fraud. I would strongly recommend you or your staff look at it because it is not a good story. One of the challenges we have, which comes back to our resources, is that we are having to pick up a lot more cases ourselves. We tackle this stuff but we are not a fraud investigator per se. We are having to do a lot more of it” (<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-work-of-the-financial-conduct-authority/oral/103313.html> (accessed on 23 November 2020)).

<sup>999</sup> The Investigation has not investigated, and makes no findings on, whether these difficulties, in fact, existed.

such firms are using their FCA-authorized status to attract investors to non FCA-regulated business. Such staff must also keep the possibility of authorized firms committing fraud in mind when discharging their functions.

6.3 The importance of the FCA's role in combatting fraud during the Relevant Period was clear because:

- (a) The FCA's statutory objectives included protecting and enhancing the integrity of the UK financial system, which included ensuring that the UK financial system was not being used for a purpose connected with financial crime.<sup>1000</sup> Other statutory objectives included protecting consumers<sup>1001</sup> and ensuring that relevant markets functioned well.<sup>1002</sup>
- (b) The FCA's public statements indicated that it took responsibility for preventing financial crime, albeit within the inter-agency framework for dealing with fraud.<sup>1003</sup>
- (c) The FCA had significant powers in respect of FCA-authorized firms, such as LCF, that were suspected of engaging in financial crime. Such powers included powers under sections 55J and 55L of FSMA to vary or cancel an authorized person's permissions or impose requirements prohibiting or restricting the disposal of an authorized person's assets. Ultimately, no legislative changes were required for the FCA's intervention against LCF in December 2018. This demonstrates that the FCA had the necessary powers to intervene against LCF and could have done so earlier.

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<sup>1000</sup> See the FCA's integrity objective: section 1D(2) FSA 2012.

<sup>1001</sup> See the FCA's consumer protection objective: section 1C FSA 2012.

<sup>1002</sup> See the FCA's strategic objective: section 1B and 1F of FSA 2012.

<sup>1003</sup> See, for example, the FCA's statement in its Business Plan 2014/2015 which stated at page 22 under the heading "Preventing financial crime" "Where we find evidence of financial crime we will intervene and take action, and seek redress for consumers where appropriate. For example, we will target consumer fraud, such as boiler room or carbon credit scams, liaising with the police and other enforcement agencies where necessary to punish financial crime and deter firms and individuals from future wrongdoing" (see: <https://www.fca.org.uk/publication/corporate/business-plan-2014-2015.pdf> (accessed on 23 November 2020)).

6.4 The Investigation has concluded that the mindset of FCA staff in respect of fraud needs to change. In interview, FCA staff have repeatedly suggested that fraud is not the responsibility of the FCA.<sup>1004</sup> On some occasions, FCA staff appear not to have considered whether LCF was engaging in fraud, despite being aware of red flags.<sup>1005</sup>

## **7. The FCA’s intervention against LCF in late 2018**

### *Introduction*

7.1 The FCA’s intervention against LCF in December 2018 (the “**2018 Intervention**”) does not excuse the FCA’s earlier failures. As explained elsewhere in this Report, the FCA had received multiple red flags regarding LCF’s conduct and, as such, the FCA should undoubtedly have intervened at a much earlier stage.

7.2 In the lead up to the 2018 Intervention, there were again a number of errors and weaknesses in the FCA’s actions. However, there were also a number of positive aspects to the work done by the FCA (particularly individuals in the Intelligence and Listing Transactions Teams) to ensure that the 2018 Intervention occurred. The paragraphs below set out the work conducted by the FCA that resulted in the 2018 Intervention.

### *The concerns raised by the FCA’s Listing Transactions Team*

7.3 In early September 2018, the Listing Transactions Team contacted the Supervision Division and raised concerns regarding LCF. The sequence of events was as follows:

- (a) LCF submitted a prospectus in early August 2018.<sup>1006</sup> Although the FCA conducted standard checks on LCF in early August, the FCA did not at this stage realise there were concerns regarding LCF.<sup>1007</sup> In August 2018, the Listing

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<sup>1004</sup> See for example: Interview Transcript F. See also the suggestions that it was not the responsibility of FCA staff to pursue allegations made in the Anonymous Letter sent to the FCA in early 2017 because the matters raised were primarily for the police as described in **Chapter 6** (The FCA’s approach to the Perimeter).

<sup>1005</sup> As explained in **Chapter 6** (The FCA’s approach to the Perimeter), an individual with responsibility for reviewing LCF’s First VOP Application appears not to have realised that LCF might have been engaging in fraud despite noticing many red flags in LCF’s financial accounts.

<sup>1006</sup> Email from FCA – No Reply address to Associates in the Listings Team, 2 August 2018 at 5:29pm.

<sup>1007</sup> For instance, on 6 August 2018 the Listings Team lodged a request with the Consumer Credit Supervision inbox requesting information which constituted “*material issues with the firm*” such as regulatory investigations and enforcement action. An Associate in the Retail Lending Evaluation Team responded on 8 August 2018 and stated he had “*checked the firm’s regulatory history and identified no open risk events or ongoing concerns with the firm. The intact case history does*

Transactions Team considered the prospectus and requested information and awaited responses from LCF.<sup>1008</sup>

- (b) Around early September 2018, LCF resubmitted its prospectus. Following the review of that resubmitted prospectus, the Listing Transactions Team raised concerns with the Supervision Division.<sup>1009</sup> On 7 September 2018, the Listing Transactions Team wrote to the Supervision Division’s Retail Lending Evaluation Team. That email stated that “*we think the firm and the transaction may pose some significant risks to the FCA as a whole and we would like to explore whether there is the possibility of us we can work with you as the firm’s supervisors to address some of these risks*”.<sup>1010</sup>
- (c) The Supervision Division replied on 10 September 2018. The email noted that it was possible for Supervision to set up a case to investigate further and requested further specific information on the nature of the Listing Transactions Team’s concerns.<sup>1011</sup>
- (d) On 11 September 2018, the Listing Transactions Team provided the Supervision Division with its detailed concerns. The relevant email stated:
- “*Our concerns are summarised as follows:*
- *Growth – the loan book has grown 5 fold in 2017 - £10m in loans in 2016 £50m at the end of 2017 expected £130 in 2018 (once accounts finalised). Looking to grow loan book by a further £175m in the next 12 months in 2019.*

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*not suggest any enforcement action and the firm are not part of any thematic reviews*” (see: Email from Associate in the Supervision Division to the Listings Team, 8 August 2018 at 12:35pm).

<sup>1008</sup> Email from Listings Team to an Associate in the Supervision Division, 30 August 2018 at 9:48am.

<sup>1009</sup> Email from Listings Team to an Associate in the Supervision Division, 3 September 2018 at 1:36pm. In that email the associate in the from the Listings Team said “... *I am still concerned about the cash management policy of the company and also their speed of growth.*” They went on to ask the associate in the Supervision Division “ *I wanted to ask you for view [sic] on cash management of the Company, have you had any concerns, or have they ever reviewed that aspect of the company’s business? Also has the speed of growth raised any red flags at all?*”

<sup>1010</sup> Email from Listings Team to an Associate in the Supervision Division, 7 September 2018 at 3:42pm.

<sup>1011</sup> Email from an Associate in the Supervision Division to Listings Team, 10 September 2018 at 12:31pm.

*Chapter 13: Other matters of importance to the Investigation*

- *No impairment provisions raised against loan book and no bad debt writes off in 2016 or 2017 accounts – Compare this to [a leading provider of loans] which undertakes sophisticated impairment provisioning. It doesn't make sense given the high risk nature of its loan book to have no write offs and no impairment provisions.*
- *Have had 3 auditors in 3 years.*
- *Cash Management – only one bank account at Lloyds into which proceeds from bonds issued go into and loans made goes out of. No demonstrable procedures for how liquidity is managed (compared to say a [redacted] which does have minimum liquidity requirements).*
- *Bonds will be distributed by [LCF] and some intermediaries (yet to be named) – we are concerned that these bonds made be promoted to unsophisticated retail investors in breach of the COB rules for non-readily realisable securities (which these unlisted public offer bonds will be).*

*The primary risk we are concerned about are:*

- *That as a result of inaccurate impairment provisioning, poor liquidity management procedures and the rapid growth of the loan book the firm will find itself in position where it cannot meet its obligations to retail bond holders and default as a result. If this occurs to a sufficient degree then the firm could fail*
- *The firm is promoting these high risk bonds to unsophisticated retail investors in breach of the COB rules.”<sup>1012</sup>*

- (e) Also on 11 September 2018, the Supervision Division opened a case in INTACT relating to the Listing Transactions Team's concerns.<sup>1013</sup> This case was not progressed until a significant volume of adverse intelligence regarding LCF was identified by the Intelligence Team (see paragraph 7.5 to 7.8).

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<sup>1012</sup> Email from Listings Team to an Associate in the Supervision Division, 11 September 2018 at 10:55am.

<sup>1013</sup> FCA Response to Information Request LCF\_JUN\_014. See also Case Detail.

*Chapter 13: Other matters of importance to the Investigation*

7.4 The knowledge, understanding and assessment of the risks posed by LCF by the Listing Transactions Team is to be commended. In addition, the relevant member of the Listing Transactions Team who wrote the email quoted at paragraph 7.3(d) has an accounting background<sup>1014</sup> and was, therefore, able to review the LCF's financial statements and identify the obviously worrying elements.

*Action by the Intelligence Team*

7.5 In mid-October 2018, the Intelligence Team independently became aware of concerns regarding LCF while working on another matter. The individual in the Intelligence Team who uncovered the concerns is to be commended for escalating the issues quickly, professionally and diligently and for their knowledge and appreciation of the potential risks posed by LCF.

7.6 The Investigation does not know what matter the Intelligence Team was working on when it became aware of these concerns. This is because certain documents have not been disclosed to the Investigation on the basis that they contain sensitive information irrelevant to the Investigation.

7.7 The concern regarding LCF was identified by the Intelligence Team on around 15 October 2018.<sup>1015</sup> The Intelligence Team flagged their initial concerns to the relevant member of the Supervision Division on 18 October 2018.<sup>1016</sup> Following the initial referral, the matter was investigated further and, by 22 October 2018,<sup>1017</sup> the Intelligence Team had conducted an initial review of the available information and escalated the matter wider within the FCA. The work product escalated by the Intelligence Team was extremely clear and detailed. Such actions led to the FCA realising that LCF posed a significant risk to consumers. This work resulted in the 2018 Intervention. Accordingly, there is a real possibility that there would have been further consumer detriment if the Intelligence Team had not identified this issue

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<sup>1014</sup> Interview Transcript A.

<sup>1015</sup> Interview Transcript B, at page 14; Email between associates in the Intelligence Team dated 18 October 2018 at 12:15 (Document Control Number 222099).

<sup>1016</sup> Email from the Intelligence Team to the Supervision Division, 18 October 2018 (Document with Control Number 222246).

<sup>1017</sup> Email from an Associate in the Intelligence Team to Associates in the Supervision Division and UK Listings Authority, 22 October 2018 at 11:30am (Document Control Number 222310).

in mid-October 2018, particularly in circumstances where other teams within the FCA had failed to escalate issues regarding LCF despite multiple red flags.

7.8 However, it is clear that the Intelligence Team became aware while working on another matter. The relevant member of the Intelligence Team, who first identified the risk LCF posed, stated in interview that the intelligence had been identified during the course of a review of an external database (only accessible to a limited group within the FCA and on strict conditions of use) concerned with another firm. The information on the external database referred to LCF. The FCA staff member stated: “[i]f [the report] *didn’t mention LCF, it’s entirely possible that nobody would have looked at it...*”<sup>1018</sup> The member of the Intelligence Team also stated in an email to colleagues, “[t]his was *stumbled across while looking for something else.*”<sup>1019</sup>

*The FCA failed to act promptly in response to concerns regarding LCF*

7.9 Although the work of the Listing Transactions Team to escalate concerns in relation to LCF in September 2018 is to be commended, there were failures in the handling of the concerns by the Supervision Division.

7.10 The case was not assigned to the relevant member of the Supervision Division until around 4 October 2018.<sup>1020</sup> Furthermore, even in mid-October 2018, the relevant individual had still not investigated or appreciated the risks which LCF posed.<sup>1021</sup>

7.11 The Supervision Division failed to pursue the concerns raised by the Listing Transactions Team because Supervision incorrectly assessed LCF as a relatively low priority case.<sup>1022</sup>

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<sup>1018</sup> Interview Transcript B, at page 15.

<sup>1019</sup> Email from an Associate in the Intelligence Team to Associates in the Supervision Division and UK Listings Authority, 22 October 2018 at 11:30am (Document Control Number 222310).

<sup>1020</sup> FCA Response to Information Request LCF\_JUN\_014. See also Task Detail.

<sup>1021</sup> Demonstrated by an email in which the relevant member of the Supervision Division wrote: “[e]arly warning, I received a bundle of stuff from [the Intelligence team] yesterday about this firm[.] I’ve yet to work my way through the Intel but early signs are it’s not looking good” (Email from an Associate in Supervision Division to an Associate in the Authorisations Division, 19 October 2018 at 8:38am).

<sup>1022</sup> The relevant individual stated in interview that a case was referred to Supervision in around September 2018 but when prioritising LCF in the “*grand scheme of things and other things going on*” the information available at the time “*didn’t tend to suggest that there were significant amounts of consumer harm that were going on*” (Interview Transcript AD, at pages 8 and 9). A further reason why the relevant individual might not have prioritised LCF is because it had only recently been transferred to their remit around the time the case was assigned due to an error in how LCF had been categorised in



This occurred because the relevant Supervision team was subject to excessive workloads. The relevant member of the Supervision Division stated in interview that workloads in their team were high.<sup>1023</sup> The relevant individual also stated “*not all of those cases would have been being progressed at any one time but obviously you have to prioritise which are the important ones and which you can push down the line a bit, but there was a lot on.*”<sup>1024</sup> An email dated 16 October 2018 from the relevant individual to a colleague stated “*I have a huge amount of work on at the moment.*”<sup>1025</sup> It appears the individual only really progressed the case once the Intelligence Team escalated their significant concerns.

7.12 In addition to delays in the handling of the concerns of the Listings Team, there was also a delay in the handling of the issues circulated by the Intelligence Team. Even when the Intelligence Team raised significant concerns around 22 October 2018, the FCA still failed to act promptly. The unannounced site visit to LCF only took place on 10 December 2018. The relevant events were:

- (a) On 18 October 2018, the Intelligence Team flagged their initial concerns to the relevant member of the Supervision Division.<sup>1026</sup>
- (b) The Intelligence Team circulated a copy of the detailed intelligence report which identified significant concerns regarding LCF’s business on 22 October 2018.<sup>1027</sup>

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the FCA’s systems (i.e. this would have been the supervisor’s first encounter with LCF). The FCA explained this categorisation error as follows: “[t]he transfer of LCF from Consumer Credit to the Overseas Wholesale Banks Department should have taken place at the points when [the First VOP Application] was granted in June 2017. However, while certain details were updated within the FCA’s IT systems...the relevant details...identifying the relevant supervision team were not” (Response to information request LCF\_DEC11/12\_16).

<sup>1023</sup> The supervisor estimated he had 80-100 cases at the time. (Interview Transcript AD, at page 6). The FCA’s response to an information request indicated that the staff member had in the region of 60 cases as at 9 October 2018 (see FCA Response to Information Request LCF\_JUN\_014).

<sup>1024</sup> Interview Transcript AD, at page 6.

<sup>1025</sup> See email from an Associate in Supervision Division to another Associate in the Supervision Division, 16 October 2018 at 10:59am. When asked in interview, how cases were prioritised, the supervisor said it was necessary for FCA staff to consider each case, with particular focus on consumer harm (Interview Transcript AD, at page 7). The risk that cases will be incorrectly prioritised is, accordingly, higher if staff have excessive workloads such that they do not have adequate time to determine how to prioritise each case.

<sup>1026</sup> Email from the Intelligence Team to the Supervision Division, 18 October 2018 (Document with Control Number 222246).

<sup>1027</sup> Email from an Associate in the Intelligence Team to Associates in the Supervision Division and UK Listings Authority, 22 October 2018 at 11:30am (Document Control Number 222310).

- (c) Also on 22 October 2018, the relevant member of the Supervision Division sought advice from the FCA’s General Counsel’s Division to understand, among other things, the Perimeter issues and the impact of LCF purportedly managing IFISAs.<sup>1028</sup> The email from the Supervision Division stated: “[b]earing in mind the significant sums involved £50m+ and the potential criminality, I would be grateful if this matter could be prioritised”. Although there were some email exchanges between the relevant members of the Supervision and General Counsel’s Divisions before the provision of detailed advice,<sup>1029</sup> it appears that detailed advice was only delivered on 8 November 2018.<sup>1030</sup> The gap between the initial request for advice and the delivery of detailed advice is surprising given the request for prioritisation in the initial email from the Supervision Division and the clear understanding among those involved that the advice from the General Counsel’s Division was central to determining next steps.<sup>1031</sup>
- (d) It appears the Supervision Division only formally engaged with the Enforcement Division on 2 November 2018.<sup>1032</sup> The Investigation considers it took too long to escalate the matter to the Enforcement Division given the concerns expressed in the intelligence report circulated on 22 October 2018.<sup>1033</sup>
- (e) Given the size and scale of the proposed intervention, the Supervision and Enforcement Divisions coordinated well and by 13 November 2018 had prepared a detailed plan for an unannounced visit and were anticipating executing that plan on 21 or 22 November 2018.<sup>1034</sup>

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<sup>1028</sup> Email of 22 October 2018 in Document with Control Number 219233.

<sup>1029</sup> E.g. Email of 30 October 2018 in Document with Control Number 219066.

<sup>1030</sup> Email of 8 November 2018 in Document with Control Number 219346.

<sup>1031</sup> For example, an email among the Supervision Division on 2 November 2018 summarised the LCF case and noted: “[w]e are awaiting advice from [the General Counsel’s Division] on our remit and will act accordingly.” (Email of 2 November 2018 in Document with Control Number 209738.)

<sup>1032</sup> Email of 2 November 2018 in Document with Control Number 221826.

<sup>1033</sup> A member of the Enforcement Division expressed a similar view in interview: “[s]o I think there is obviously the two-week delay before it comes over to us, which, potentially, should have been quicker.” (Interview Transcript AC, at page 22.)

<sup>1034</sup> Email of 13 November 2018 in Document with Control Number 223057.

- (f) On or about 19 November 2018, the FCA team preparing for the 2018 Intervention identified certain firearms concerns in connection with the unannounced site visit. As a result of these concerns, a FCA team participating in the 2018 Intervention stated that they would not participate in the unannounced site visit unless the FCA had on site police support. The local police force ultimately refused to attend as they did not consider the firearms risk was significant. Accordingly, there were delays whilst the FCA took steps to address the firearms risks and the unannounced site visit eventually took place on 10 December 2018.<sup>1035</sup>
- (g) Throughout this period, the FCA was aware, or should have been aware, that there was ongoing potential for consumer detriment if the concerns regarding LCF were justified. For example:
- (i) The FCA continued to receive calls to the Contact Centre from members of the public who were looking to invest in LCF's products.<sup>1036</sup>
- (ii) LCF provided its business plan to the FCA in September 2018 in the context of the Second VOP Application. This business plan was provided to the Supervision Division on 6 November 2018 in the context of the 2018 Intervention.<sup>1037</sup> The business plan specifically noted: “[p]resently, the Firm receives in bound investments via its bonds of £10m to £15m per calendar month into unregulated business.”<sup>1038</sup> It is unclear whether anyone involved in the 2018 Intervention noticed these figures, but the team identified from alternate sources on or about 28 November 2018 that LCF had, “in the last month”, taken in over £4 million in “new investments”.<sup>1039</sup>

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<sup>1035</sup> Interview Transcript AD, at page 29. See also Interview Transcript V, at pages 14 and 30.

<sup>1036</sup> Internal data showed that the Contact Centre received 19 calls regarding LCF in October 2018 which was the highest number of calls in the “Consumer Investment Products” area.

<sup>1037</sup> Document with Control Number 215260.

<sup>1038</sup> Document with Control Number 215261.

<sup>1039</sup> Document with Control Number 209078.

- (iii) An internal email within the Enforcement Division on 7 November 2018 provided a summary of the potential site visit and explained “*as it comes from our own proactive work it looks like we can make a real impact here to stop further potential detriment.*”<sup>1040</sup>

7.13 The Investigation appreciates that interventions of the size and scale of the 2018 Intervention require significant planning and coordination. The Investigation also accepts that the FCA has a duty to ensure the safety of its staff and that the firearms issues were a legitimate concern. However, taking account of all of these issues, the Investigation concludes that there are areas where the FCA could and should have acted more quickly in connection with the 2018 Intervention, particularly given the concerns that had been identified regarding consumer detriment.<sup>1041</sup>

*FCA’s failure to consider action against connected companies and individuals*

7.14 In advance of the unannounced site visit on 10 December 2018, the FCA gave consideration to freezing LCF’s assets.<sup>1042</sup> However, in preparing for the 2018 Intervention, the FCA appears, based on the evidence seen by the Investigation, not to have considered what actions could be taken against companies and individuals connected with LCF *prior* to its unannounced site visit on 10 December 2018.<sup>1043</sup> The FCA should have done so. Once LCF was aware that the FCA was investigating or acting against it, there was a risk that any assets LCF had placed with connected persons would be dissipated.

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<sup>1040</sup> Document with Control Number 212847.

<sup>1041</sup> This point appears to have been appreciated by an individual in the Listing Transactions Team at the end of November 2019 who stated: “...it seems to be quite slow progress so far and I’m a little surprised they aren’t moving at a faster pace given that as you mention that the mini bonds continue to be issued but hopefully there is a more action focussed update following their meeting on Monday”.

<sup>1042</sup> This is also what happened in practice: the FCA ensured there were measures in place to freeze LCF’s assets once it intervened.

<sup>1043</sup> In interview, multiple senior FCA staff members stated in interview that they were unaware of the FCA having considered this issue (see Interview with M. Butler, 19 June 2020, at page 20; Interview Transcript F at pages 16 and 17; Interview with J. Davidson, 15 June 2020, at page 47).

The FCA did consider whether to proceed against connected entities after conducting the unannounced site visit (see: EMO Project Plan (Investigations and Interventions), 30 January 2019; and FCA Enforcement Memo, *Operation Melbourne RE01025*, 21 January 2019).

7.15 One FCA staff member suggested in interview that a reason why the FCA did not need to consider this issue was because such persons may not have been FCA-authorized. The Investigation disagrees:

- (a) First, even if such persons were not FCA-authorized,<sup>1044</sup> the FCA had powers to seek remedies against non-FCA authorized persons. For example, the FCA's powers to seek injunctions extended to persons "*knowingly concerned*" in the breach of relevant requirements. Moreover, the FCA could seek injunctions pursuant to the Court's inherent jurisdiction (see paragraphs 4.8 to 4.11 of **Chapter 11** (FCA rules and policies relating to LCF's financial promotions)). This jurisdiction is not limited to FCA-authorized persons.<sup>1045</sup>
- (b) Second, other agencies such as the police were not limited to acting against FCA-authorized persons. The FCA could have considered potential co-operation with them to resolve any difficulties created by connected persons not being FCA-authorized.

7.16 The FCA has represented that the "*FCA had a plan to preserve the relevant assets, which was to seek restraint orders under the Proceeds of Crime Act 2002*" and referred to the plan for the unannounced site visit which stated:

*"If necessary, take firm or individual disciplinary action to the extent that it meets Enforcement priorities. This may include seeking to suspend or remove the firm's permissions and or freeze assets through the RDC, or to seek cancellation of the firms' permissions through TCT."*

7.17 Although the Executive Director of Enforcement and Market Oversight referred to restraint orders in his interview with the Investigation, the contemporaneous documentation does not suggest the FCA gave consideration to taking action against companies connected to LCF.

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<sup>1044</sup> The Investigation has not analysed whether the connected companies and individuals were in fact FCA-authorized.

<sup>1045</sup> Similarly, the FCA had powers to seek administration orders against authorized persons under section 359 of FSMA. An administrator may have, if appointed, considered whether monies should have been recovered from connected companies or individuals.

*Chapter 13: Other matters of importance to the Investigation*

7.18 The Investigation is aware that even if the FCA had considered this issue, it may have decided no action should be taken prior to the site visit. However, the Investigation has concluded that the FCA should have at least *considered* actions against connected persons given the risk of dissipation of assets once LCF became aware of the 2018 Intervention.

**8. Conclusion**

8.1 The Investigation has set out above its conclusions in respect of other matters it deems relevant to whether the FCA discharged its functions in respect of LCF in a manner which enabled it to fulfil effectively its statutory objectives.

8.2 In short, the Investigation has identified additional failings by the FCA such as in its regulation of LCF's ISA products and in certain delays in advance of the intervention against LCF.

8.3 The Investigation has also identified some commendable conduct by the Intelligence and Listing Transactions Team which resulted in the intervention against LCF.

## **PART D: RECOMMENDATIONS**

### **CHAPTER 14: RECOMMENDATIONS**

#### **1. Introduction**

1.1 This Chapter sets out the Investigation’s recommendations. These recommendations should be read in the light of three prefatory points:

- (a) First, the Investigation was asked to consider the FCA’s regulation of LCF during the Relevant Period (i.e. from 1 April 2014 to 30 January 2019). Accordingly, the Investigation’s conclusions are based on the rules and policies<sup>1046</sup> that were in force, and the events and actions that took place during that period. The Investigation’s recommendations are necessarily based on those conclusions. Therefore, these recommendations primarily focus on the FCA’s rules, policies and practices during the Relevant Period. On a number of occasions, the FCA has informed the Investigation that there have been material changes to its rules and policies after the Relevant Period.<sup>1047</sup> The FCA suggested that it was “*essential for the Investigation to take account of these improvements in order to ensure that any recommendations... are relevant to the current context in which the FCA operates*”.<sup>1048</sup> However, it is not within the remit of this Investigation to assess whether changes to the FCA’s policies and practices in the 22 months after the Relevant Period have addressed the deficiencies identified in this Report. Indeed, it would be impracticable for the Investigation to do so as the FCA’s policies and practices are likely to have continually changed and evolved over time. It is for the FCA to examine whether, and to what extent, the Investigation’s recommendations have been implemented after the Relevant Period.<sup>1049</sup> The

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<sup>1046</sup> See Section 3 of **Chapter 1** (Introduction and background) of this Report for an explanation of the Investigation’s use of the terms “*rules*” and “*policies*”.

<sup>1047</sup> Some of these changes, such as the DES and DEA programmes, started during the Relevant Period, but their implementation continued after the Relevant Period. The DES and DEA programmes are considered in **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” programmes) of this Report.

<sup>1048</sup> FCA’s representation to the Investigation dated 4 November 2020, paragraph 2(h).

<sup>1049</sup> As to which, see paragraph 1.1(b) below.

Investigation accepts that it is, in principle, possible that the FCA could conclude that the steps it has taken since the end of the Relevant Period may be sufficient to satisfy one or more of the recommendations set out in this Chapter, but the Investigation makes no findings as to whether that is in fact the case.

- (b) Second, in some instances,<sup>1050</sup> the Investigation has recommended that the FCA should consider amending its existing policies or introducing new policies. In each such instance, the new or amended policy should be accompanied by appropriate operational steps. Where appropriate, these operational steps should include providing regular training on the policies to relevant FCA personnel and effective follow-up measures to ensure that the policies have had the desired impact at a practical level.
- (c) Third, although it is a matter for the FCA to determine how it responds to the recommendations in this Report, the Investigation considers that any such response should involve an assurance exercise to confirm that any steps taken by the FCA have achieved the desired objective. This assurance exercise could involve the FCA's Internal Audit and/or the Risk & Compliance functions (or other relevant teams) conducting a review of the materials identified by the relevant FCA team as satisfying each applicable recommendation and confirming that they agree with that team's assessment that the recommendation is satisfied and can be closed (including, as appropriate, any assessment that no further steps are required by the FCA to satisfy a recommendation in light of changes made since the end of the Relevant Period).

1.2 Section 2 below sets out the Investigation's recommendations in relation to the FCA's policies and practices. Section 3 sets out recommendations in relation to the regulatory regime.

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<sup>1050</sup> See, for example, Recommendations 2 and 5 below.



## 2. Recommendations regarding the FCA's policies and practices

*Recommendation 1: the FCA should direct staff responsible for authorising and supervising firms, in appropriate circumstances, to consider a firm's business holistically.<sup>1051</sup>*

- 2.1 As explained in **Chapter 6** (The FCA's approach to the Perimeter) of this Report, the FCA's approach to the Perimeter failed to pay sufficient regard to the risks posed by unauthorised activities of regulated firms. These risks were identified and summarised in numerous FCA papers. It appears that the Senior Management of the FCA was aware of these risks during the Relevant Period. However, in connection with the FCA's regulation of LCF, such awareness did not result in changes at an operational level to remedy the problem.
- 2.2 The Investigation considers that the FCA should direct its staff responsible for authorising and supervising firms to consider a firm's business holistically in appropriate circumstances. For the avoidance of doubt, the Investigation considers that any such direction should extend to members of the Financial Promotions Team.
- 2.3 In particular, the FCA staff should be made aware of the risks arising from non-regulated activities of a regulated firm and of the possibility that firms may be abusing their authorised status to attract investments to their unregulated activities. Accordingly, FCA staff should be encouraged to look beyond the regulated activities of a firm in appropriate circumstances. Examples of circumstances where it would be appropriate to do so are when: (i) an overwhelming proportion of a firm's business does not involve the use of its authorised status; and (ii) information regarding a firm suggests the possibility of fraud or serious irregularity.

*Recommendation 2: the FCA should ensure that its Contact Centre policies clearly state that call-handlers: (i) should refer allegations of fraud or serious irregularity to the Supervision Division, even when the allegations concern the non-regulated activities of an authorised firm; (ii) should not reassure consumers about the non-regulated activities of a firm based on its regulated status; and (iii) should not inform consumers (incorrectly) that all investments in FCA-regulated firms benefit from FSCS protection.*

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<sup>1051</sup> The meaning that the Investigation ascribes to the requirement that the FCA should assess a firm's business 'as a whole' or 'holistically' was explained in paragraph 4.2 of **Chapter 1** (Introduction and background) of this Report.

## *Chapter 14: Recommendations*

- 2.4 This recommendation addresses three ways in which the FCA's deficient approach to the Perimeter was reflected in its Contact Centre policies.
- 2.5 First, as explained in Section 2 of **Chapter 12** (Information provided by third parties) of this Report, the FCA's Contact Centre policy documents were unclear about whether call-handlers should refer allegations of fraud or serious irregularity regarding the unregulated activity of FCA-authorized firms more widely within the Supervision Division. Some FCA documents suggested that call-handlers need not refer such concerns.<sup>1052</sup> The unclear Contact Centre policy documents are one example of the broader deficiency in the FCA's approach to its Perimeter and of the failure to ensure appropriate operational change at lower levels of the organisation (in this instance, the Contact Centre).<sup>1053</sup> The Investigation considers that the FCA should ensure that its Contact Centre policies clearly state that call-handlers should refer allegations of fraud or serious irregularity to the Supervision Division even if the allegations concern the non-regulated activities of an authorised firm. Further, when referring any such allegations, call-handlers should ensure that the description for the relevant team within the Supervision Division is sufficiently clear on its face.
- 2.6 Second, as explained in paragraph 2.8 of **Chapter 12** (Information provided by third parties), the FCA's Contact Centre policies and documents failed to state clearly that Contact Centre call-handlers should not reassure callers in respect of an FCA-authorized firms' unregulated activities based on its FCA-authorized status. As a result, call-handlers sometimes reassured callers that LCF's bond issues were reputable; that purported reassurance was based solely, and erroneously, on LCF's FCA-authorized status. Such reassurance reinforced LCF's ability to abuse the imprimatur of respectability and integrity which it had obtained from FCA-authorization in order to attract investors to its non-FCA authorised bond business.
- 2.7 Third, the FCA's Contact Centre documents failed to state with sufficient clarity that LCF's bond issues did not benefit from FSCS protection.<sup>1054</sup> For example, an internal FCA knowledge document which described how Contact Centre call-handlers should deal with

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<sup>1052</sup> See paragraphs 2.7 to 2.10 of **Chapter 12** (Information provided by third parties).

<sup>1053</sup> See paragraph 2.12 of **Chapter 12** (Information provided by third parties).

<sup>1054</sup> See paragraphs 2.34 to 2.37 of **Chapter 12** (Information provided by third parties).

permissions queries in relation to LCF stated that the FCA’s General Counsel’s Division had “advised that the firm did not need to be regulated for its investment activity as the issued bonds in this case relate to an investment in the firm itself, rather than the firm dealing in investments on behalf of another.” However, the article did not expressly go on to state that LCF’s bond issues did not benefit from FSCS protection. It appears that the FCA internal knowledge documents which expressly stated that LCF’s bonds did not benefit from FSCS protection only appeared from around late 2018.<sup>1055</sup> As a result, in a limited number of instances, FCA call handlers incorrectly advised callers that LCF’s bonds benefited from FSCS protection.<sup>1056</sup>

*Recommendation 3: the FCA should provide appropriate training to relevant teams in the Authorisation and Supervision Divisions on: (i) how to analyse a firm’s financial information to recognise circumstances suggesting fraud or other serious irregularity; and (ii) when to escalate cases to specialist teams within the FCA.*

- 2.8 The Investigation considers that it is crucial for FCA staff to be trained appropriately to assess a firm’s business as a whole by reading its financial information for indicators of financial crime or serious irregularity.
- 2.9 As explained in paragraphs 6.15 and 6.16 of **Chapter 9** (Appropriateness of LCF’s permissions), the Case Officer in charge of LCF’s First VOP Application noticed a number of potentially concerning aspects of LCF’s business. However, these did not cause the Case Officer to question whether, on the whole, there was something fundamentally wrong with LCF. Had the Case Officer appreciated that LCF’s financial information required further analysis, he could have referred LCF to more specialist personnel within the FCA who had experience of reviewing company accounts and other financial information.
- 2.10 As explained in paragraph 6.17 of **Chapter 9** (Appropriateness of LCF’s permissions), the FCA’s deficient handling of LCF’s First VOP Application occurred because the Case Officer had not received training on how to consider LCF’s business holistically by examining its financial information. When interviewed, the Case Officer stated that his training at the FCA

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<sup>1055</sup> See paragraphs 2.34 and 2.35 of **Chapter 12** (Information provided by third parties).

<sup>1056</sup> See paragraph 2.5 of **Chapter 12** (Information provided by third parties).

in terms of reading company accounts was mainly “*on-the-job training*”.<sup>1057</sup> In contrast, the FCA staff in the Listing Transactions Team and the Intelligence Team who, in late 2018, eventually appreciated the risks which LCF posed had backgrounds directly relevant to analysing financial information to detect potential irregularities.<sup>1058</sup>

*Recommendation 4: the Senior Management of the FCA should ensure that product and business model risks, which are identified in its policy statements and reviews<sup>1059</sup> as being current or emerging, and of sufficient seriousness to require ongoing monitoring, are communicated to, and appropriately taken into account by, staff involved in the day-to-day supervision and authorisation of firms.*

2.11 The effort and resource that the FCA puts into identifying significant current or emerging product and business model risks are of limited utility, unless those risks are communicated to and appropriately taken into account by staff authorising and supervising firms on a daily basis. The Investigation has seen multiple examples of the FCA’s relevant high-level policy statements which have not resulted in changes to the approach of those members of staff who engaged with or assessed LCF during the Relevant Period. For example:

- (a) As explained in section 2 of **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks), the FCA had identified mini-bonds as carrying particular risks for consumers during the Relevant Period. Thus, an internal FCA “*CMI Insight Report*” paper titled “*Insight Paper Unlisted Mini-bonds*” from 2013 stated that mini-bonds were “*arguably inherently risky*” because (1) the products were not covered by the FSCS; (2) there was no secondary market for the products; (3) high headline rates could mean consumers would fail to evaluate the underlying merits of the products; and (4) the products were subject to less onerous disclosure requirements.<sup>1060</sup> In relation to LCF, the FCA had also identified that: (i) LCF was using mini-bonds in an unusual manner; (ii) LCF had committed multiple financial promotions breaches; and (iii) there were numerous consumer concerns

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<sup>1057</sup> See paragraph 6.17 of **Chapter 9** (Appropriateness of LCF’s permissions).

<sup>1058</sup> See paragraphs 7.5 to 7.8 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>1059</sup> Whether published internally or externally.

<sup>1060</sup> See paragraph 2.2 of **Chapter 7** (The FCA’s awareness of mini-bonds and the related risks).

regarding LCF's business model. Despite this, the risks associated with mini-bonds were insufficiently taken into account by those dealing with LCF until late 2018.

- (b) The FCA's Senior Management formulated a high-level strategy to deal with Perimeter risks in 2013.<sup>1061</sup> Subsequently, the FCA also published a formal policy statement on its appetite for intervention in respect of Perimeter risks as part of its April 2017 Mission Statement.<sup>1062</sup> However, the Investigation has not seen evidence in the authorisation and supervision of LCF of any practical or operational measures which informed the relevant staff members how to implement this policy in practice.<sup>1063</sup> Indeed, in December 2018, a Board paper stated that “[the FCA tends] to have a reactive approach to risks outside the Perimeter and [does] not have a coherent or consistent methodology for making decisions to act at or beyond the Perimeter.”<sup>1064</sup> In short, the FCA failed to articulate clearly, and in a manner intelligible to frontline staff dealing with the authorisation and supervision of LCF, when it would intervene outside the Perimeter.

*Recommendation 5: the FCA should have appropriate policies in place which clearly state what steps should be taken or considered following repeat breaches by firms of the financial promotion rules.*

- 2.12 LCF breached the FCA's financial promotions rules on multiple occasions. However, apart from writing on each occasion to LCF requiring it to cure the breaches identified, the FCA did not take any further action.<sup>1065</sup> This was because the FCA did not have in place appropriate policies stating what steps should be taken in respect of repeat offenders under its financial promotion rules during the Relevant Period.<sup>1066</sup>

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<sup>1061</sup> See paragraph 5.3 of **Chapter 6** (The FCA's approach to the Perimeter).

<sup>1062</sup> See paragraph 5.8 of **Chapter 6** (The FCA's approach to the Perimeter).

<sup>1063</sup> See paragraphs 6.1 and 6.2 of **Chapter 6** (The FCA's approach to the Perimeter).

<sup>1064</sup> See paragraph 6.2 of **Chapter 6** (The FCA's approach to the Perimeter).

<sup>1065</sup> See paragraph 3.1 of **Chapter 3** (Key events in the FCA's regulation of LCF).

<sup>1066</sup> See paragraph 4.17 of **Chapter 11** (FCA rules and policies relating to LCF's financial promotions).

2.13 The FCA's policies regarding repeat offenders of its financial promotion rules were unsatisfactory in a number of respects:

- (a) The FCA considered a firm a “repeat offender” if it had breached the financial promotions rules three or more times within a rolling 12-month period.<sup>1067</sup> Thus, the “repeat offenders” process did not trigger any proactive monitoring by the FCA. For example, no special attention was paid to financial promotions by a firm which had accumulated, say, two breaches in two months.
- (b) For a large part of the Relevant Period, the only action that the FCA's repeat offender policy required was the “attestation” procedure. That is, the FCA would ask for an attestation (i.e. a self-certification) by a person with a ‘significant influence function’ in the firm that that individual was content that the firm's procedures were sufficient and their staff were adequately trained to sign off promotions.<sup>1068</sup> This was too restrictive an approach and, even then, was not triggered in the case of LCF.
- (c) In early 2018, the attestation procedure was abandoned. Instead, the FCA decided that it would use “*the most appropriate supervisory tool to fit the circumstances of a particular case.*”<sup>1069</sup> This policy lacked clarity. In particular, it did not provide any guidance to FCA staff that they should consider whether breaches of the financial promotion rules might be an indicator of a more serious problem (as in the case of LCF, where the repeat rule breaches were directly linked to the promotion of, and the impact of the halo effect on, a large, unconventional, unregulated retail bond business) or what further steps should be considered where such concerns were identified. The FCA should have appropriate policies in place to deal with these matters.

*Recommendation 6: the FCA should ensure that its training and culture reflect the importance of the FCA's role in combatting fraud by authorised firms.*

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<sup>1067</sup> See paragraph 4.15 of **Chapter 11** (FCA rules and policies relating to LCF's financial promotions).

<sup>1068</sup> See paragraph 4.17 of **Chapter 11** (FCA rules and policies relating to LCF's financial promotions).

<sup>1069</sup> See paragraph 4.18 of **Chapter 11** (FCA rules and policies relating to LCF's financial promotions).

## Chapter 14: Recommendations

- 2.14 Protecting consumers from fraud by FCA-authorized firms is clearly within the remit of the FCA. This is especially so when a firm, such as LCF, is using its FCA-authorized status to attract investors to its non-regulated business. The FCA had significant powers in respect of FCA-authorized firms that were suspected of engaging in potential financial crime.<sup>1070</sup> Nevertheless, when interviewed, FCA staff repeatedly told the Investigation that fraud was a matter for the police rather than the FCA.<sup>1071</sup>
- 2.15 This attitude appears to be the reason why the clear allegations regarding LCF in the Anonymous Letter were not pursued by the relevant staff within the Authorisation and Supervision Divisions. As explained in paragraph 6.21 of **Chapter 9** (Appropriateness of LCF's permissions), the FCA Case Officer in charge of LCF's First VOP Application was copied on the correspondence from the Supervision Division regarding the Anonymous Letter. Despite this, the Case Officer did not take any steps to consider the issues raised in the Anonymous Letter. When interviewed, the Case Officer said that allegations of fraud would be "*principally a matter for the police*".<sup>1072</sup>
- 2.16 In an email exchange between Mr Bailey and the Executive Director of Enforcement and Market Oversight in January 2019 regarding the FCA's approach to cases involving possible fraud and other alleged misconduct (including the LCF case), the Executive Director of Enforcement and Market Oversight appeared to acknowledge the need to change the mindset within the FCA: "[t]he organisational history of risk tolerance still haunts the way these cases are tackled or not tackled as has often been the case. The mindset is very risk averse and resilient but it is changing".<sup>1073</sup>
- 2.17 Accordingly, the Investigation considers that there needs to be a demonstrable change in mindset at the FCA in respect of fraud. The FCA should consider taking steps to create

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<sup>1070</sup> See paragraphs 6.1 to 6.9 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>1071</sup> Paragraph 6.10 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>1072</sup> When pressed on where responsibility lay for responding to allegations regarding FCA-authorized firms, the Case Officer stated that responsibility would rest with the Supervision rather than the Authorisations Division (Interview Transcript X, at page 25). As explained in **Chapter 10** (Adequacy of the FCA's supervision of LCF) however, the FCA's Supervision Division also considered the matter primarily one for the police and also failed to properly consider LCF's business following receipt of the letter.

<sup>1073</sup> Email from the Executive Director of Enforcement and Market Oversight to the CEO, 26 January 2019, at 7:07pm (Document with Control Number 300444).

greater awareness among its staff that protecting consumers from fraud by FCA-authorised firms falls clearly within the FCA's remit.

*Recommendation 7: the FCA should take steps to ensure that, to the fullest extent possible: (i) all information and data relevant to the supervision of a firm is available in a single electronic system such that any red flags or other key risk indicators can be easily accessed and cross-referenced; and (ii) that system uses automated methods (e.g. artificial intelligence/machine learning) to generate alerts for staff within the Supervision Division when there are red flags or other key risk indicators.*

- 2.18 Senior Management of the FCA informed the Investigation that, even today, the FCA does not “have [an IT] system where all information is available in one place”.<sup>1074</sup> The Investigation has also been informed that the FCA's supervision efforts were hampered initially by the multiplicity of the FCA's IT systems.<sup>1075</sup> The Investigation understands that progress has been made in rolling out and enhancing the functionality of the FCA's INTACT case management system. The FCA should take steps to ensure that this progress continues and full functionality of INTACT is implemented as soon as reasonably practicable.
- 2.19 The FCA receives a vast amount of data from authorised firms, consumers and the financial markets and it should leverage that data as much as possible to identify firms or activities which have the hallmarks of fraud or other irregularities. The FCA should consider using examples of suspicious conduct to develop typologies which can then be used by its systems to generate automated alerts when similar patterns are identified in the data. The FCA has stated that it is undertaking an extensive data strategy<sup>1076</sup> and the Investigation anticipates this work could be brought within that ongoing project to the extent it is not already covered by it.

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<sup>1074</sup> Interview with M. Butler, 6 August 2020, at page 14.

<sup>1075</sup> See paragraph 7.6 of **Chapter 8** (The “Delivering Effective Supervision” and Delivering Effective Authorisations” programmes).

<sup>1076</sup> See: <https://www.fca.org.uk/publications/corporate-documents/data-strategy> (accessed on 22 November 2020).



*Recommendation 8: the FCA should take urgent steps to ensure that all key aspects of the DES programme that relate to the supervision of flexible firms are now fully embedded and operating effectively.*

2.20 As explained in paragraph 7.4 of **Chapter 8** (The “Delivering Effective Supervision” and “Delivering Effective Authorisations” programmes), the Investigation was informed that some aspects of the DES programme that relate to the supervision of flexible firms are still incomplete. In particular, the Investigation was told that the portfolio assessment for Corporate Finance, the portfolio to which LCF was assigned under the DES programme in 2017, was not complete as at September 2020 because of “*the additional time required to carry out a thorough analysis of a group of firms with a relatively high level of variation between and complexity within their business models*”.<sup>1077</sup> Portfolio assessment is at the heart of the model for effective supervision of the flexible portfolio firms, which resulted from the DES programme. It is a matter of concern, therefore, that this aspect of the programme remains to be implemented.

2.21 Although the DES programme was closed in November 2018, this was a programme management step (i.e. confirming that the programme could transition into “*Business As Usual*”), but it was not an assessment that all elements of the programme were fully implemented and operating effectively. Given the importance of the DES programme to the supervision of a firm such as LCF, it is imperative that the FCA confirms the full implementation of the programme as a matter of urgency. To the extent full implementation has not been possible due to ongoing systems (or other) dependencies,<sup>1078</sup> the FCA should undertake an assessment of what is still to be done, the timeline for completion and any appropriate measures that could be implemented in the interim.

*Recommendation 9: the FCA should consider whether it can improve its use of regulated firms as a source of market intelligence.*

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<sup>1077</sup> FCA Clarification to earlier Response of Request 80 made by the Investigation.

<sup>1078</sup> By this the Investigation is referring to a situation where, for example, the Supervision Division would be unable to complete the full implementation of the programme until a broader FCA-wide update/improvement to its IT systems has been completed.

- 2.22 Some industry participants suggested to the Investigation that the FCA could make better use of regulated firms as a source of intelligence on industry concerns, particularly where, as in case of LCF, those concerns had not been identified by the FCA itself.
- 2.23 The Investigation suggests that the FCA should consider giving greater encouragement to regulated firms to act as a source of intelligence in this way, as well as the best way of utilising such intelligence. Possible actions which have been suggested to the Investigation include:
- (a) amending FCA’s “Approach to Supervision” paper specifically to include gathering and assessing intelligence from regulated firms on activities in the industry causing concern;
  - (b) appointing a senior FCA staff member to be responsible for intelligence gathering whose remit includes engagement with the industry;
  - (c) adding a portal to the FCA’s website so that regulated firms can easily report information (the Investigation has been told that at present there is no information on FCA’s website detailing how firms should report their concerns);<sup>1079</sup>
  - (d) providing a dedicated FCA telephone number staffed by suitably trained staff rather than having to go through the Contact Centre;
  - (e) providing a clear explanation of the process the FCA follows when presented with intelligence;
  - (f) giving generic details in FCA’s Annual Report on the intelligence received during the year and the types of action taken; and
  - (g) ensuring, where possible, that due recognition is given to any supervisory or enforcement action taken as a result of intelligence provided by the industry.

### **3. Recommendations regarding the regulatory regime**

- 3.1 Paragraph 3(3) of the Direction provides that the Investigation may “*highlight to the Treasury any aspects of the regulatory framework that the Investigator considers may have*

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<sup>1079</sup> The Investigation notes, however, the introduction in October 2020 of new whistleblowing information on the FCA website (see: <https://www.fca.org.uk/firms/whistleblowing/speaking-fca> (accessed on 22 November 2020)).

*affected the FCA's ability to effectively supervise LCF*". In the Investigation's view, there are four aspects of the regulatory framework that merit consideration by the Treasury. They are set out in Recommendations 10 to 13 below.

*Recommendation 10: the Treasury should consider addressing the lacuna in the allocation of ISA-related responsibilities between the FCA and HMRC.*

- 3.2 As explained in paragraph 2.1 of **Chapter 13** (Other matters of importance to the Investigation), the fact that LCF's bonds could be acquired in an ISA wrapper was crucial in attracting investment. Bondholders believed that ISA status indicated LCF's products were subject to an additional level of regulatory scrutiny and assurance. Thus, once LCF obtained approval to act as an ISA manager in November 2017 and marketed its bonds as ISA eligible, its sales significantly increased.<sup>1080</sup>
- 3.3 However, as explained in Section 2 of **Chapter 13** (Other matters of importance to the Investigation), there is a gap in the allocation of ISA-related responsibilities between the FCA and HMRC. In order to be an ISA manager, it is necessary to obtain HMRC's approval. However, HMRC does not scrutinise whether individual products offered by an ISA manager comply with the ISA regulations. Since acting as an ISA manager is not a regulated activity, it is not within the FCA's remit to consider whether the individual products offered by an ISA manager are compliant either. The Treasury should consider addressing this lacuna.
- 3.4 In paragraph 9.11 of its representations to the Investigation, the FCA said that "*it was not within the FCA's remit to check compliance with ISA requirements*". In contrast, HMRC's representations suggested that it would not be appropriate to impose this regulatory responsibility on it either. HMRC said that "[a]ny additional HMRC compliance activity on the products offered by ISA managers would not necessarily protect investors from risky or poorly regulated investments, but instead the sanctions available to HMRC could mean that they have to pay tax on them".<sup>1081</sup> The Investigation has not considered whether

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<sup>1080</sup> See paragraph 2.1 of **Chapter 13** (Other matters of importance to the Investigation).

<sup>1081</sup> HMRC also said that imposing this regulatory responsibility on them would require an Act of Parliament and "*move us away from the Self-Assessment principle we use to administer taxes etc.*"

responsibility (if imposed) for scrutinising the compliance of individual ISA products should rest with HMRC, the FCA or some other body. That is a decision for the Government and the Treasury.

*Recommendation 11: the Treasury should consider whether Article 4 of MiFID II or section 85 of FSMA should be extended to non-transferable securities.*

3.5 As explained in **Appendix 5** to this Report, in the Investigation’s view, LCF did not carry on regulated activity by issuing its bonds. LCF was “*selling... securities*” within the meaning of Article 14 of the RAO. However, this did not constitute a regulated activity because, pursuant to Article 18 of the RAO, Article 14 does not apply to a company issuing its own “*shares*”.<sup>1082</sup> The exclusion provided by Article 18 is designed to enable a company to issue its own securities to raise funds for its business without having to obtain FCA-authorisation. LCF exploited the Article 18 exclusion by mass-marketing a highly flawed, non-transferable, financial product to retail investors with virtually no regulatory oversight or control of the product or the sales process.

3.6 The Investigation considers that there are at least two alternative methods by which the current regulatory regime could be extended to cover non-transferable financial products such as LCF bonds:

- (a) Pursuant to Article 4(5) of MiFID II,<sup>1083</sup> the regulated activity of “*execution of orders on behalf of clients*” includes “*the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their issuance*”.<sup>1084</sup> For these purposes, a firm’s execution of orders “*on behalf of clients*” includes contracting with the client on a principal-to-principal basis.<sup>1085</sup> In order for MiFID II to apply, the “*regular occupation or business*” of the firm must be to “*provide investment services and/or perform*

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<sup>1082</sup> For these purposes, “*shares*” include “*any investment of the kind specified by [Article 77 of the RAO]*”. LCF’s bonds were a kind of investment specified by Article 77 of the RAO: see paragraph 5.4 of **Appendix 5**.

<sup>1083</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

<sup>1084</sup> See also MiFID II, Recital 45.

<sup>1085</sup> The Committee of European Securities Regulators, Best Execution Under MiFID, paragraph 8, at page 22 (see: [https://www.esma.europa.eu/sites/default/files/library/2015/11/07\\_320.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/07_320.pdf) (accessed on 22 November 2020)).

*investment activities on a professional basis*".<sup>1086</sup> The Investigation considers that the regulated activity of "*execution of orders on behalf of clients*" is well-suited to cover financial products such as LCF bonds, which: (i) involved the conclusion of agreements to sell financial products; (ii) by LCF with its clients on a principal-to-principal basis; (iii) in circumstances where LCF was acting on a professional basis. However, MiFID II does not cover non-transferable securities such as LCF bonds.<sup>1087</sup> However, after Brexit, it would be open to the UK to extend the application of the regulated activity of "*execution of orders on behalf of clients*" to non-transferable securities.

- (b) An alternative way of regulating financial products such as LCF bonds would be to expand the scope of the Prospectus Regulation<sup>1088</sup> as applicable in the UK. Section 85 of FSMA, which implements the Prospectus Regulation in the UK, makes it unlawful for certain securities to be offered to the public "*unless an approved prospectus has been made available to the public before the offer is made*". A prospectus is required to contain detailed disclosures relating about the issuer's business and needs approval from the UK Listing Authority. Currently, the prospectus requirement only applies to "*transferable securities*". However, after Brexit, the UK could extend this requirement to non-transferable securities.

3.7 The Investigation has not examined the policy implications of the measures identified in paragraph 3.6 above. This is likely to require extensive legislative and economic consultation.

*Recommendation 12: the Treasury should consider the optimal scope of the FCA's remit.*

3.8 The Senior Management of the FCA drew the Investigation's attention to the formidable size and scope of the FCA's remit and the potential impact of this on its operational effectiveness. The FCA has responsibility for a very wide range of risks and sectors varying from systemic risk in the wholesale markets to individual consumer protection, with constantly changing

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<sup>1086</sup> MiFID II, Recital 12.

<sup>1087</sup> MiFID II, Article 4(1)(44); Annex 1, Section C(1).

<sup>1088</sup> Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

risk profiles and the periodic addition of new responsibilities. The FCA's evidence was that the transfer of consumer credit regulation from the OFT to the FCA had brought particular challenges, with the number of firms regulated by the FCA increasing from 26,000 in 2014 to 59,000 in 2019.<sup>1089</sup>

3.9 It was suggested to the Investigation that this 'single regulator' approach is not found in other national regulatory regimes with a comparable financial services sector. In many other countries, such responsibilities are divided among a number of different bodies, and that prioritisation and management of such a diverse range of responsibilities within a single organisation carries particular challenges.

3.10 The Investigation invites the Treasury to consider the future optimal scope of the FCA's remit (including whether that remit should be restructured or even reduced) in order to enable it to maximise its effectiveness at both senior management and operational levels.

*Recommendation 13: the Treasury and other relevant Government bodies should work with the FCA to ensure that the legislative framework enables the FCA to intervene promptly and effectively in the marketing and sale through technology platforms, and unregulated intermediaries, of speculative illiquid securities and similar retail products.*

3.11 A number of industry participants expressed concern at the increasing role of unregulated intermediaries in the sale, particularly via the internet, of mini-bonds and other speculative illiquid securities. Industry participants told the Investigation that these intermediaries typically characterised themselves as 'introducers', but that the proactive nature of their marketing and sales processes strongly suggested they were conducting regulated business in breach of section 19 of FSMA, and/or in breach of the restriction on financial promotions in section 21 of FSMA.

3.12 The same participants also represented to us that a collateral effect of the FCA's temporary intervention of November 2019, in which it prohibited regulated firms from promoting

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<sup>1089</sup> Other examples which the FCA gave of the scope of its remit and workload during the Relevant Period were: priority work on high cost consumer credit, high risk investments and the impact of Brexit, the implementation of major EU legislation in the form of the Payment Services Directive II, MiFID II and the PRIIPS Regulations and a major review of the mortgage market, and additions to its remit as the new regulator for claims management companies and the formation of the Office of Professional Bodies Anti-Money Laundering Supervision, a new body within the FCA with oversight of anti-money laundering and anti-terrorist-financing regimes.

speculative illiquid securities, had been to encourage a shift of such promotional activities from the regulated to the unregulated intermediary market. The Investigation has not investigated this point as it fell outside the Relevant Period.

3.13 The FCA told the Investigation that it shared these concerns. The FCA also drew the Investigation's attention to the practical difficulties of investigating unregulated, online sales channels with some or all of the following features:<sup>1090</sup>

- (a) utilisation of search engines and social media for marketing purposes;
- (b) use of algorithms to generate personalised results in response to search phrases such as 'high return investments';
- (c) payments made by the promoter to the search engine provider in return for placing the promoter at the top of the search results;
- (d) generation of an on-line invitation to the consumer to provide his/her name and contact details;
- (e) no clear identification of who is behind the invitation or precisely what products will be offered; and
- (f) a follow-up call or other communication which included encouraging consumers to self-certify as 'high net worth' or 'sophisticated' in order to bring them within one of the exemptions from section 21 FSMA contained in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005.

3.14 The FCA informed the Investigation that, on the basis of the current legislative framework, in order for a regulator or enforcement authority to investigate such a sales channel, it would need to (i) follow the same "customer journey"<sup>1091</sup> as the consumer (in effect "mystery-shopping") and to do so in compliance with restrictions in the Regulation of Investigatory Powers Act 2000 and the E-Commerce Directive; (ii) gather evidence of a breach; and (iii) locate and identify the wrongdoer, before it could start a criminal investigation or

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<sup>1090</sup> It is relevant to note that, according to information provided by Bondholders, some of these features were present in the marketing by LCF of its own bonds.

<sup>1091</sup> I.e. it would need to participate in the sales process in the same way as an investor.

prosecution. The FCA further stated that such a process would face considerable difficulties in terms of the time it would take, the resources it would require and the obtaining evidence which would meet the requisite standard of proof, with the associated risks that, while this was going on, consumers might be losing money or the sales channel being investigated might close down and disappear.

- 3.15 While the Investigation has not investigated these concerns, the risk of consumer harm in this area appears to the Investigation to be potentially significant. The Investigation recommends that the Treasury and other relevant Government departments work with the FCA to ensure that the legislative framework enables the FCA to intervene promptly and effectively in the marketing and sale through technology platforms and unregulated intermediaries of speculative illiquid securities and similar retail products. The Investigation recommends that serious consideration should be given to the coverage of financial harm in the proposed Online Harms Bill.<sup>1092</sup>

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<sup>1092</sup> See the Government's Online Harms White Paper of April 2019 at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/793360/Online\\_Harms\\_White\\_Paper.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/793360/Online_Harms_White_Paper.pdf) (accessed on 22 November 2020); and the Initial Consultation Response of 12 February 2020 at: <https://www.gov.uk/government/consultations/online-harms-white-paper/public-feedback/online-harms-white-paper-initial-consultation-response> (accessed on 22 November 2020).



**APPENDIX 1: THE DIRECTION**

## Direction to the Financial Conduct Authority to investigate events and circumstances surrounding the failure and placing into administration of London Capital & Finance plc

The Treasury give the following direction in exercise of the powers conferred by sections 77(1) and (2) and 78(5) and (6) of the Financial Services Act 2012 (“the Act”).

In accordance with section 77(1) of the Act, the Treasury consider that it is in the public interest that the Financial Conduct Authority (“the FCA”) should undertake an investigation into the relevant events relating to the regulation of London Capital & Finance plc (“LCF”) and it does not appear to the Treasury that the FCA has undertaken or is undertaking an investigation into those events.

### Direction

#### *The Relevant Events*

1. In this direction—

“the relevant events” means the events and circumstances surrounding the failure of LCF, and the supervision of LCF by the FCA (with reference to the specific matters set out in paragraph 3 below), during the relevant period,

“the relevant period” means the period beginning on 1 April 2014 (being the date on which the FCA assumed responsibility for consumer credit from the Office of Fair Trade and the date from which LCF held interim permission to carry on certain regulated activities), and ending on 30 January 2019 (being the date on which joint administrators were appointed under the Insolvency Act 1986).

2.—(1) The FCA must appoint an independent person (“the Investigator”) to carry out an investigation (“the Investigation”) into the relevant events and the circumstances surrounding the relevant events.

(2) Before appointing the Investigator, the FCA must obtain the approval of the Treasury to the appointment.

#### *Scope of the Investigation*

3.—(1) The Investigation must focus on whether the FCA discharged its functions in respect of LCF in a manner which enabled it to effectively fulfil its statutory objectives, and must consider the following matters—

- (a) whether the FCA adequately supervised LCF’s compliance with its rules and policies;
- (b) whether the FCA had in place appropriate rules and policies relating to the communication of financial promotions by LCF;
- (c) whether—
  - (i) the FCA had established appropriate policies for responding to information provided by third parties regarding the conduct of LCF,
  - (ii) whether the FCA received such information during the relevant period, and
  - (iii) whether those policies were properly applied;
- (d) whether the permissions that LCF were granted were appropriate for the business activities that it carried on.

(2) The Investigator may also consider any other matters which they may deem relevant to the question of whether the FCA discharged its functions in a manner which enabled it to effectively fulfil its statutory objectives.

(3) The Investigator may, in an interim report or in the final report (or both), highlight to the Treasury any aspects of the regulatory framework that the Investigator considers may have affected the FCA's ability to effectively supervise LCF.

#### *Conduct of the Investigation*

4.—(1) The FCA must facilitate the disclosure to the Investigator of such information as the Investigator considers is relevant to the scope of the Investigation.

(2) The duty in sub-paragraph (1) does not apply in respect of any information which is subject to any legal restriction on its disclosure.

5. The Investigation must be conducted in accordance with the statement of policy that the FCA has prepared in accordance with section 80(1) of the Act.

6.—(1) The Investigator may rely upon any evidence relating to the relevant events set out in or gathered during the preparation of—

- (a) any review or report into the market for non-transferable securities commissioned or conducted by the Treasury prior to the Investigation being concluded, and
- (b) such other reports, notices or other publications as the Investigator considers appropriate.

(2) The Investigator must liaise with the Serious Fraud Office (“the SFO”) and FCA in order that reasonable precautions are taken to ensure that the ongoing joint SFO/FCA investigation and any subsequent prosecution or regulatory action by the SFO and/or FCA are not prejudiced by the Investigation or written report (as referred to in paragraphs 8 and 9 below).

#### *Duration of the Investigation*

7.—(1) Subject to sub-paragraph (2), the Investigation must be completed within a period of 12 months beginning on the date upon which the Investigator is appointed by the FCA.

(2) If the Investigator considers that it will not be possible to complete the Investigation within the period of 12 months mentioned in sub-paragraph (1), the FCA must inform the Treasury of—

- (a) the reasons for the delay in the conclusion of the Investigation, and
- (b) a revised target date for the conclusion of the Investigation.

(3) In considering the matters in sub-paragraph (2), the Investigator must have regard to the requirement to avoid prejudicing any ongoing investigation by the SFO and/or FCA, as required by paragraph 6(2).

#### *Reporting*

8. The Investigator may, at any time prior to the making of the written report referred to in paragraph 9, make an interim report to the Treasury setting out such matters as the Investigator may deem appropriate.

9. On completion of the Investigation, the FCA must as soon as reasonably practicable make a written report to the Treasury—

- (a) setting out the Investigator's findings, conclusions and such recommendations (if any) as the Investigator considers appropriate;
- (b) setting out the FCA's response to the Investigator's findings, conclusions and recommendations, including the lessons (if any) the FCA considers that it should learn from the Investigation; and
- (c) making such recommendations (if any) as the FCA considers appropriate.

Date

22nd May 2019

John P. Glen

John Glen MP  
Economic Secretary to the Treasury  
Her Majesty's Treasury

**APPENDIX 2: THE PROTOCOL**



## **PROTOCOL**

### **For the conduct of the independent investigation into the events and circumstances surrounding the failure and placing into administration of London Capital & Finance Plc ("LC&F") pursuant to the Direction from HM Treasury to the Financial Conduct Authority ("FCA") on 23rd May 2019**

#### **A. Introduction**

1. Dame Elizabeth Gloster (hereafter "you") has been appointed by the FCA, to carry out an independent investigation into the events and circumstances surrounding the failure and placing into administration of LC&F.
2. The scope of the investigation is set out in the Direction issued to the FCA on 23<sup>rd</sup> May 2019 by Her Majesty's Treasury ("HMT") pursuant to section 77 of the Financial Services Act 2012 ("the Direction"). The Direction therefore stands as the Terms of Reference for the investigation. It also reflects the statutory requirement that at the conclusion of the investigation the FCA must make a written report to HMT.
3. This Protocol sets out the procedures under which the investigation is to be carried out, reflecting the requirement for this investigation to be, and to be seen to be, independent.

#### **B. Administrative Matters**

4. You will be given specific individual contacts at the FCA, including the Accountable Executive ('AE') to whom the Sub-Committee of the Board has delegated responsibility for oversight of this investigation.
5. The AE will be supported in his/her role by a Project Review Board which will provide advice to the AE when he/she requests it but which will not have any delegated decision-making powers.
6. To facilitate you in conducting the investigation, particularly in relation to requesting and obtaining relevant documents and information, a dedicated email inbox for communications relating to the investigation has been set up. You should send communications relating to the investigation to this inbox as this will ensure that they are logged and actioned efficiently.

## **C. Documents, other information and meeting**

### **Documents: requests and production**

7. You will send all requests for the production of relevant documents held by the FCA (to include, for the purposes of this Protocol, documents, information and communications in hard copy and in electronic form) to the email address referred to in paragraph 6 above. Such requests will set out the documents or class of documents requested for production.
8. Provided that the documents requested for production are within the FCA's power, custody or possession, they will be provided to you either in hard copy or in electronic form (via a secure IT route) as soon as possible. No such documents will be withheld from you.
9. Where documents are not within the FCA's power, custody or possession you may either contact the relevant organisation directly or send a request to the FCA via the email address referred to in paragraph 6 above, who will contact the relevant organisation and request the documents on your behalf.

### **General information requests and general explanations**

10. In the event that you require other information and/or explanations from the FCA as to how it carries out its regulatory activities, and falling within the scope of the Direction, you will send a request to the email address referred to in paragraph 6 above.
11. The FCA will respond as soon as possible to any such request.
12. In the event that you require other information and/or explanations relating to the activities of another organisation, falling within the scope of the Direction, you may either contact the relevant organisation directly or send a request to the FCA via the email address referred to in paragraph 6 above, who will contact the relevant organisation to request its assistance and obtain the relevant information and/or explanations for you.

### **Meetings with individuals**

13. In the event that you wish to meet with any individual currently or formerly employed by the FCA, you will notify the FCA of the individuals whom you wish to meet (using the email address referred to in paragraph 6 above, attaching a letter from you to the individual for the FCA to pass on to the individual).

14. The FCA will endeavour to secure the attendance at a meeting of any identified individuals who are current or former employees of the FCA. It should be noted, however, that attendance by an individual at a meeting with you is not compulsory under statutory powers.
15. Any meetings with individuals not within paragraphs 13 and 14 will be arranged by your team (the Independent Reviewer's team).
16. Meetings will, to the extent possible, be arranged at a mutually convenient time for yourself and the individual. For individuals who are current or former employees of the FCA, you will provide to the FCA, a reasonable time in advance of the meeting (i) a broad outline of the topics you wish to cover during the meeting and (ii) a list of the principal documents you may wish to reference during the meeting (together the "meeting information"). The FCA will pass the meeting information to each individual as soon as possible after receipt and in advance of the meeting between that individual and yourself. Meetings will be recorded by your professional services team and a transcript provided to the individual<sup>1</sup>. The information obtained by reason of the interviews may be relied upon by you in preparing your report.
17. If you require it, the FCA will make available for any meeting a suitable room at its premises at 12 Endeavour Square, Stratford.

### **Third party assistance**

18. You may contact third parties directly for assistance in relation to the investigation and the FCA will, to the extent that it is able to do so, facilitate such assistance, if requested by you (for the avoidance of doubt this is not in relation to your professional services team).

### **Escalation**

19. The FCA is committed to providing you with assistance to facilitate your conduct of the investigation. However, in the event that you consider that the FCA is not providing you with the co-operation or information that you reasonably require to fulfil your responsibilities, please escalate matters promptly to the Chairman of the FCA or the Senior Responsible Officer at HMT.

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<sup>1</sup> For the avoidance of doubt, the transcripts will not be made available to the FCA. The transcripts, however, will be retained by the FCA after the review has been completed in a secure electronic area, in accordance with the FCA's Records Management Policies and Standards

## **D. Legal privilege and confidentiality**

### **Privilege**

20. It may be necessary for the FCA to provide you with information that is subject to the FCA's legal privilege. The FCA will not withhold documents from you on the grounds of legal privilege but, for the avoidance of doubt, the provision of such material to you does not constitute a more general waiver of legal privilege.
21. You may refer to privileged documents in your report but the FCA will decide, after consulting you, whether to redact parts of the material provided to persons as part of the representations process referred to in paragraphs 25 and 26 below or of the final report before its submission to HMT on the basis that this is necessary to protect and preserve privilege. If the FCA considers that redaction is necessary, it will include in the report to be submitted to HMT reasons for the redaction.

### **Confidentiality**

22. It may be necessary for the FCA to provide you with information that is deemed to be confidential within the meaning of section 348 of the Financial Services and Markets Act 2000 ("FSMA").
23. You may refer to such confidential information in your report. If required it will be the responsibility of the FCA, for the purposes of such references, to obtain the consent of the person from whom the information was obtained by the FCA and, if different, the consent of the person to whom it relates. If such consent is not obtained, you may nevertheless refer to such confidential information in your final report and the FCA will decide whether to suggest redactions when submitting the report to HMT on the basis of the restrictions in section 348 of FSMA. If the FCA suggests such redactions, it will include in the report to be submitted to HMT reasons for suggesting them.

### **Naming personnel**

24. It is the policy of the FCA that employees at Director and above should be publicly accountable for the FCA's performance, so that employees below that level have a legitimate expectation that they will not be publicly identified in an investigation of this kind. If you consider that there are exceptional circumstances requiring the FCA to take action in respect of any employee below the level of Director, you will raise the matter with and identify such personnel to the Chairman of the FCA.

## **E. Representations Process**

25. Insofar as you intend in your report to criticise individuals, groups of individuals whose members are identifiable or organisations, including the



FCA (both in its own right and/or as the successor of the FSA for actions pre-April 2013), you will (i) identify those individuals, groups or organisations (ii) provide them with a reasonable opportunity to make representations in relation to your proposed criticism and (iii) consider those representations before finalising your report.

26. The contacts referred to in paragraph 4 above will (i) assist you, if so requested, in deciding which individuals, groups or organisations should be given the opportunity to make representations and (ii) provide you with such administrative assistance as you may reasonably require for the purposes of conducting the representations process.

#### **F. Governance and reporting**

27. You will keep the AE informed in relation to the logistical progress of the investigation, but not in relation to matters of substance.
28. You should raise directly with the AE any matter which you consider to be so urgent or important that it needs to be disclosed to him/her.
29. You will provide a copy of the final draft of your report to the AE for information only, unless in your discretion you consider it inappropriate to do so. The AE may at his/her discretion share, and discuss, the draft with the Project Review Board, Board Sub-Committee and subject matter experts.
30. To the extent that you consider it necessary for the FCA to address issues relating to factual accuracy, or confidential information pursuant to section 348 of FSMA or legal privilege, you may provide copies of the relevant sections of your draft report to the contacts referred to at paragraph 4 above. These contacts will, with your specific and express permission, be entitled to share these sections with appropriate individuals at the FCA for the purposes of assisting you and finalising the draft report.

#### **G. Publication**

31. The FCA will arrange for your final report to be submitted to HMT which will consider whether to publish it in full or whether part(s) of it should be withheld from publication (in accordance with section 82 of the Financial Services Act 2012).

#### **H. Interim Report**

32. If you produce an interim report, that report will be subject to all aspects of this Protocol.

## **APPENDIX 3: THE INVESTIGATION TEAM**

### **1. Introduction**

1.1 This Report was prepared by Dame Elizabeth with the assistance of the Investigation Team, the key members of which are listed below, together with brief details of their professional careers. Dame Elizabeth is grateful to all those people who gave up their time to be interviewed during the course of the Investigation or who otherwise provided information or assistance for the purposes of this Report. But she would like to express her particular thanks to those members of her Investigation Team mentioned below (and, indeed those members of the Dechert team who are not so mentioned) who have been integral to the Investigation, and without whose hard work completion of this Report would not have been possible.

### **2. Rt. Hon. Dame Elizabeth Gloster DBE**

2.1 Dame Elizabeth has had a high-profile career as a barrister, QC and as a judge of the High Court and a Lady Justice of the Court of Appeal. As well as her current work as an international arbitrator, she has extensive experience of commercial law, with expertise in financial services, insolvencies and regulation.

2.2 Dame Elizabeth practised as a commercial and Chancery QC at One Essex Court from 1991 until 2004, before accepting an appointment as a High Court judge. She became the first woman to be appointed a judge of the Commercial Court and as Judge in Charge of that Court from 2010-2012. She was appointed to the Court of Appeal in 2013 and became Vice-President of the Civil Division of that Court in 2016.

2.3 Since retiring from the Court of Appeal in 2018, Dame Elizabeth has returned to One Essex Court to practise as an international commercial arbitrator. She has been appointed both as chair and co-arbitrator in a wide range of international arbitrations including banking, insurance/reinsurance, energy, telecoms, construction, joint venture and State investment disputes.

2.4 As a junior barrister she was a member of the panel of barristers acting for the Department of Trade, or Department of Trade and Industry (“**DTI**”) in Chancery and corporate matters. In that capacity, she was involved in a number of insolvency cases where the DTI intervened

### *Appendix 3: The Investigation Team*

in order to stop the continuation of businesses where the circumstances strongly suggested that fraud, or illegitimate commercial practices, were being perpetrated.

- 2.5 As a QC, she had a high-profile City practice specialising in corporate, banking, financial regulation, insolvency, insurance and reinsurance, and energy cases. For example, she acted for creditors, investors and/or office holders in cases arising out of major international insolvencies such as: Barlow Clowes, Maxwell, Canary Wharf (Olympia & York), Heron, Garuda Airways, Enron, Telewest, Parmalat, Marconi, TXU, Barings etc. and for the Secretary of State in the disqualifications of the Barings directors and the Blue Arrow directors.
- 2.6 As a High Court judge, Dame Elizabeth presided over numerous important commercial and financial markets cases, including *JP Morgan Chase Bank v Springwell Navigation Corporation*, *Masri v Consolidated Contractors International* and the notable *Berezovsky v Abramovich* trial.
- 2.7 As a Lady Justice, she sat on numerous important commercial and financial cases, ranging from capital markets, arbitration, shipping, gas and oil, insurance, tax, and insolvency to criminal LIBOR fixing.
- 2.8 Dame Elizabeth was Treasurer of the Honourable Society of the Inner Temple for 2018; she is an Honorary Fellow of Girton College, Cambridge and of Harris Manchester, Oxford. She sits as a Justice of Appeal in Bermuda and as a Judge of the Abu Dhabi Global Markets Court on a part-time basis.

### **3. James Petkovic**

- 3.1 James Petkovic is a junior counsel at One Essex Court and was called to the Bar in 2009.
- 3.2 He has a depth of experience in financial regulatory law, having been seconded to the FSA (a previous regulator to the FCA) in September 2011 until February 2012 and with the FCA part-time in March 2017 until June 2017, as well as assisting the FSA on its work in preparing the Handbook for the transition of functions from the FSA to the FCA. Work has included assisting on drafting rules pertaining to tax-transparent funds, master-feeder structures and also assisting on issues concerning Brexit and the Central Securities

### *Appendix 3: The Investigation Team*

Depositories Regulation. While at the FSA and FCA, James had no involvement in respect of LCF.

3.3 James also practises in a range of other commercial areas. In recent years, much of his work has been in international arbitration and he has appeared in arbitration disputes in the oil and gas, banking and international investment treaty sectors as well as in other arbitration disputes of a more general commercial nature. James has also acted in a range of proceedings in the English High Court including banking disputes and proceedings, seeking and obtaining urgent injunctive relief.

#### **4. KV Krishnaprasad**

4.1 Krishnaprasad is a junior counsel at One Essex Court. He was called to the Bar in 2017.

4.2 He has experience of being involved in many pieces of complex commercial dispute resolution including the Lloyds/HBOS trial (assisting Sebastian Isaac) and *Minera Las Bambas SA v Glencore Queensland Ltd* (assisting Conall Patton QC). From March to July 2019, he worked as a Judicial Assistant at the Commercial Court where he assisted the judges with some of the leading cases decided during that period including *Arcelormittal v Essar Steel* (Jacobs J), *PJSC Tatneft v Bogolyubov* (Butcher J), and *Ministry of Defence v International Military Services Ltd* (Phillips J).

4.3 Among other matters, he is currently instructed on behalf of the Danish Customs and Tax Administration on a £1.5 billion fraud claim against nearly 80 defendants.

#### **5. Dechert LLP, London Office**

The following individuals from Dechert LLP were key members of the Investigation Team.

##### *Dorothy Cory-Wright*

5.1 Dorothy Cory-Wright is the Head of Dechert LLP's London Disputes Practice and is a highly experienced lawyer advising on a variety of complex disputes matters and contentious regulatory issues. In June 2019, Dorothy was honoured with an award for "Best in Litigation" at Euromoney's European Women in Business Law Awards 2019.

5.2 Her practice spans many sectors including financial services, with clients including banks, funds, asset managers, payment services providers, private equity houses, insurers and

### *Appendix 3: The Investigation Team*

reinsurers. Dorothy has extensive experience in supporting similar reviews having been one of the primary legal advisors to HSBC's Monitor and having led the inquiries into the "Spygate" and "Crashgate" issues for the Fédération Internationale de l'Automobile. She also advised the world's then second largest reinsurer on its EU and Bermuda entities' responses to the US Securities and Exchange Commission and the New York Attorney General's investigations into alternative risk transfer and finite reinsurance products and broker commissions.

#### *Richard Frase*

5.3 Richard Frase is a Partner in the Financial Services Group in Dechert LLP's London office and has extensive experience of the legal and regulatory aspects of the UK financial services industry, gained in private practice, in-house and with the regulators, covering both wholesale and retail markets and including regulation and compliance.

5.4 Richard was head of litigation at the Personal Investment Authority (which later became the FSA and subsequently the FCA) from 1995 to 1998, where he dealt with a range of compliance and enforcement matters involving life companies and financial advisers. He was seconded to the Securities and Futures Authority during 1989 to 1991, where he advised on policy and legal matters, and carried out extensive work on the conduct of business rules. He was a member of the London Metal Exchange and SFA arbitration panels for 10 years, sitting as an arbitrator in more than 30 arbitrations.

#### *John Bedford*

5.5 John Bedford acts as Counsel in the Contentious Regulatory and Investigations team in Dechert LLP's London office and has advised corporations and board committees on the conduct of investigations into allegations of bribery, corruption, money laundering, fraud and breach of domestic and international sanctions and/or export controls. These matters have involved prosecutors, regulators and enforcement agencies, including the FCA.

5.6 John has extensive experience in supporting similar reviews having been one of the primary legal advisors to HSBC's Monitor. He has also assisted clients at voluntary interviews with the FCA in connection with authorisation issues.

#### *Timothy Bowden*

### *Appendix 3: The Investigation Team*

5.7 Tim Bowden is a Partner in the White Collar, Compliance and Investigations department in Dechert LLP's London office and has a practice focused on international fraud, corruption and money laundering. He was recommended in The Legal 500 UK 2020 for regulatory investigations and corporate crime and was identified as a “*Future Leader*” by Who's Who Legal: Investigations in consecutive years 2019 and 2020.

5.8 Tim has experience representing companies and individuals under investigation by, and interacting with, the Serious Fraud Office, the FCA, the National Crime Agency, HMRC and their international counterparts. Prior to joining Dechert, Tim spent 12 years in practice at the independent bar where he was a Grade 4 prosecutor for the Crown Prosecution Service and served on the Serious Fraud Office panel of prosecuting counsel.

#### *Emma Ward*

5.9 Emma Ward is an associate in the complex commercial litigation in Dechert LLP's London office. Emma focuses her practice on complex commercial litigation, arbitration and regulatory disputes. Emma is experienced in assisting clients across a range of international commercial disputes relating to breach of contract, breach of fiduciary duty, misrepresentation and termination. In addition, she has participated in matters involving financial litigation and enforcement actions. Emma is a Solicitor-Advocate (Higher Courts Civil).

#### *Jason Mbakwe*

5.10 Jason Mbakwe is an associate in the complex commercial litigation in Dechert LLP's London office. Jason focuses his practice on complex commercial litigation and white collar crime. Jason advises on a broad range of commercial litigation, including commercial contracts disputes, insolvency litigation, internal corporate investigations, regulatory investigations and defending clients against government enforcement agencies.

## **6. Lansons**

6.1 Lansons, established in 1989, is a strategic reputation management consultancy that has advised the Investigation since its formation on reputation, external communications and public relations as well as advising on liaison and communications with Bondholders.

*Appendix 3: The Investigation Team*

- 6.2 Lansons has been a leading communications consultancy for over 30 years, advising on many of the highest profile and most significant issues in that sector.
- 6.3 The core Lansons team comprised Tony Langham, Rimmi Shah, Ed Hooper, Emma Robinson and Lydia Wyatt.

## **APPENDIX 4: GLOSSARY**

The following list of terms is not intended to be exhaustive nor conclusive in the definitions used but is intended as a helpful indication of key defined terms used in this Report.

<b>Term/ Acronym</b>	<b>Explanation</b>
<b>AIFMD</b>	The European Union Alternative Investment Fund Managers Directive
<b>Anonymous Letter</b>	The undated letter addressed to a Detective Constable in the Metropolitan Police.
<b>ASA</b>	Advertising Standards Authority.
<b>Authorisations Division</b>	An FCA division that considers applications for permission to carry out regulated activities. The Authorisations Division sits within the Supervision, Retail & Authorisations Division.
<b>Bondholder Group</b>	A group of Bondholders who made a written submission to the Investigation.
<b>Bondholder Group Submission</b>	The detailed written submission received by the Investigation from the Bondholder Group.
<b>Bondholders</b>	Investors to whom LCF issued bonds.
<b>Bondholders' Meeting</b>	The public meeting held by the Investigation on 23 January 2020, the primary purpose of which was for the Investigation to hear directly from Bondholders.
<b>CIS Order</b>	Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001.
<b>CMI</b>	Consumer Market and Intelligence.



Appendix 4: Glossary

<b>COB/ COBS</b>	FCA Conduct of Business rules.
<b>COND</b>	This is the part of the FCA Handbook in High Level Standards which has the title “ <i>Threshold Conditions</i> ”.
<b>Consumer Credit Supervision Team</b>	The sub team within the Supervision Division that had responsibility for consumer credit firms.
<b>Dame Elizabeth</b>	The Rt. Hon. Dame Elizabeth Gloster DBE.
<b>DEA Programme</b>	The FCA’s Delivering Effective Authorisations programme.
<b>DES Programme</b>	The FCA’s Delivering Effective Supervision programme.
<b>Direction</b>	A direction issued by HM Treasury on 22 May 2019, included as Appendix 1 to this Report.
<b>Enforcement and Market Oversight Division</b>	An FCA division that conducts forensic investigations into suspected misconduct and compliance failures, and brings administrative, civil and criminal proceedings against firms and individuals, enforcing FSMA, the FCA’s rules and other regulatory requirements.
<b>ERPC</b>	The FCA’s Executive Regulation and Policy Committee.
<b>ESMA</b>	European Securities and Markets Authority.
<b>EWRM</b>	The FCA’s Enterprise Wide Risk Management.
<b>ExCo</b>	The FCA’s Executive Committee.
<b>FCA</b>	The Financial Conduct Authority.
<b>FCA Investigation Liaison Team</b>	The FCA team with responsibility for facilitating the Investigation.

Appendix 4: Glossary

<b>Financial Promotions Team</b>	A specialist FCA team that forms part of the Conduct Specialists Department and is responsible for the identification and mitigation of risk associated with financial advertising.
<b>First VOP Application</b>	The first Variation of Permission application submitted by LCF to the FCA in October 2016.
<b>FOS</b>	Financial Ombudsmen Service.
<b>FSA</b>	Financial Services Authority, which was the predecessor to the FCA.
<b>FSA 2012</b>	Financial Services Act 2012.
<b>FSCS</b>	Financial Services Compensation Scheme.
<b>FSMA</b>	The Financial Services and Markets Act 2000, as amended from time to time.
<b>General Counsel's Division</b>	An FCA department which provides legal advice to the rest of the FCA, with the exception of some limited areas including enforcement and employment law matters.
<b>HMRC</b>	Her Majesty's Revenue and Customs.
<b>ICO</b>	Information Commissioner's Office.
<b>IFISA</b>	Innovative Finance ISAs.
<b>Initial Authorisation Application</b>	LCF's initial application for interim permissions following LCF's transfer from the OFT to the FCA submitted on 21 October 2015.
<b>INTACT</b>	The FCA's case management system used across the Authorisations Division and the Supervision Division.

*Appendix 4: Glossary*

<b>Intelligence Team</b>	An FCA department that, among other things, works in partnership with a range of external bodies to tackle economic crime.
<b>Investigation</b>	The independent investigation conducted by Dame Elizabeth into the relevant events relating to the FCA’s regulation of LCF as required by the HM Treasury pursuant to the Direction.
<b>Investigation Inbox</b>	The email inbox set up by the Investigation to which Bondholders and other relevant parties, including industry professionals, were invited to send information that was relevant to the Investigation
<b>Investigation Team</b>	The legal team that assisted Dame Elizabeth in the conduct of the Investigation and the preparation of this Report.
<b>Investigation Website</b>	The website set up by the Investigation.
<b>ISA</b>	Individual Savings Account designated as such in accordance with the ISA Regulations.
<b>ISA Regulations</b>	Individual Savings Account Regulations 1998 (SI 1998/1870).
<b>LCF</b>	London Capital & Finance plc.
<b>Listing Transactions Team</b>	An FCA team within the Enforcement and Market Oversight Division that is responsible for reviewing and approving prospectuses and circulars under the Prospectus Regulation Rules and the Listing Rules, for reviewing the eligibility for listing of applicants for the Official List, and for giving guidance on the Listing Rules and Prospectus Regulation Rules.
<b>Liversidge Letter</b>	The letter from Mr Neil Liversidge, an independent financial adviser, addressed to the FCA dated 29 November 2015.
<b>MiFID</b>	Markets in Financial Instruments Directive (2004/39/EC).

Appendix 4: Glossary

<b>MiFID II</b>	Markets in Financial Instruments Directive (2014/65/EU).
<b>MiFID Override</b>	The disregard of Article 18 of the RAO pursuant to Article 4(4) of the RAO.
<b>Money Advice Service</b>	A free and impartial money advice service, set up by the UK Government.
<b>NED</b>	Non-executive director.
<b>OEIC</b>	Open-Ended Investment Company.
<b>OFT</b>	Office of Fair Trading.
<b>OFT Firms</b>	The consumer credit firms, previously regulated by the OFT, for which the FCA assumed the responsibility of their regulation in April 2014.
<b>PA Report</b>	A report by PA Consulting Services Limited, dated July 2016 titled “ <i>Effectiveness assessment of the FCA approach to flexible firm supervision</i> ” which was commissioned by the Executive Directors of the FCA’s Supervision Division.
<b>Protocol</b>	A protocol agreed between the FCA and Dame Elizabeth pursuant to which the Investigation has been conducted.
<b>PRR</b>	The FCA’s Policy, Risk and Research Department.
<b>PSD</b>	The FCA’s Prudential Specialist Division.
<b>PSD2</b>	The European Union Payment Services Directive (2015/2366).

Appendix 4: Glossary

<b>R&amp;CO</b>	The FCA’s Risk & Compliance Oversight Division.
<b>RAO</b>	The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001 No. 533), as amended from time to time.
<b>Register</b>	The Financial Services Register.
<b>Regulated Activity</b>	Activities listed under section 22 of RAO for which a firm must be granted permission to undertake by the FCA, unless exempt, in accordance with section 19 FSMA.
<b>Regulatory Narrative Document</b>	The narrative document prepared by the FCA for the Investigation providing regulatory context to the issues being considered by the Investigation.
<b>Relevant Period</b>	The timeframe from when regulation of LCF first transferred to the FCA on 1 April 2014 until LCF appointed administrators on 30 January 2019 as set out in the Direction
<b>Retail Lending Evaluation Team</b>	An FCA team within the Enforcement and Market Oversight Division.
<b>RiskCo</b>	The FCA’s Risk Committee.
<b>Second VOP Application</b>	The second Variation of Permission application submitted by LCF to the FCA in September 2018.
<b>Sentient Capital</b>	Sentient Capital London Limited.
<b>Series 1 Bonds</b>	LCF’s first, small, private debt raise in 2013 which was repaid in 2014.
<b>Series 1 ISA Bonds</b>	The 3-year 8% ISA bonds sold by LCF between December 2017 and July 2018.

*Appendix 4: Glossary*

<b>Series 2 Bonds</b>	The 8.5% bonds issued and sold by LCF between September 2013 and January 2016.
<b>Series 2 ISA Bonds</b>	The 2-year 6.5% ISA bonds sold by LCF between December 2017 and December 2018.
<b>Series 3 Bonds</b>	The 1-year 3.9% income bonds sold by LCF between December 2015 and October 2018.
<b>Series 3 ISA Bonds</b>	The 5-year 8.95% ISA bonds sold by LCF between June and December 2018.
<b>Series 4 Bonds</b>	The 2-year 6.5% income bonds sold by LCF between November 2015 and December 2018.
<b>Series 4 ISA Bonds</b>	The 3-year 8% ISA bonds sold by LCF between June and December 2018.
<b>Series 5 Bonds</b>	The 3-year 8% AER growth bonds sold by LCF between December 2015 and February 2017.
<b>Series 6 Bonds</b>	The 2-year 6.5% growth bonds sold by LCF between February 2016 and December 2018.
<b>Series 7 Bonds</b>	The 3-year 8% growth bonds sold by LCF between January 2016 and December 2018.
<b>Series 8 Bonds</b>	The 3-year 8% growth bonds sold by LCF between February and September 2017.
<b>Series 9 Bonds</b>	The 2 and 5-year 11% income bonds issued by LCF between February 2014 and September 2015.
<b>Series 10 Bonds</b>	The 3-year 8% bonds sold by LCF between August 2017 and December 2018.

Appendix 4: Glossary

<b>Series 11 Bonds</b>	The 5-year 8.95% bonds sold by LCF between June and December 2018.
<b>SFO</b>	Serious Fraud Office.
<b>SIWS</b>	Supervision – Investment, Wholesale and Specialists.
<b>SRA</b>	Supervision – Retail & Authorisations.
<b>StoneTurn Accountancy Report</b>	The report written by a chartered accountant in the consultancy firm of StoneTurn, as engaged by the Investigation Team.
<b>SUP</b>	The FCA's Supervision Manual.
<b>Supervision Division</b>	An FCA department that oversees firms and of individuals controlling firms to reduce actual and potential harm to consumers and markets. For most of the Relevant Period, the Supervision Division was split into two: (i) SIWS; and (ii) SRA.
<b>Surge</b>	Info Connection (UK) Limited, trading as Surge Financial.
<b>UKLA</b>	United Kingdom Listing Authority.
<b>Unauthorised Business Department</b>	An FCA department that investigates possible unauthorised businesses.
<b>VREQ</b>	Voluntary application for the imposition of requirements.

## **APPENDIX 5: ANALYSIS OF WHETHER LCF WAS CONDUCTING REGULATED ACTIVITY**

### **1. Introduction**

1.1 This **Appendix 5** is split into three sections dealing with the Investigation’s findings on the following matters:

- (a) The first section sets out the definition of “regulated activity” under FSMA. If LCF’s activities fell within this definition they constituted regulated activity and LCF required permission to carry them on;
- (b) The second section explains that in certain limited instances LCF may have carried on regulated activity for which it did not have permission. Those instances were (1) where LCF, or Surge acting on its behalf, advised on investments<sup>1093</sup> and (2) where LCF made arrangements for an investor to switch their investment from an existing investment such as a stocks and shares ISA to an LCF bond such that LCF arranged the disposal of the existing investment;<sup>1094</sup> and
- (c) The third section explains the Investigation’s conclusion that LCF did not carry on regulated activity by issuing its bonds. LCF, accordingly, did not require permission for issuing bonds.

### **2. Why these issues are dealt with in this Appendix 5**

2.1 The issues dealt with in this **Appendix 5** are finely balanced in fact and law and, frequently, novel. Only a Court can ultimately determine these issues, therefore, the Investigation considers it most appropriate to provide its views in this appendix.

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<sup>1093</sup> In respect (1) LCF had permission for corporate finance advice from June 2017. There is a technical question as to whether that permission extended to the activity described in (1). The Investigation concludes that LCF’s permission is unlikely to have extended to this activity because it would not have extended to advising retail clients (potential investors in LCF’s bonds would normally be retail clients rather than eligible counterparties or professional clients). See paragraphs 4.2 - 4.8 below.

<sup>1094</sup> In respect of (2) LCF had an arranging permission from June 2017. There is a technical question as to whether that permission extended to the activity described in (2). On balance, the Investigation concludes that it did not for the reasons explained in paragraphs 4.9 – 4.15 below.



*Appendix 5: Analysis of whether LCF was conducting regulated activity*

2.2 The Investigation is aware that judicial review proceedings have been instituted on behalf of certain investors which are ongoing as at the date of this Report. These proceedings raise the question of whether LCF carried on regulated activity by issuing its bonds after 3 January 2018.<sup>1095</sup> As stated, only a Court, rather than this Investigation, can ultimately determine that question.

**3. The definition of “regulated activity” under FSMA**

3.1 Whether LCF carried on “regulated activity” requires consideration of the definition of “regulated activity” set out in section 22 of FSMA. Section 22 of FSMA provided, so far as is material,:

*“(1) An activity is a regulated activity for the purposes of this Act if it is an activity of a specified kind which is carried on by way of business and –*

*(a) relates to an investment of a specified kind; or*

*(b) in the case of an activity of a kind which is also specified for the purposes of this paragraph [i.e. 22(1)(b) of FSMA], is carried on in relation to property of any kind.”<sup>1096</sup>*

3.2 Accordingly, in order for an activity to be a regulated activity within the meaning of section 22(1)(a) of FSMA, it had to:

(a) “relate to an investment of a specified kind”; and

(b) be an “activity of a specified kind” which was “carried on by way of business”.

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<sup>1095</sup> The judicial review proceedings have been initiated on behalf of certain investors against the Financial Services Compensation Scheme and raise the issue of whether LCF was conducting regulated activity in issuing its bonds following the introduction of MiFID 2 on 3 January 2018: Claim No. CO/1176/2020. The investors have not sought to contend that LCF was conducting regulated activity in issuing its bonds prior to 3 January 2018. See: the Claimant investors’ Amended Detailed Statement of Facts and Grounds, 9 April 2020, at paragraph 114. The FSCS has submitted a Summary of Grounds for Contesting the Claim, 11 May 2020.

<sup>1096</sup> S.22(1)(b) of FSMA is of limited relevance. Art. 4(2) of the RAO specified certain activities for the purposes of s.22(1)(b) of FSMA. Of those specified activities, the only ones of potential relevance on the facts of LCF were: (1) Art. 51ZC of the RAO (“*Managing an AIF*”); paragraphs 5.18-5.23 below explain why this activity did not apply and (2) Art. 51ZE of the RAO (“*Establishing etc. a collective investment scheme*”); paragraphs 5.24-5.29 below explain why this activity did not apply.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

3.3 The instrument which specified “*investments*” and “*activities*” for the purposes of section 22(1) of FSMA was the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (“**RAO**”).

*Investments of a specified kind*

3.4 LCF’s activities “[*related*] to an investment of a specified kind”:

(a) Most of LCF’s business activities related to the issue of its bonds. The Investigation concludes that LCF’s bonds were “*an investment of a specified kind*”. Article 77 of the RAO specified investments which were “*any... instrument creating or acknowledging indebtedness*”. The LCF bonds created or acknowledged indebtedness on the part of LCF to the investors which purchased them. Furthermore, Article 77(1)(d) of the RAO expressly provided that “*bonds*” were a specified investment within the meaning of Article 77.

(b) As set out below,<sup>1097</sup> one of LCF’s activities related to the disposal of investments held by investors in stocks and shares ISAs. These investments would have been either “*shares*” or “*debentures*” and as such were also investments of a “*specified kind*” as defined in the RAO.<sup>1098</sup>

*Activities of a specified kind*

3.5 A more difficult question arises as to whether LCF conducted “*an activity*” of a specified kind. The Investigation’s views are set out in the sections which follow.

*LCF required permission to carry on regulated activity*

3.6 If LCF’s activities fell within the above definition, they constituted regulated activity.

3.7 Firms such as LCF required permission to carry on regulated activity. Section 19 of FSMA provided that no person may carry on, or purport to carry on, a “*regulated activity*” unless he was an authorised person or an exempt person. Pursuant to section 20 of FSMA, an authorised person was not permitted to carry on a “*regulated activity*” unless it was in

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<sup>1097</sup> Paragraphs 4.8 to 4.15 below.

<sup>1098</sup> See Art. 76 and 77 of the RAO.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

accordance with that authorised person’s permission under Part 4A of FSMA or resulting from any other provision of FSMA.

**4. LCF may have carried on limited regulated activity for which it did not have permission**

4.1 As explained below, the Investigation’s view is that in certain limited<sup>1099</sup> instances LCF may have carried on regulated activity for which it did not have permission. Those instances are:

- (a) where LCF, or Surge acting on its behalf, advised investors or potential investors on investments; and
- (b) where LCF made arrangements for an investor to switch their investment from an existing investment in a stocks and shares ISA to an LCF bond, such that LCF arranged the disposal of the existing investment.

*Article 53 of the RAO: Advising on investments*

4.2 The Investigation’s view is that LCF may have advised on investments for the reasons which follow.

4.3 Determining whether LCF advised on investments is highly fact-sensitive.<sup>1100</sup> In determining the eligibility of bondholders for compensation under its compensation scheme, the FSCS

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<sup>1099</sup> The instances below were limited. As stated in the Claimant investors’ Amended Detailed Statement of Facts and Grounds in the judicial review proceedings paragraph 42 “[The FSCS] concluded... that Bondholders will only be permitted to recover if (a) they transferred into the Bonds from existing ISAs (apparently only 159 bondholders out of 11,500); or (b) they have separate advisory claims. The Claimants estimate that, taken together, this will provide recourse for little more than 1% of LCF Bondholders (and the FSCS announcement confirms that it is the FSCS’s view that “many LCF customers are unlikely to be eligible for compensation on the basis of misleading advice).” As at 30 July 2020, the FSCS stated it had paid out over £13.5m in compensation (see: <https://www.fscs.org.uk/failed-firms/lcf/> (accessed on 3 October 2020)).

<sup>1100</sup> The issue is fact sensitive because it requires determining whether LCF, or Surge, gave “advice” within the meaning of Art. 53 on separate occasions when communicating with investors or potential investors. For example, the issue is in part determined by whether what was communicated on a particular occasion fell within the definition of a “personal recommendation” in Art. 53 of the RAO which included that the recommendation: (1) was made to a person in their capacity as an investor or a potential investor, or in their capacity as an agent for a potential investor; (2) constituted a recommendation to buy, sell etc. an investment which was a security; and (3) was presented as suitable for the person to whom it was made or based on a consideration of the circumstances of that person.

Guidance is also potentially relevant to this issue. The FCA’s and ESMA’s guidance both said that a retail investor could legitimately treat communications with a significant element of value judgment or persuasion as constituting the regulated activity of investment advice. See PERG 8.28 generally and by way of example: “PERG 8.28.5G A key question is whether an impartial observer, having due regard to the regulatory regime and guidance, context, timing and what passed between the parties, would conclude that what the adviser says could reasonably have been understood by the customer as being advice. PERG 8.28.6G An explicit recommendation to buy or sell is likely to be advice. However, something falling short

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

has conducted a detailed factual review of the issue of whether LCF in fact advised on investments which included reviewing calls between investors and Surge made on behalf of LCF to determine whether such advice was given. As a result of this, the FSCS determined in July 2019 that it had identified instances of (regulated) “*advising on investments*” by Surge acting on behalf of LCF.<sup>1101</sup>

- 4.4 This Investigation has not conducted a similar factual review which would have been excessive in terms of time and cost. Nor has this Investigation had sight of the materials which the FSCS had considered in reaching this conclusion. Given that the FSCS conducted a detailed review of this issue, and on the untested assumption that the FSCS is correct in its findings, the Investigation has adopted the view that LCF may have advised on investments.
- 4.5 Prior to June 2017 LCF was a limited permission credit broker, which permitted it only to introduce persons who wished to enter into credit agreements to potential lenders. Accordingly, any investment advice it provided to investors on the merits of acquiring LCF bonds would have been provided without the necessary regulatory permission.
- 4.6 From 13 June 2017 onwards, following the granting of the VOP, LCF had permission to provide investment advice and arrange transactions in investments, subject to a corporate finance requirement that LCF must not conduct designated investment business other than corporate finance business. In a corporate finance transaction, the corporate finance firm normally acts for the issuer whose securities are being offered and deals with investors in those securities as ‘corporate finance contacts’ rather than clients. However, the definition of corporate finance business does not preclude the firm from also acting for those investors and treating them as its clients in their dealings with the issuer. This would mean that any advice provided to investors by LCF would have been covered by LCF’s corporate finance permission (although LCF would have failed to categorise them as clients, consider the suitability of the investment to their personal circumstances or provide them with any other

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*of an explicit recommendation can be advice too. Any significant element of evaluation, value judgment or persuasion is likely to mean that advice is being given.”*

Accordingly, the issue is fact-sensitive because it depends on whether what was said on particular occasions fell within “advice” as set down in the relevant legislation, which may also be influenced by relevant guidance.

<sup>1101</sup> FSCS: *Summary note on the basis for protected claims against London Capital & Finance plc*, 12 July 2019 (see: <https://www.fscs.org.uk/news/protection/summary-note-basis-lcf-claims/> (accessed on 3 October 2020)).

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

protections of client status). In addition, LCF only had permission to advise eligible counterparties and professional clients and did not have permission to advise retail clients. Potential investors in LCF's bonds would normally be retail clients.<sup>1102</sup>

- 4.7 Accordingly, prior to June 2017, LCF did not have permission to advise on investments as set out in paragraphs 4.2 to 4.6 above. After June 2017, LCF's permission is unlikely to have extended to this activity because it would not have extended to advising retail clients (potential investors in LCF's bonds would normally be retail clients).

Article 25(1) of the RAO: Arranging deals in investments

- 4.8 Article 25(1) of the RAO provided, insofar as is material, that "*making arrangements for another person (whether as principal or agent) to... sell... a particular investment*" of a kind set out in Article 25(1)(a) to (c) was a specified kind of activity.

- 4.9 The FSCS concluded that where LCF procured the sending of transfer instructions to an investor's existing ISA manager, instructing the ISA manager to sell the investor's existing securities held in a stocks and shares ISA, this amounted to the regulated activity of arranging. This is because, by arranging the disposal, LCF was "*making arrangements for*" another person (the investor) to "*sell*" their existing investment in the stocks and shares ISA<sup>1103</sup> within the meaning of Article 25(1) of the RAO.

- 4.10 The Investigation has not conducted an independent review into whether LCF carried on this regulated activity or the number of investors affected. On the assumption that the FSCS is

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<sup>1102</sup> As explained in this paragraph, from 17 June 2017 LCF had permission to provide both advisory and arranging services. The Investigation understands that the terms of these permissions specified that LCF was allowed to advise and arrange transactions for eligible counterparties and professional and retail clients, but its investment advice permission was limited to eligible counterparties and professional clients.

These client categories were described in great detail COBS 3 of the FCA handbook. To over-simplify somewhat, (i) a client was a person to whom an authorised firm such as LCF provided a service in the course of carrying on a regulated activity; (ii) an eligible counterparty was a professional financial services counterparty with or for whom the firm executed a financial transaction; (iii) a professional client was a financial institution, investment professional or large commercial business to whom the firm provided regulated services; and (iv) a retail client was any client who was not an eligible counterparty or professional client.

In the Investigation's view it is extremely unlikely that a private individual investing in LCF's bonds would have been an eligible counterparty or professional client.

<sup>1103</sup> Art. 25(1)(a) arranging has to be an arrangement in respect of an investment. The securities held in stocks and shares ISA are such an investment. The cash held in a Cash ISA does not qualify.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

correct in its findings, the Investigation considers that LCF may have advised on investments as set out above.

4.11 LCF did not have permission to arrange deals in investments prior to June 2017.

4.12 After 13 June 2017 LCF was granted an arranging permission but this did not extend to the activity described above. LCF's arranging permission was subject to the corporate finance restriction referred to in paragraph 4.7 above. The transaction effected by LCF which constituted the regulated activity of arranging did not relate to an investment by the investor in the issuer's (i.e. LCF's) securities (which would potentially have come within the definition of corporate finance business) but a separate arrangement for the disposal of the investor's existing investment. This is a fine point but, on balance,<sup>1104</sup> the Investigation considers that such a disposal was outside the definition of corporate finance business and was therefore carried out without the required permission.

4.13 Accordingly, LCF never had permission to carry out the activity described in paragraph 4.10 above.

4.14 For the reasons set out above, the Investigation's considers (based on the assumption that the FSCS's findings are correct) that, in certain limited instances, LCF may have conducted regulated activity for which it did not have permission.

**5. LCF's issuing of its bonds did not constitute regulated activity**

5.1 The Investigation's view is that LCF did not carry on regulated activity by issuing its bonds. Consequently, LCF did not require permission to do so because this did not constitute regulated activity.

5.2 The Investigation explains below why LCF's issuing its bonds did not fall within various kinds of regulated activity.<sup>1105</sup>

*Article 5 of the RAO: Accepting deposits*

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<sup>1104</sup> Bearing in mind, among other things, that the arranging was not part of a substantive or *bona fide* corporate finance activity.

<sup>1105</sup> The below does not address those forms of activity which were obviously inapplicable to LCF's activities such as the issuance of electronic money (Art. 9B of the RAO) or effecting and carrying out contracts of insurance and assisting in the administration of a contract of insurance (Art. 10 and 39A of the RAO).

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

5.3 LCF did not “[accept] deposits” within Article 5 of the RAO. Article 9(1) of the RAO provided<sup>1106</sup> that a sum was not a deposit for the purposes of Article 5 if it was received by a person as consideration for the issue by him of any kind of investment specified by Article 77. As explained in paragraph 3.4(a) above, LCF’s bonds were a kind of investment specified by Article 77 of the RAO.

Article 14 of the RAO: Dealing in investments as principal

5.4 LCF did not deal in investments as principal:

- (a) LCF, in issuing its bonds, “[sold]”<sup>1107</sup> “securities”<sup>1108</sup> within the meaning of Article 14 of the RAO.
- (b) However, Article 18 of the RAO excluded the application of Article 14 where a company issued its own “shares”. Article 18(2)(b) of the RAO defined “shares” to “include any investment of the kind specified by [Article 77 of the RAO].” As explained in paragraph 3.4(a) above, LCF’s bonds were a kind of investment specified by Article 77 of the RAO. It follows that Article 18 excluded the application of Article 14 in respect of LCF.

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<sup>1106</sup> Subject to Art. 9(2) which is inapplicable in LCF’s case.

<sup>1107</sup> Art. 3 of the RAO provided ““selling”, in relation to any investment, includes disposing of the investment for valuable consideration, and for these purposes “disposing” includes (a) in the case of an investment consisting of rights under a contract— (i) surrendering, assigning or converting those rights; or (ii) assuming the corresponding liabilities under the contract; (b) in the case of an investment consisting of rights under other arrangements, assuming the corresponding liabilities under the arrangements; and (c) in the case of any other investment, issuing or creating the investment or granting the rights or interests of which it consists.”

<sup>1108</sup> Art. 3 of the RAO defined “security” as (except where the context otherwise required) “any investment of the kind specified by any of articles 76 to 82 [of the RAO]”. As explained above, LCF’s bonds were an investment of a specified kind pursuant to Art. 77 of the RAO.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

*MiFID: Dealing on own account*

- 5.5 The European Union’s Markets in Financial Instruments Directive<sup>1109</sup> (“MiFID”) introduced into UK law a number of regulated activities (described in MIFID as “services” or “activities”), which were similar to but not identical with their UK equivalents. The MIFID activity which corresponded to “dealing in investments as principal” was “dealing on own-account”<sup>1110</sup> This activity was defined as “*trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments*”, and contains no equivalent of the Article 18 exclusion.
- 5.6 Investors have raised arguments both in correspondence with the FSCS and in the judicial review proceedings, that Article 18 did **not** exclude the application of Article 14 in respect of LCF. Such arguments rely on Article 4(4) of the RAO:
- (a) Broadly, Article 4(4) of the RAO was designed to ensure that, in implementing the relevant MiFID and MiFID 2 Directives, any activities which require regulation at EU level would not be excluded from the scope of the RAO as a matter of domestic law.
  - (b) To this end, Article 4(4) of the RAO provided, among other things, that where a firm which was within the scope of the MiFID Directives provides or performs “*investment services and activities on a professional basis*”, the exclusion in Article 18 of the RAO was to be disregarded (the “**MiFID override**”).
  - (c) The Investigation was informed that investors have argued that the issue by LCF of its bonds constituted the MiFID activity of trading against LCF’s proprietary capital; with LCF first entering into bonds with individual investors and then into loans with the companies it invested in.
- 5.7 On balance, however, the Investigation disagrees. Subject, again, to the point that this is an issue for a court to decide in due course, the Investigation’s view is that LCF’s issue of bonds

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<sup>1109</sup> Directive 2004/39/EC (“MiFID I”); restated and replaced by Directive 2014/65/EU (“MiFID II”); MiFID I & II together with all related directives and regulations in force at the relevant time “MiFID”)

<sup>1110</sup> MiFID 1 Annex 1, Section A § 3 and Article 4(6) and MiFID 2 Annex 1, Section A paragraph 3 and Article 4(6).



*Appendix 5: Analysis of whether LCF was conducting regulated activity*

and investment of the proceeds did not constitute “*trading against proprietary capital*” for the purposes of “*dealing on own account*”. “*Trading*” implies a process of buying and selling securities or other assets with counterparties to make a profit, with any potential losses covered by house capital. An issue of debt securities in contrast is a way of borrowing money to be repaid in due course with interest and therefore does not appear to fall within the natural meaning of the term “*trading*”.<sup>1111</sup>

5.8 The investors’ arguments in the judicial review proceedings appear to focus on the contention that LCF’s bonds constituted “*transferable securities*” within the meaning of Article 4.1(44) of MiFID 2 and the effect of this on the operation of the MiFID override.

5.9 These arguments include that: (i) the definition of transferable securities in Article 4.1(44) of MiFID 2 applies with reference to classes of securities (one such class being bonds), and therefore applies to any bond whether or not the individual bond is transferable; and (ii) the contractual terms of certain of bonds sold as ISA-eligible contained two irreconcilable provisions, that the bonds were ISA-eligible (meaning that they must be transferable) and that the bonds were not transferable (meaning they could not be ISA eligible), and the Consumer Rights Act 2015 requires the meaning most favourable to the consumer (that the bonds were transferable) to prevail.<sup>1112</sup>

5.10 These are, again, novel and legally complex arguments which the Investigation acknowledges are solely for the Court to decide. However, for the reasons below, the Investigation considers that LCF’s bonds did not constitute transferable securities.

*MiFID override: Execution of orders on behalf of clients*

5.11 A further difficult question is whether LCF “[*executed*] orders on behalf of clients” within the meaning of MiFID 2.<sup>1113</sup>

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<sup>1111</sup> Similarly, PERG 13.1 Q 16 refers to dealing on own account as involving “*position taking*” and “*trading financial instruments on a regular basis*”.

<sup>1112</sup> The Investors also argue the same result is achieved through common law rules of contractual construction.

<sup>1113</sup> Claimant investors in the judicial review proceedings and Sherman & Sterling’s correspondence with the FSCS have not sought to argue that LCF executed orders on behalf of clients.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

5.12 MiFID 2 **extended** the definition of executing orders on behalf of clients from that in MiFID 1 to include situations where the order related to a financial instrument issued by the MiFID firm itself (see Recital 45 and Article 4 of MiFID 2). The Investigation considers it arguable that this extended definition could capture the issuing by LCF of its bonds subject to the general rule that the bonds would need to fall within the MiFID 2 definition of transferable securities.

5.13 On balance, however, the Investigation's view is that the extended definition in MiFID 2 did not apply to LCF:

(a) Specifically, and although this is, again a difficult issue, the Investigation considers that LCF's bonds were not "*transferable securities*" within the meaning of Article 4.1(44) of MiFID 2.<sup>1114</sup> Such definition requires the securities to be "*negotiable on the capital market*". While "*bonds or other forms of securitised debt*" are given as an example of such negotiable securities, in the case of LCF's bonds the Investigation considers that the bonds were not transferable securities within the meaning of MiFID 2:

(i) First, LCF's bonds were – *de facto* – not tradable on the capital markets. No secondary market existed for these bonds and they were, in reality, not traded.

(ii) Second, the bonds that the Investigation has seen were, by their terms and conditions, expressed to be "*non-transferable*".<sup>1115</sup>

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<sup>1114</sup> As stated above, the Investors have raised novel and complex arguments in this regard in the judicial review proceedings.

<sup>1115</sup> The Investigation has not conducted an exhaustive review of all the terms and conditions of LCF's bonds and, indeed, has not been provided with all such terms and conditions.

Nonetheless, and by way of example only, the following terms and conditions provided that LCF's bonds were non-transferable and prohibited the bondholder from assigning or transferring any of its rights, benefits or obligations therein (see: Bond Instrument Constituting Series 1 ISA 3 Year 8% Secured Bonds, 29 November 2017, at clause 7; Bond Instrument Constituting Series 6 2 year 6.5% Growth and Protect Secured Bonds, 14 December 2015, at clause 7).

Furthermore, and by way of further example, the following documents stated that LCF's bonds were non-transferable (see: 8.95% 5 year ISA brochure, 1 June 2018, at page 22: "**Bonds are non-transferable** There is, and will be, no established market for the bonds as they are non-transferable, and you should not invest if you may need to realise your investment prematurely. **Illiquidity** Investments in unquoted securities (i.e. investments not listed or traded on any regulated market or exchange), such as these bonds, are illiquid (i.e. they cannot be cashed in during the bond term). The bonds are non-transferable, so your money is effectively locked in until the maturity date of each specific bond"; at page 34: "**Can I sell**

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

- (b) In any event, as the extended definition was new to MiFID 2 it could not apply to LCF's bonds issued prior to 3 January 2018.

Article 21 of the RAO: Dealing in investments as agent

- 5.14 LCF did not deal in investments as agent. The RAO did not define the term "agent". However, LCF did not act as an "agent" in the natural and ordinary meaning of the word in the sense of acting as an intermediary for a principal so as to effect the principal's relations with third parties.<sup>1116</sup>

Article 25 of the RAO: Arranging deals in investments

- 5.15 Article 34 excluded the application of Article 25 in respect of LCF's issuing bonds:<sup>1117</sup>
- (a) Article 25 of the RAO [provided], insofar as is material, that "making arrangements for another person (whether as principal or agent) to buy... a particular investment which is... a security" was a specified kind of activity.
- (b) However, Article 34 excluded "arrangements made by a company for the purposes of issuing its own shares". "Shares" had the meaning given in Article 18(2) of the RAO.<sup>1118</sup>
- (c) As explained in paragraph 5.4(b) above, LCF's bonds fell within the meaning of "shares" under Article 18(2) of the RAO such that the Article 34 exclusion applied.

Article 36A of the RAO: Credit broking

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*my bond / exit early? No, the bonds have a fixed term, are not transferable and investors do not have the right to redeem their bonds prior to the maturity date"; and Series 10, 3-year 8% Bonds (Non-Transferable Securities) Information Memorandum, 25 August 2017, at page 17: "How is a non-transferable corporate bond different from a transferable corporate bond? This bond is effectively a private borrowing agreement between LC&F and a Bondholder that cannot be transferred to someone else. In contrast, transferable corporate bonds are freely tradeable instruments").*

<sup>1116</sup> By way of an example (see: McMeel and Virgo, Financial Advice and Financial Products (3<sup>rd</sup> Ed.) (Oxford University Press, 2014) in the context of insurance mediation activities paragraph 14.96: "...The key point is that an insurance intermediary acts on behalf of another party. The principal may be the insurer, or the prospective insured. It does not matter. If the intermediary buys, sells, or subscribes for, or underwrites a contract of insurance for either insurer or insured, he is dealing as agent and the activity is a regulated one...")

<sup>1117</sup> As explained in paragraphs 4.2-4.8 above, the Investigation's view is that LCF may have arranged deals in investments in respect of other activities it carried on.

<sup>1118</sup> Art. 34(2) of the RAO.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

5.16 The Investigation also concludes that LCF's loans were not "*credit broking*" within the meaning of Article 36A of the RAO. Article 36D provided an exclusion from the definition of credit broking where the person carrying on the activity as itself the lender. LCF lent to businesses as principal, and so the Article 36D exclusion applied.

*Article 36H of the RAO: Operating an electronic system in relation to lending*

5.17 Article 36H did not apply. Article 36H(1) applied where an operator ("A") operated an electronic system which facilitated persons ("B" and "C") becoming lender and borrower under an Article 36H agreement. In this case, LCF (as person "A") was not operating such an electronic system which facilitated the investors (as person "B") lending to the borrowers (as person "C"). Rather LCF itself raised money from investors through issuing its bonds.

*Article 37 of the RAO: Managing investments*

5.18 Article 37 did not apply. Although the LCF raised money through issuing its bonds, the investors had no proprietary claim over the money raised and so LCF did not manage assets "*belonging to another person*" as required by Article 37 of the RAO.

*Article 51ZC of the RAO: Managing an AIF*

5.19 For the reasons set out below, the Investigation's view is that LCF's issuing of bonds did not constitute "*Managing an AIF*."

5.20 The definition of an "*AIF*" appears in Regulation 3(1) of the Alternative Investment Fund Managers Regulations 2013 and means "*a collective investment undertaking, including investment compartments of such an undertaking, which (a) raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of these investors; and (b) does not require authorisation pursuant to Article 5 of the UCITS directive.*"

5.21 The Alternative Investment Fund Manager Regulations 2013 were designed to give effect in English law to the Alternative Investment Fund Managers Directive ("**AIFMD**"). ESMA guidelines on what constituted a collective investment undertaking for AIFMD purposes

provided that if an undertaking met all the following criteria it was a “collective investment undertaking” for AIFMD purposes:<sup>1119</sup>

- (a) the undertaking does not have a general commercial or industrial purpose;
- (b) the undertaking pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors; and
- (c) the unit holders or shareholders – as a collective group – have no day-to-day discretion or control. The fact that one or more but not all of such unit holders or shareholders are granted day-to-day discretion or control should not be taken to show that the undertaking is not a collective investment undertaking.

5.22 In the Investigation’s view, the proceeds of LCF’s bonds were not pooled to generate a return from the pooled risk arising from acquiring, holding or selling investment assets within the meaning of (b) above. The bonds paid a fixed return which was not dependent on any return actually generated by LCF’s investment of the proceeds. Accordingly, the requirement set out in paragraph 5.20(b) above was not satisfied.

5.23 In order for LCF to be “*managing an AIF*” the underlying assets also had to be invested in accordance with a defined investment policy for the benefit of the investors. ESMA stated<sup>1120</sup> that, if an undertaking had a policy about how the pooled capital in the undertaking was to be *managed* to generate a pooled return for the investors from whom it has been raised, this amounted to a defined investment policy for AIFMD purposes.

5.24 LCF’s issuing of bonds did not fulfil this requirement for the reasons given in paragraph 5.21 of this Appendix 5. The proceeds of LCF’s bonds were not invested for the benefit of investors because there was no agreement or disclosure as to how the proceeds would be invested by LCF and, even if there had been such a policy, the return to investors was not based on the investment of their capital in line with such a policy.<sup>1121</sup>

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<sup>1119</sup> ESMA Level 3 Guidelines on Key Concepts of the AIFMD 24 May 2013 (ESMA/2013/600) at paragraph 12 (see: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-600\\_final\\_report\\_on\\_guidelines\\_on\\_key\\_concepts\\_of\\_the\\_aifmd\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-600_final_report_on_guidelines_on_key_concepts_of_the_aifmd_0.pdf) (accessed on 3 October 2020)).

<sup>1120</sup> ESMA Level 3 Guidelines on Key Concepts of the AIFMD 24 May 2013 (ESMA/2013/600) at paragraphs 20 – 22; PERG 16.2 Q 2.13 (see: <https://www.handbook.fca.org.uk/handbook/PERG/16/2.html> (accessed on 3 October 2020)).

<sup>1121</sup> See also PERG 16.2 Q 2.44

*Article 51ZE of the RAO: Establishing etc. a collective investment scheme*

- 5.25 For the reasons set out below, the Investigation’s view is that the definition of “*collective investment scheme*” was inapplicable to LCF’s business such that Article 51ZE of the RAO did not apply. The Investigation recognises that this issue is, however, complex and finely balanced.
- 5.26 The definition of a collective investment scheme was set out in section 235 of FSMA. However, Schedule 1 paragraph 21 of the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (the “**CIS Order**”) provided (insofar as is material) that “*no... body corporate...other than an open-ended investment company, amounts to a collective investment scheme.*” Accordingly, where a corporate issuer such as LCF was concerned, the principal test was whether it came within the definition of an open-ended investment company (“**OEIC**”) in section 236 of FSMA.<sup>1122</sup>
- 5.27 Where a corporate issuer such as LCF did not fall within the definition of an OEIC it would benefit from the exemption in paragraph 5(1)(a) of the schedule to the CIS Order which provided<sup>1123</sup> that “[a]rrangements do not amount to a collective investment scheme if they are arrangements under which the rights or interests of participants are... investments of the kind specified in [Article 77 of the RAO [debentures]] which are issued by a body

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<sup>1122</sup> Section 236 defines an open-ended investment company as: “(1)...a collective investment scheme which satisfies both the property condition and the investment condition.” Section 236(2) of FSMA states: “The property condition is that the property belongs beneficially to, and is managed by or on behalf of, a body corporate (“BC”) having as its purpose the investment of its funds with the aim of— (a) spreading investment risk; and (b) giving its members the benefit of the results of the management of those funds by or on behalf of that body.” Section 236(3) states that “The investment condition is that, in relation to BC, a reasonable investor would, if he were to participate in the scheme – (a) expect that he would be able to realise, within a period appearing to him to be reasonable, his investment in the scheme (represented, at any given time, by the value of shares in, or securities of, BC held by him as a participant in the scheme)(the “expectation test”); and (b) be satisfied that his investment would be realised on a basis calculated wholly or mainly by reference to the value of property in respect of which the scheme makes arrangements.”

<sup>1123</sup> In the version in force as at 1 April 2014.

*corporate other than an open-ended investment company... and which are not convertible into or exchangeable for investments of any other description.”*

5.28 In the Investigation’s view, LCF’s bond issues did not constitute a collective investment scheme because (1) LCF was not an OEIC; and (2) the bonds it issued were debentures within the scope of paragraph 5(1)(a) of the CIS Order:

- (a) LCF was not an OEIC within the meaning of section 236 of FSMA because:
  - (i) It did not have as the purpose of the investment of its funds the aim of giving its members the benefits of the results of the management of those funds by or on behalf of LCF (section 236(2)(b) of FSMA). This is because the investors in LCF’s bonds were not members of LCF, but lenders who advanced funds in exchange for an obligation to repay principal and a fixed rate of return;
  - (ii) Furthermore, the Investigation does not consider that the bonds met the investment condition in section 236(3) of FSMA. As regards section 236(3)(a) of FSMA, given that the bonds were non-transferable and intended to be held to maturity, a reasonable investor would not expect that he would be able to realise, within a reasonable period, his investment in the scheme. As regards section 236(3)(b) of FSMA, a reasonable investor would not be satisfied that the basis on which his investment would be realised would be calculated “*wholly or mainly*” by reference to the value of the property in respect of which the scheme makes arrangements (in this case the loans which LCF made to its own customers). The investor’s return was not calculated by reference to the value of those LCF customer loans. Rather the amount an investor would realise was an independent obligation calculated solely on the basis of the agreed rate of return set down by the terms and conditions of the bonds;<sup>1124</sup>

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<sup>1124</sup> As stated in Cornick, **Collective Investment Schemes: Law and Practice** (Looseleaf) (Sweet and Maxwell): § A3.380 as at October 2018: “*The FCA explains in its guidance at PERG 9.9 that this definition is intended to focus on the way that the body corporate operates over time so that the reasonable investor is satisfied that he will realise his proportionate*

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

- (b) As explained in paragraph 3.4(a) above, LCF's bonds were investments of a kind specified by Article 77 of the RAO and therefore satisfied the requirement in paragraph 5(1)(a)(i) of the CIS Order that the investments be issued by a single body corporate *other than an OEIC*.
- (c) The Investigation's view that paragraph 5(1)(a) of the schedule to the CIS Order operated to exclude LCF's bond issuances from the definition of "*collective investment scheme*" is supported by McMeel and Virgo, **Financial Advice and Financial Products** (3<sup>rd</sup> Ed.) (Oxford University Press, 2014) paragraph 13.23 which states:

*"Paragraph 5 of the CIS Order is intended to carve out arrangements where the participants' rights are debentures issued by a body corporate (other than an [OEIC]) and government debt. Additionally, arrangements where the interests of the participants comprise warrants which confer rights in respect of debentures are caught. Paragraph 5 therefore excludes most securitisation and bond issue arrangements."*<sup>1125</sup>

*Sherman and Sterling's contentions*

5.29 The Investigation has seen that Shearman and Sterling have suggested in correspondence with the FSCS<sup>1126</sup> that, contrary to the Investigation's view, paragraph 5 of the CIS Order did not apply. Shearman and Sterling have said by reference to Lord Sumption's<sup>1127</sup> comments in **Asset Land Investments Plc v Financial Conduct Authority**<sup>1128</sup> at paragraph 88 and 91 that, in construing the word "*arrangements*" "*a broad and untechnical word*"

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*share in the value of the body corporate's underlying assets, less any dealing costs (i.e. the net asset value). The test looks to the general methodology applied when calculating the value of the investment..."*

<sup>1125</sup> McMeel and Virgo, **Financial Advice and Financial Products** (3<sup>rd</sup> Ed.) (Oxford University Press, 2014) paragraph 13.23.

<sup>1126</sup> Letter from Shearman & Sterling LLP to FSCS, 7 May 2019, at page 12 in an appendix to a letter from Shearman and Sterling to HM Treasury dated 29 August 2019. Such arguments have not been run by the investors in the judicial review proceedings.

<sup>1127</sup> Lord Sumption was a Justice of the Supreme Court and one of the judicial panel which decided **Asset Land v Financial Conduct Authority**.

<sup>1128</sup> [2016] UKSC 17.



under section 235 of FSMA, one must take into account shared understandings of the parties and this shared understanding prevents paragraph 5 of the CIS Order from applying.

5.30 While noting, again, that this issue will need to be determined by a court, the Investigation respectfully disagrees with Shearman and Sterling's views:

- (a) Lord Sumption's statements upon which Shearman and Sterling rely pertained to the statutory construction of the term "arrangements" in section 235 of FSMA. While that term may be "broad and untechnical" as Lord Sumption stated, the exclusion in paragraph 5(1) of the Schedule to the CIS Order is drafted in highly technical language. The Investigation, therefore, considers that Lord Sumption's statements are inapplicable to a proper construction of paragraph 5(1) of the Schedule to the CIS Order.<sup>1129</sup>
- (b) Further, Lord Sumption's comments were made in the context of arrangements under section 235 of FSMA whereas, as noted above, the key tests for a corporate issuer is the test in respect of what constitutes an OEIC set out in section 236. According to the FCA Handbook (PERG 9.4.4<sup>1130</sup>), a typical body corporate is likely to constitute a collective investment scheme, in that money is paid to the corporate in exchange for securities; the corporate becomes the beneficial owner of that money in exchange for rights granted to the securities holders against the body corporate; the securities holders do not have day to day control over the management of the property, and the property is managed as a whole by or on behalf of the corporate. Accordingly, what is key is not the section 235 tests but the section 236 test for OEICs. Provided the section 236 test is not met, a typical

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<sup>1129</sup> This is particularly so in circumstances where provisions such as paragraph 5(1) of the Schedule to the CIS Order serve an important purpose of narrowing the otherwise potentially extremely wide definition of a collective investment scheme in s. 235 of FSMA. see *e.g.* Lord Sumption's comments in **Asset Land v FCA** § 90: "Section 235 begins in subsection (1) with a wholly general description of collective investment schemes which on its own would cover virtually all cooperative arrangements for deriving profits or income from assets. Subsections (2), (3) and (4) narrow down the breadth of that description..."

<sup>1130</sup> PERG 9.4 Collective investment scheme (section 235 of the Act) (see: <https://www.handbook.fca.org.uk/handbook/PERG/9/4.html> (accessed on 3 October 2020)).

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

corporate is prevented from being classed as a collective investment scheme by paragraphs 5 and 21 of the CIS Order (see PERG 9.4.5G).<sup>1131</sup>

*Article 60B of the RAO: Regulated credit agreements*

5.31 The Investigation considers it unlikely that LCF's lending activities involved the entering into regulated credit agreements. Article 60C(3) of the RAO provided an exemption if the lender provided the borrower with credit exceeding £25,000 and the agreement was entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on by the borrower. This exemption appears to apply to the type of commercial loans made by LCF.<sup>1132</sup>

*Article 64 of the RAO: Agreeing to carry on specified kinds of activity*

5.32 Article 64 of the RAO provided that, “[a]greeing to carry on an activity of the kind specified by any other provision of this Part or Part 3A (other than article 5, 9B, 10, 25D, 51ZA, 51ZB, 51ZC, 51ZD, 51ZE, 52 or 63N) is a specified kind of activity.”

5.33 Investors have argued in the judicial review proceedings that, even if LCF's ISA products were subject to non-transfer provisions, under the subscription agreements which LCF formed with investors, it agreed to provide them with transferable bonds capable of being used as ISA investments. As the Investors have acknowledged, this argument “piggy-backs” the analysis referred to above, viz. that the non-transferability provisions in LCF's ISA products should be struck down. As recognised above, these are novel and legally complex arguments which are ultimately for the Court to decide. Overall, however, the Investigation

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<sup>1131</sup> *Ibid.*

<sup>1132</sup> LCF's Administrators' Report and Statement of Proposals of 25 March 2019 describes LCF's loan book as at 30 January 2019 as comprising 12 limited companies owing in aggregate £237,854,124, with the smallest debt owed by a single borrower identified as £839,776. As at 25 March 2019 all extant loans were made, not to private individuals but to corporate borrowers and were well above the Article 60C £25,000 threshold. In the Investigation's view it is also extremely unlikely that they were not made wholly or predominately for the purposes of the borrowers' businesses. See Administrators' Proposals, at pages 9 and 10.

*Appendix 5: Analysis of whether LCF was conducting regulated activity*

considers that LCF's bonds did not constitute transferable securities for the reasons set out above.

**6. Conclusion**

6.1 For the reasons set out above, the Investigation's non-binding view is that in certain limited instances LCF may have carried on regulated activity for which it did not have permission. However, in the Investigation's view, LCF's issuing of bonds did not constitute regulated activity. Consequently, the Investigation has concluded that LCF did not require FCA permission in order to issue its bonds.

## **APPENDIX 6: INFORMATION WHICH THE FCA RECEIVED FROM THIRD PARTIES DURING THE RELEVANT PERIOD REGARDING LCF'S CONDUCT**

### **1. Introduction**

1.1 The FCA received a considerable amount of information from third parties regarding the conduct of LCF during the Relevant Period. In summary, the FCA received communications to its contact centre (see Sections 3 to 6 below) and also information through other channels (see Section 7 below).

1.2 The purpose of this Appendix is to summarise such information in detail.<sup>1133</sup> Other chapters of this Report, especially **Chapters 9 to 13**, contain the Investigation's criticisms of the FCA's failures in how it responded, or failed to respond, to such information. This appendix is of special relevance to **Chapter 12** because that chapter addresses questions raised by paragraph 3(c) of the Direction concerning the FCA's response to information provided by third parties. In that chapter, the Investigation makes particularly serious criticisms of the FCA's regulation of LCF and its repeated failures to respond to allegations made by third parties to the FCA that LCF might have been engaged in fraud or serious irregularity.

### **2. Communications to the Customer Contact Centre**

2.1 This section describes Contact Centre's functions (paragraphs 2.2 to 2.6 below) and the methods by which the Investigation has obtained samples of calls and other communications to the Contact Centre regarding LCF (paragraphs 2.7 to 2.11 below). Sections 3 to 6 then summarise communications which the Contact Centre received regarding LCF and the FCA's response.

#### *The Contact Centre's functions*

2.2 The Contact Centre formed part of the FCA's Supervision Division.<sup>1134</sup> The primary role of the Contact Centre was to provide an interface between the FCA and (1) consumers and (2)

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<sup>1133</sup> A less detailed summary is provided in **Chapter 3** (Key events in the FCA's regulation of LCF), at Section 4.

<sup>1134</sup> The Supervision Division was divided into two broad groups: (i) Retail & Authorisations for whom the relevant director is Jonathan Davidson; and (ii) Investment, Wholesale & Specialists for whom the relevant director is Megan Butler. The

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

firms. In order to carry out this role, the Contact Centre operated two helplines: (1) a Consumer Helpline and (2) a Firm Helpline.

2.3 The Consumer Helpline handled queries from consumers through phone calls, e-mails, letters, web-chat and web-forms. It handled matters relating to all sectors of the FCA's activity.<sup>1135</sup>

2.4 Until 2014, the Consumer Helpline was operated by an outsourcing partner. The FCA has stated that this arrangement "*provided limited feedback about the experiences or concerns consumers were reporting.*"<sup>1136</sup> In 2014, the Consumer Helpline was brought in-house and within the FCA's Supervision Division. The FCA has stated that this occurred in order to "[develop] a flow of intelligence from contact with consumers" and that "*the insourcing of the consumer helpline in 2014 began a process of shifting the consumer helpline from a purely service operation to an integral part of Supervision.*"<sup>1137</sup>

2.5 The Firm Helpline handled queries from firms rather than consumers.<sup>1138</sup>

2.6 The Investigation has primarily focused on communications to the Consumer Helpline rather than the Firm Helpline for two reasons:

- (a) First, as set out in **Chapter 12**, paragraph 3(c) of the Direction addresses information received by the FCA from third parties.<sup>1139</sup> Such third parties used the Consumer Helpline.
- (b) Second, although the FCA had contact with LCF through its Firm Helpline during the Relevant Period, such contact tended to be in the nature of enquiries from LCF

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Contact Centre sat within Retail & Authorisations (see: Slides for the meeting between Independent Investigation Team & FCA, 20 September 2019, at slides 5 to 7). This is also the case at the time of drafting this Report.

<sup>1135</sup> Enclosure to the letter from the Executive Director of R&CO to the Investigation, 19 May 2020, at page 19.

<sup>1136</sup> *Ibid.*

<sup>1137</sup> *Ibid.*

<sup>1138</sup> *Ibid.* The FCA has stated that the subject matter of queries varies but tended to fall into one of four categories, namely (1) how regulations applied to a firm; (2) enquiries about the FCA's systems; (3) whether a firm was compliant and (4) whether a firm needed to be authorised.

<sup>1139</sup> Paragraph 3(c) of the Direction.

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

on points of detail as to financial regulation.<sup>1140</sup> Accordingly, the nature of the communications was such that they were generally unlikely to have revealed the significant underlying issues in LCF's business.<sup>1141</sup>

*Samples of communications to the Contact Centre regarding LCF*

2.7 The Contact Centre received a high volume of communications from consumers regarding LCF.<sup>1142</sup> The Investigation has not reviewed all such communications, which would have been disproportionate in time and cost. Instead, the Investigation obtained communications through targeted document requests to the FCA. In the case of calls, the Investigation requested samples of calls to the Contact Centre regarding LCF. Such calls were transcribed by the FCA and then provided to the Investigation. Where call transcripts contained points of interest to the Investigation, the Investigation requested further materials such as INTACT

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<sup>1140</sup> For example, the FCA set up windows of time for firms that were transferring over to FCA authorisation from the OFT. In such windows, transferring firms could apply for full permission status with the FCA. In one call, LCF asked the FCA the dates in which its window fell (see: Transcript of call to the FCA Contact Centre, 1 May 2015).

<sup>1141</sup> One exception to this is identified in the internal FCA document titled London Capital and Finance: Supervision Hub Internal Review, of which states: "*I of the 60 contacts with the firm should have been escalated to CC Supervision. This occurred in November 2017 when the firm advised that its accounts would be submitted late to Companies House. They were told to submit a notification which arrived shortly after and was acknowledged. This case was closed – the likely reason for this closure is that the explanation (a change in auditors) was a plausible reason for the late submission. The possible impact of this is unknown*" (see: London Capital and Finance: Supervision Hub Internal Review, January 2020, at pages 6 to 7). The Investigation has reviewed the relevant documents associated with this incident, namely: (1) Transcript of call to the FCA Contact Centre 29 November 2017; (2) Email Message Detail, 29 November 2017 (Document with Control Number 124282); (3) Task Detail 29 November 2017 (Document with Control Number 124286) and (4) Email Message Detail 30 November 2017 (Document with Control Number 124285). The INTACT case notes record that the reason for case closure was "[u]sed own knowledge" (see: Case Detail 29 November 2017 (Document with Control Number 124280)).

<sup>1142</sup> London Capital and Finance: Supervision Hub Internal Review, January 2020, at page 3 which indicated that 611 queries from consumers were received regarding LCF. The same document also stated that the FCA received 60 queries from the firm also at page 3. Furthermore, as already stated in **Chapter 10** (Adequacy of the FCA's Supervision of LCF), from around mid-2016 LCF featured increasingly prominently in a document which was produced monthly by the FCA which summarised calls received about firms titled "*Consumer Investment Products Emerging Themes*". LCF was in the top 3 firms for June, July, August, September and October 2016. Such information indicates that the FCA was receiving a high volume of queries from consumers regarding LCF (see: Consumer Investment Products Emerging Themes, June 2016 (Document with Control Number 209344); Consumer Investment Products Emerging Themes, July 2016 (Document with Control Number 209335); Consumer Investment Products Emerging Themes, August 2016 (Document with Control Number 209325); Consumer Investment Products Emerging Themes, September 2016 (Document with Control Number 209341); and Consumer Investment Products Emerging Themes, October 2016 (Document with Control Number 209323)).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

case notes summarising the calls and details regarding how the concerns expressed in the calls were subsequently pursued by the FCA.<sup>1143</sup>

*The FCA Review Document*

- 2.8 Near the end of the investigative phase of the Investigation, in August 2020,<sup>1144</sup> the FCA disclosed a document titled “*London Capital & Finance: Supervision Hub Internal Review, January 2020*” (“the **FCA Review Document**”). The document contained the Supervision Hub’s<sup>1145</sup> findings in respect of an internal review it carried out in respect of the handling of consumer contacts about LCF as well as the contacts from LCF directly and the initial approach to the cases raised. The Supervision Hub’s internal review was carried out independently and towards the end of the investigative phase of the Investigation. The Investigation had no knowledge that the internal review was taking place until the FCA Review Document was disclosed to the Investigation in August 2020.<sup>1146</sup> The FCA stated that this document was not disclosed to the Investigation earlier owing to human error. The Investigation regards it as highly unsatisfactory that the FCA Review Document was only provided to it some eight months after it was initially produced.
- 2.9 The methodology adopted by the FCA’s review differed from that adopted by the Investigation. Whereas the Investigation obtained samples of call transcripts and then asked for further information such as call notes in respect of those calls which contained points of interest to the Investigation, the FCA’s review began by looking at call notes first and only listened to the calls themselves “[w]here there was a lack of call notes, or comments which

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<sup>1143</sup> The Investigation also received transcripts of calls between the FCA and LCF made to the FCA’s Firm Helpline. However, as already stated above, it is calls to the Consumer Helpline rather than the Firm Helpline that are of primary relevance to the Investigation.

<sup>1144</sup> The effect which the late production of this Document had on the Investigation, and the delays it contributed to, are described further in **Chapter 1** (Introduction and background).

<sup>1145</sup> The FCA have stated that the Contact Centre was re-branded the “*Supervision Hub*” in early 2019. The FCA has stated that this was a “*deliberate move to signal both internally and externally that the conversations should be considered “supervisory” in nature and a recognition that the role of the department is more strategically important than the “contact centre” name implied*” (see: Enclosure to the letter from Ms Howard to the Investigation, 19 May 2020, at page 28).

<sup>1146</sup> Mr Davidson stated in interview that he had not requested the commissioning of this review (see: Interview with J. Davidson, 28 August 2020, at page 42).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

*caused concern...*"<sup>1147</sup> The different methodologies meant that the Investigation and the FCA reviewed different calls.<sup>1148</sup>

2.10 Following disclosure of the FCA Review Document, the Investigation made a series of document requests to the FCA arising from the FCA Review Document. The documents received as a result of those requests have contributed to the Investigation's conclusions, particularly in respect of the FCA's handling of information provided to it by third parties (see: **Chapter 12**).

2.11 The conclusions reached by the FCA in the FCA Review Document are different to those reached by the Investigation.<sup>1149</sup> This is likely, at least in part, as a result of the different methodologies adopted by the FCA's review and the Investigation's review which resulted in different materials being considered. Furthermore, the FCA review was ultimately not addressing the same issues as those put to the Investigation in the Direction. The FCA's review was more focussed on guidance which consumers were given by the FCA whereas the Investigation's focus is on how the FCA responded to information provided by third parties regarding LCF.<sup>1150</sup>

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<sup>1147</sup> London Capital and Finance: Supervision Hub Internal Review, January 2020, at page 4.

<sup>1148</sup> By way of example, the Investigation has identified calls where fraud or serious irregularity was alleged against LCF but those allegations were not recorded in the call notes (see the call of 18 July 2016 (paragraphs 3.6 to 3.11 of this Chapter) and 21 June 2017 (paragraphs 3.23 to 3.26 of this Chapter)). However, if the FCA's review began by looking at call notes it is unlikely that the FCA's review would have detected allegations of fraud or irregularity made in such calls where they were not recorded in call notes.

<sup>1149</sup> For example, the "key learnings" section of the FCA Review Document, stated that "[t]raining material and knowledge articles were found to be relevant and correct, however there were errors made in the guidance given to some consumers" (see: London Capital and Finance: Supervision Hub Internal Review, January 2020, at page 3). **Chapter 12** of the Investigation's report, however, identified deficiencies in both training materials and knowledge articles. Another "key learning" of the FCA Review Document was that "risk events were raised by the Supervision Hub and (except for a selection of financial promotions risks) were assessed as not requiring further action, in line with advice from Consumer Credit Supervision, based on GCD advice." However, one of the failings identified by the Investigation in **Chapter 12** (Information Provided by Third Parties) of this Report, was that allegations of fraud or serious irregularity were not raised within the wider Supervision Division. The Investigation does, however, agree with the final "key learning" of the FCA Review Document: "[LCF] did feature in [internal management information reports] provided by the Supervision Hub, but they did not have sufficient impact." As described in **Chapter 10** (Adequacy of the FCA's Supervision of LCF), from mid-2016 LCF featured increasingly prominently in the internal FCA document Consumer Investment Products Emerging Themes which indicated that the FCA was receiving a high volume of calls regarding LCF. As stated in **Chapter 10** (Adequacy of the FCA's Supervision of LCF) this was one of a number of red flags that LCF posed a risk to consumers, the significance of which the FCA failed to appreciate.

<sup>1150</sup> This is as a result of paragraph 3(c) of the Direction which raises the issue of whether (i) the FCA had established appropriate policies for responding to information provided by third parties regarding the conduct of LCF; (ii) the FCA



*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

**3. Calls to the Contact Centre which alleged that LCF was engaged in fraud or serious irregularity**

3.1 The Contact Centre received a number of calls which alleged that LCF was engaged in fraud or serious irregularity. These included at least 15 calls from a single individual between 15 July 2016 and 22 February 2018 which raised detailed concerns regarding LCF. The Investigation provides a detailed summary of some of the calls which alleged fraud or irregularity by LCF, and the FCA's responses, below.<sup>1151</sup>

*15 July 2016 calls*

3.2 On 15 July 2016, the Contact Centre received two calls<sup>1152</sup> which alleged irregularities in respect of LCF.

3.3 In the first 15 July 2016 call, the caller<sup>1153</sup> raised the concern that LCF was claiming to pay large sums of money in interest<sup>1154</sup> and to lend large sums of money<sup>1155</sup> despite having little or no assets. The caller also stated that LCF's rates of interest were "*incredibly high for the current market*".<sup>1156</sup> Further, the caller suggested that LCF might be operating a "*pyramid scam*".<sup>1157</sup> The FCA call-handler's notes recording the call on INTACT, however, focussed

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received such information between 1 April 2014 and 30 January 2019; and (iii) whether those policies were properly applied.

<sup>1151</sup> **Chapter 3** (Key events), at paragraph 4.1 provides a less-detailed summary.

<sup>1152</sup> Again it appears these calls were made by the person referred to as Individual A in **Chapter 3** (Key events) above.

<sup>1153</sup> Referred to in **Chapter 3** (Key events) above as "*Individual A*".

<sup>1154</sup> Transcript of call from Individual A to the FCA Contact Centre 15 July 2016, at pages 3 and 4. The caller stated: "*I mean, they're saying that they're paying out huge amounts of interest and have done since 2013, large amounts of interest on millions of pounds coming in each year. Now, I did a credit check on them; they have no assets, either monetary or in building. They have a total outlet of £140,000 in 2015 of money to SMEs, and they're saying they're paying interest out from that, from the interest coming from the loans and they said in 2016, they'd lent out millions, and that's how they're paying the interest back. But the figures don't say that.*"

<sup>1155</sup> *Ibid.*, at page 6. The caller stated: "*I mean, they seem very nice people, they're open, they explain things but they haven't been able to answer my queries why they've only got £8 in the bank and why they've only lent out £140,000 last year when they've lent out millions this year. They just can't answer these questions.*"

<sup>1156</sup> *Ibid.*, at page 7.

<sup>1157</sup> *Ibid.*, at page 6. The caller stated: "[b]ut what concerns me is where that money is held. What they're doing with it, because they're certainly not lending it out to people, and that's what I'm concerned about, are they paying the interest rates, and if they are doing that, out of the money that people are investing in the bonds. In which case, it's just a pyramid scam." Later in the call, the caller stated (see: *Ibid.*, at page 11): "*But I don't want to give them money and find out I'm not going to get it back because when the pyramid scams were made illegal, a lot of people who were involved in the pyramid scams, they went onto this type of thing. They realised that they can make a lot of money from getting money in from people into these mini-bonds which are just worthless bits of paper, as it were, just based on trust, and then they go an invest in*

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

on the caller's queries as to whether LCF held the correct permissions and did not record that the caller had raised concerns as to whether LCF was engaged in fraud or serious irregularity.<sup>1158</sup>

- 3.4 The same caller telephoned the FCA's Contact Centre again later the same day. The caller raised concerns as to whether LCF was really lending to SMEs as it claimed.<sup>1159</sup> The caller also commented on LCF's website<sup>1160</sup> and raised concerns regarding LCF's limited assets.<sup>1161</sup> On this call, again, the caller raised the concern that LCF might be operating a "pyramid scam" rather lending out the money to SMEs.<sup>1162</sup> Again, the call-handler (a different individual from the one who handled call on 15 July) failed to record in his notes the concerns the caller had raised regarding LCF potentially engaging in fraud or irregularity.<sup>1163</sup>

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*things, like the prime mortgage scam, which is basically just these loans to people and then, you know, are they going to pay them back or not? Probably not."*

<sup>1158</sup> The call-handler's notes stated: "[caller] querying permission of another firm. Went through permission explained credit broking and referred him to PERG 2.6 and 2.7. [Caller] feels firm is lending and carrying out activities they are not authorised for. [D]id not want to raise this yet" (see: FCA Text Notes 15 July 2016).

<sup>1159</sup> Transcript of second call from Individual A to the FCA Contact Centre 15 July 2016, at page 2. The caller stated: "[a]t the moment they've got £30 million lent out to 120 SMEs. That's what they're saying. But I have absolutely no evidence or proof of that and they cannot provide that to me, because they say it's confidential."

<sup>1160</sup> *Ibid.*, at page 5. The caller stated: "[f]or example, they have a website, you can go to yourself, you know, and obviously you probably don't want to, and all it talks about is these bonds, which they basically get in – bring in these bonds, from the public. Mini bonds. And people invest in those, and then they lend that money out to these SMEs. And then they pay the interest back on the bonds to the public. Now, of course, this is extremely risky, because its like the prime mortgage situation where money was lent to people that couldn't pay it back."

<sup>1161</sup> *Ibid.*, at page 7. The caller stated: "[t]here were some things that I asked them, which, you see, they don't talk about this on their website of course because it's not good. They're talking now that they've raised £30 million and given that out in loans this last year. Now, I did a credit check on them and the credit check came up – basically they have no assets and no liabilities. Now, they had assets, which was £1.5 million in terms of property. But they had the equivalent in liabilities. So basically they cancelled it out. So they had zilch in the year 2015. Now, they had £3 million coming in in bonds from revenue in that period, but that's not anywhere in their account. So it's really strange... All they've got in their account is £8 at the moment, in their account..."

<sup>1162</sup> *Ibid.*, at page 8. The caller stated: "...they've only got four people working in the lending team. It rings bells, doesn't it. It rings warning bells. So I'm thinking that this company is doing exactly what the pyramid scams doing. What they're doing is they're paying the money out, the interest out from money which people are paying on the bond... In other words, it's just a pyramid scam. And of course it will work, for a year or so, and then it will collapse when people realise what's happening. I may be totally wrong. And hopefully I am. But their revenue last year was £140,000. Now, you're not telling me that they can pay interest out on millions of pounds from £140 million - £140,000. All of that wouldn't go to the interest, anyway, because of all of their other expenditures."

<sup>1163</sup> The call handler's notes stated: "Guided caller the firm he is querying under FRN 722603 do have CB however caller thinks firm is lending through bonds – he does not want to raise anything with the FCA as of yet."

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

3.5 A referral was made from the Contact Centre to the Consumer Credit Supervision Team who in turn referred the case to the Financial Promotions Team.<sup>1164</sup> This resulted in a letter being sent from the FCA to Sentient Capital dated 2 September 2016 raising concerns regarding LCF's website.<sup>1165</sup> Further correspondence between the FCA and Sentient Capital followed.<sup>1166</sup> However, although the FCA raised concerns regarding LCF's financial promotions, it did not consider whether LCF was engaging in fraud or irregularity as the caller had alleged. Nor did it interrogate LCF's accounts for indicia of such fraud or irregularity.<sup>1167</sup>

*18 July 2016 call*

3.6 On 18 July 2016, the same caller<sup>1168</sup> alleged that there were various irregularities in respect of LCF. For example, the caller alleged that LCF's recent rate of growth was suspicious. The caller stated:

*“They're claiming that they have 160 SMEs which they lend money to and they've invested £30 million with them so far since the beginning of the new published financial year. Now I did a company search on them and they have no assets, their amount of money in the bank is £8 and it goes on basically... So they had – during that year, their income was £14,000 and the lending was to one person only and that person was another company of which the director of the company was the same director as the lending company... So basically what I'm trying to find out is how on earth can they suddenly get 160 customers that they lend to when they only had one last year and that was someone basically who was the director of their own company”*<sup>1169</sup>

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<sup>1164</sup> See the summary in **Chapter 3**, at paragraph 3.1 in respect of the FCA's involvement with LCF's financial promotions between 2 September and 3 October 2016.

<sup>1165</sup> Letter from FCA Financial Promotions to Sentient Capital London Limited, 2 September 2016 (Document with Control Number 214183). As explained in **Chapter 3**, the reason for the delay between the referral on 15 July 2016 and the sending of the FCA's letter on 2 July 2016 is unclear.

<sup>1166</sup> See the summary in **Chapter 3**, at paragraph 3.1 (Key Events) in respect of the FCA's involvement with LCF's financial promotions between 2 September to 3 October 2016.

<sup>1167</sup> See the summary in **Chapter 3** paragraph 3.1 (Key Events) in respect of the FCA's involvement with LCF's financial promotions between 2 September- 3 October 2016.

<sup>1168</sup> Again, this appears to be the caller referred to as Individual A in **Chapter 3** (Key Events) above.

<sup>1169</sup> Transcript of call from Individual A to the FCA Contact Centre 18 July 2016, at pages 4 and 5.

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

- 3.7 The caller also made other allegations of irregularity against LCF on the call.<sup>1170</sup>
- 3.8 The Contact Centre call-handler stated that LCF's lending business did not "*fall within our remit as to what we would regulate*".<sup>1171</sup> Subsequently, the call-handler reiterated that "[s]o far as the bonds are concerned that falls outside what we would regulate, that's not something that would be forwarded on because it's not anything that we would have rules against..."<sup>1172</sup> Nonetheless, the call-handler raised a risk event so that the call would be considered within the wider Supervision Division.
- 3.9 However, the call-handler's notes on INTACT summarised the call as one which focussed on whether LCF had the correct FCA permissions for its business.<sup>1173</sup> The call-handler's notes made no mention of the fact that the caller had alleged that there were various irregularities in respect of LCF as summarised in paragraph 3.6 above.
- 3.10 The case was allocated to a supervisor on 28 July 2016 and closed the same day as within risk tolerance having been given a risk score of "*Medium-Low*".<sup>1174</sup> The supervisor's enquiries focussed on whether LCF had the correct permissions.<sup>1175</sup> The notes stated: "[f]irm has correct permissions... and Fin Proms are currently considering the firm's website."<sup>1176</sup> The Investigation has not seen any evidence, however, that the supervisor pursued a broader

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<sup>1170</sup> For example, at one point in the call, the caller stated: "*And they're saying they've got charges on their property, security on them, assets on their property, of course they don't have any assets. It's all horrendous really, the whole thing*" (see: *Ibid.*, at page 15). Individual A also raised the issue of what should happen if a (hypothetical) company were illegally paying interest from bondholder money (see: *Ibid.*, at page 13). The call-handler stated that the caller could go to the police or seek legal advice.

<sup>1171</sup> *Ibid.*, at page 5.

<sup>1172</sup> *Ibid.*, at page 16.

<sup>1173</sup> The Contact Centre call-handler's notes summarised the call as a "*Query as to whether the firm has correct permissions*". The notes also stated "*consumer called to query the permissions of [LCF] as he explained the website states the firm is regulated by us for consumer credit lending*" (see: Case Detail 18 July 2016 (Document with Control Number 122276)).

<sup>1174</sup> Task Detail 28 July 2016 (Document with Control Number 122282).

<sup>1175</sup> For example, an email chain shows that the supervisor received advice issued by the FCA's General Counsel's Division in February 2016 that LCF's issuing bonds did not constitute regulated activity (see: Email Message Detail 28 July 2016 at 4.53pm (Document with Control Number 122278)).

<sup>1176</sup> Task Detail 28 July 2016 (Document with Control Number 122280) and Case Detail, 28 July 2016 (Document with Control Number 122276).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

enquiry as to whether LCF was engaged in fraud or serious irregularity, such as by interrogating LCF's financial information for concerning entries.<sup>1177</sup>

*22 July 2016 calls*

- 3.11 On 22 July 2016, a caller<sup>1178</sup> made further allegations of irregularities in respect of LCF in three separate calls.
- 3.12 In the first call, the caller said that LCF was not genuinely lending to SMEs as it claimed<sup>1179</sup> and that it might be paying interest owed from bondholder's capital.<sup>1180</sup> The caller alleged

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<sup>1177</sup> An FCA summary of how this case was handled does not suggest any such broader enquiry was made either (see: FCA Response to Information Request – LCF\_JUN\_016).

<sup>1178</sup> Again, this appears to be the caller referred to as Individual A.

<sup>1179</sup> Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at page 3. The caller stated: "...*what they say they're doing is they're lending out to SMEs to pay back the interest for the bonds. But I don't think they are, in my opinion... there's absolutely no evidence whatsoever of them doing that either in the past or in the present. There's only been one occasion where they've lent money out, and that was to another company, which was just a shell company, and that was last year on their accounts where they lent, how was it, about £20,000 out to another company, which, and the Director of that company, the debtor, was also the Director who obviously provided loans to the creditor. So that doesn't count, basically, if he's lending to himself. So they haven't basically lent money out to anyone, so I don't know what they're doing. But what they say they're doing, they're not doing.*"

<sup>1180</sup> *Ibid.*, at page 8. The caller stated: "...*they're not paying the money back, I don't care what they say, that they're lending to SMEs. They have no proof whatsoever, and they will not provide you with any proof whatsoever. They won't provide you with a phone number of the lending department, they won't provide an address for the lending department, they won't provide you with any evidence at all from the lending side. And of course everyone, well that's the basis of what they're saying. So I think what they're doing is something, which is a lot, you know, they're probably paying the interest back, but how? ...Now, they may be doing it from the bond holders' capital.*"

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

that LCF was liable to collapse.<sup>1181</sup> The caller also raised concerns regarding Global Security Trustees,<sup>1182</sup> such as whether they were independent from LCF.<sup>1183</sup>

- 3.13 The call-handler stated that the caller's concerns would be logged.<sup>1184</sup> It appears from the call-handler's notes on INTACT, however, that many of them were not recorded.<sup>1185</sup> The call-handler did not refer the case to the wider Supervision Division either.<sup>1186</sup> The call-handler advised the caller to investigate the links between LCF, Sentient and Global Security Trustees more closely<sup>1187</sup> and closed the case with the reason, "*referred to firm.*"<sup>1188</sup>
- 3.14 In the second call, the caller made further allegations. For example, the caller alleged that LCF's website referred to Global Securities Trustees Limited as a company which had been trading for eight years whereas in fact Companies House indicated it had been in existence

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<sup>1181</sup> *Ibid.*, at page 15. The caller stated: "[t]hey're telling me basically their lending, they're lending, but they're not, and if they're not, there's no way they're going to be able to service the interest on the bonds, which of course means its going to collapse... very hard to service that level of interest anyway on the bonds, even if they were getting all that money on interest. Even then, I mean there's, they're just lending to small companies they're saying, and the failure rate is incredibly high... So I have basically checked all the assets of [LCF], and they have zilch."

<sup>1182</sup> As already stated in **Chapter 10** (Adequacy of the FCA's Supervision of LCF), LCF's marketing materials alleged that an additional layer of protection was provided to Bondholders by virtue of LCF granting a charge over its assets to an independent security trustee who held the charge on trust for the benefit of bond holders. For example, the LCF marketing brochure for the two-year 6.5% Income Bonds Series 4 stated under the heading "Security Trustee" "[LCF] has granted the Security Trustee a charge over all of its assets, which includes the value of security [LCF] takes over the Borrowing SMEs' assets. The Security Trustee holds this charge over [LCF's] assets in trust for the benefit of all Bond Holders" (see: <https://shearman.sharefile.com/share/view/s13a21097cc041508>, DSFG Exhibit Part B, at page 16 (last accessed 6 October 2020)). It has since emerged that there are serious questions as to whether the security trustee was independent from LCF. The Chancery Division of the High Court has granted an application to remove the trustee: see *London Capital & Finance Plc v Global Security Trustees Ltd* [2019] EWHC 3339 (Ch) (Chief Master Marsh).

<sup>1183</sup> Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at page 2: "...the company called Global Security Trustees Limited, and they're holding millions of pounds worth of bond holder's money in trust for the bond holders at the termination of the bond period. Unfortunately, I don't have much trust in this company at the moment because they were only formed about a year ago, and they only have about £50 worth of capital and one director." Later the caller alleged links between LCF, Global Security Trustees and the firm of solicitors representing LCF (see: *Ibid.*, at page 7).

<sup>1184</sup> Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at pages 13 and 16.

<sup>1185</sup> The Contact Centre call-handler's notes stated: "[t]he consumer only wished to give his first name. The consumer was interested in investing with [LCF] who he says issue mini-bonds. He said the money deposited with the firm is lent on to SMEs in order to pay interest on the bonds. He was concerned the firm do not have the correct permissions. He also believes the money is held by Global Security Trustee. He also was concerned that the bonds are secured by LCF assets but according to Company's House, they have no assets. Advised the consumer ask LCF about Sentient Capital London's involvement as they have requisite permissions regarding bonds" (see: FCA Response to Information Request – LCF\_AUG\_001).

<sup>1186</sup> FCA Response to Information Request – LCF\_AUG\_001.

<sup>1187</sup> Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at pages 14 and 15.

<sup>1188</sup> FCA Response to Information Request – LCF\_AUG\_001.

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

for one year. The caller also stated that Global Security Trustees only had £50 as capital, had never filed any accounts and only had one director who had held directorships with directors of LCF over many years.<sup>1189</sup> The caller also stated that the caller was having difficulty obtaining information from LCF and that LCF's rate of growth was suspicious.<sup>1190</sup>

3.15 Again, the call-handler's notes on INTACT focussed on whether LCF's permissions were appropriate. The notes also referred to the fact that LCF was not providing the caller with information and was being vague and misleading. However, they did not refer to the caller's other allegations such as those regarding Global Security Trustees or the rate of growth of LCF's business.<sup>1191</sup> In the event, the call-handler did not refer the case to the wider Supervision Division.<sup>1192</sup> This is despite the fact that the call-handler had assured the caller that he would log the call as having potential supervisory interest.<sup>1193</sup>

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<sup>1189</sup> Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at pages 6, 7 and 14.

<sup>1190</sup> For example, the caller alleged that LCF's previous year's accounts indicated that LCF only had one customer but, at the time of the call, LCF was claiming to have lent £30m to 160 small-medium enterprises (see: *Ibid.*, at page 11).

<sup>1191</sup> The Contact Centre Notes read: "[c]alling to report a firm which is claiming to be able to lend but when you check the firms permissions they are only registered to broker loans. When he asked for more details about the firm and their lending criteria they are being extremely vague and misleading" (see: FCA Response to Information Request – LCF\_JUN\_017).

<sup>1192</sup> *Ibid.*

<sup>1193</sup> The call-handler stated: "I'll mark it, when I log the call, I can log it as something that has potential supervisory interest. So, when our colleagues come to listen to the call and listen to the call notes within our supervision team, they may decide that they may just watch firm a little bit more closely for any trends or any further calls we might get from consumers in this regard. Because what we don't want them doing is misleading consumers, because that's one of the things we don't want them to do, mislead. So, that's one of the main things" (see: Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at page 11).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

- 3.16 In the third call, the caller raised concerns as to whether LCF was actually lending to SMEs as it claimed.<sup>1194</sup> The caller also noted that LCF's accounts were overdue<sup>1195</sup> and that he could only ever speak to LCF's marketing team, never to LCF itself.<sup>1196</sup>
- 3.17 The FCA call-handler told the caller that she would speak to a colleague about whether to refer the case to Supervision<sup>1197</sup> and concluded the call by informing the caller that *"the contact centre actually closed about 10 minutes ago"* and that if the caller required further assistance, the caller could call back tomorrow.<sup>1198</sup> In the event, the call-handler did not refer the case to the wider Supervision Division and instead closed the case that same day.<sup>1199</sup>

*19 and 21 June 2017 calls*

- 3.18 On 19 and 21 June 2017, the Contact Centre received further calls<sup>1200</sup> alleging irregularities in respect of LCF.
- 3.19 On 19 June 2017, a caller asked whether the FCA's Principles of Business empowered a consumer to request evidence on what LCF was spending Bondholders' capital on.<sup>1201</sup> The Contact Centre call-handler responded that LCF's bonds *"fall outside of our particular remit. With regards to the information... that would be a commercial decision by the firm."*<sup>1202</sup> The

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<sup>1194</sup> Transcript of call from Individual A to the FCA Contact Centre 22 July 2016, at pages 15 to 17. The caller stated: "[s]o, that's the scenery, that's the scenery but actually, my, my problem is this, that they don't have any track record of ever doing that... They've only been doing this, so far as I know from their company accounts, for the last few months... Last year, they, made £14,000 total for the whole year... And that was from one customer... They'd basically lent £20,000 to one customer and that was the, a company debtor but the director of that company was the same director as the lender company... So, now they're saying something is very strange and that is that they're lending, at the moment, they've got 160 SMEs... and they've lent £30 million to them... But I haven't got any, when I looked into it, I haven't got any evidence whatsoever that they're doing that... There's no website for their lending side. There's no phone number that they will give me for the lending side... There's no physical base for the lending side as far as I can see... I don't know how they're doing it. They are doing it because they're paying the interest out... I mean, who could do that, a company which, for the last few years, has done zilch..."

<sup>1195</sup> *Ibid.*, at page 19.

<sup>1196</sup> *Ibid.*, at page 20.

<sup>1197</sup> *Ibid.*, at pages 13, 14, 18 and 21.

<sup>1198</sup> *Ibid.*, at page 30.

<sup>1199</sup> Case Detail, 22 July 2016 (Document with Control Number 122316).

<sup>1200</sup> Again, it appears these calls were made by Individual A.

<sup>1201</sup> Transcript of call from Individual A to the FCA Contact Centre 19 June 2017, at page 3.

<sup>1202</sup> *Ibid.*, at page 11.



*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

call-handler advised, however, that if LCF appeared unwilling to provide information “*potentially look around at other organisations.*”<sup>1203</sup> The call-handler also recommended that the caller provide the FCA with further information.<sup>1204</sup> The call-handler did not refer the case to the wider Supervision Division.<sup>1205</sup>

3.20 On 21 June 2017, the caller contacted the Contact Centre again. On this call, the caller expressed a number of concerns as to LCF's business. For example, the caller stated that:

(a) the first time he had looked at the mini-bonds offered by LCF he thought that they were an “*absolute formula for fraud... a perfect formula for a scam*”.<sup>1206</sup>

(b) he was having difficulty obtaining information from LCF on what it was spending bondholder's capital on and that the firm was refusing to divulge such information on the basis of data-protection.<sup>1207</sup>

(c) it did not appear that LCF's operations were genuinely set up to lend to businesses. The caller stated in this regard: “[n]ow, *according to Companies House [LCF] only has two employees... Now that's not many and there's supposed to be a large number of people in the Lending Team...*” Later, the caller stated:

“[a]ny, you know, *top loan company has got a public interface. You know, they've got a website, they give all the details of the interest rates, all everything is all there. All of the loan companies, they all behave in the same way. But there is no evidence at all, no email address, no phone number, no premises, no numbers of people that you are lending to, nothing like that is available to the bondholders. So, we have no idea whether this what you're doing. In fact, it doesn't look like you are doing that at all. And then they say, “Well, we'll just pass your request on*

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<sup>1203</sup> *Ibid.*

<sup>1204</sup> *Ibid.*, at page 14.

<sup>1205</sup> Case Detail 19 June 2017 (Document with Control Number 123872).

<sup>1206</sup> Transcript of call from Individual A to the FCA Contact Centre 21 June 2017, at page 10.

<sup>1207</sup> *Ibid.*, at pages 4 to 6.

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

*to...” and then it goes to another level of account management in the Marketing team again.”*<sup>1208</sup>

(d) LCF's rate of growth was suspicious. The caller stated: *“I mean, at the moment they say they've got 400, £415 million worth of securities from SMEs and this, what, 250 or something loans lent out. And this is all in a matter of months with no evidence at all that they were doing this before.”*<sup>1209</sup>

(e) LCF's marketing was misleading. The caller stated: *“And then, of course, things which are misleading and their website, things that they were saying just weren't true, for example, all of their assets, the company's assets were in security for the, for the bond, to the bondholders. But all you'd have to do is a simple credit check and it showed that all the liabilities wiped out their assets and the only at about three and a half million anyway, which isn't going to cover millions of bonds anyway so that didn't, you know, that was just ridiculous really what they were saying.”*<sup>1210</sup>

3.21 The Contact Centre call-handler told the caller that he would raise the case with the Supervision Division.<sup>1211</sup> While the call-handler did refer the case to the Supervision Division. However, the call-handler's notes did not refer to many of the points of concern which the caller had raised.<sup>1212</sup>

3.22 The Supervision Division subsequently closed the case on 26 June 2017 on the basis that there was *“no breach.”* The case resolution notes which explained the reason for the case's closure stated that the information on the LCF website sufficiently explained what the firm would do with any investment and therefore there was no breach.<sup>1213</sup> The Supervision

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<sup>1208</sup> *Ibid* at pages 6 and 7.

<sup>1209</sup> *Ibid.*, at page 9.

<sup>1210</sup> *Ibid.*, at pages 10 and 11.

<sup>1211</sup> *Ibid.*, at page 8.

<sup>1212</sup> The Contact Centre call-handler's notes read as follows: *“Consumer called back. Calling regarding mini-bond, said it's designed to fail. Said they shouldn't be offered due to high risk. Always retail marketed. Quoted Pin 7, referred to ICO and referred to Supervision”* (see: FCA Response to Information Request – LCF\_JUN\_017).

<sup>1213</sup> The case resolution notes stated: *“Firm is offering a “corporate bond” selling debentures in their own firm, which is excluded from the regulated activity of dealing in investments as principal. The information on the firm's website states: “Investors should note that repayment of the bonds offered by [LCF] and the payment of interest on the bonds, depends on*

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

Division does not appear to have interrogated whether LCF was genuinely engaged in lending activity despite the caller's concerns in this regard as set out above. Nor does the Supervision Division appear to have interrogated LCF's financial information for evidence of irregularity. As already explained, the Investigation considers that failures such as these are particularly serious.<sup>1214</sup>

*10 July 2017 call*

3.23 On 10 July 2017, the FCA received a further call from the same caller.<sup>1215</sup> The caller again alleged irregularities in respect of LCF. The concerns which the caller raised included the following:

- (a) LCF was paying interest out of Bondholders' money and the caller had suspicions that LCF may be a "pyramid scam";<sup>1216</sup>
- (b) The rates of interest which LCF charged to businesses were suspicious;<sup>1217</sup>
- (c) It did not appear that LCF's operations were genuinely set up to lend to businesses;<sup>1218</sup>

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*the performance of loans made by [LCF] to various small and medium-sized enterprises. In the event that these borrowers default on the loans, investors may lose some or all of their investment." This seems to explain what the firm will do with any investment they received therefore there does not appear to be a breach" (see: Case Detail 21 June 2017 (Document with Control Number 123786)).*

<sup>1214</sup> The Investigation has set out its criticisms of the FCA with regard to such failures in **Chapter 12**.

<sup>1215</sup> Again, it appears these calls were made by Individual A.

<sup>1216</sup> Transcript of call from Individual A to the FCA Contact Centre 10 July 2017, at pages 24 and 25 (Document with Control Number 120784). The caller stated: "...I'm just trying to understand how it is that they're raising the money because I'm unfortunately coming to the conclusion that they are paying interest out of the bonds' money... Not out of these loans and interest... but they're paying it out of the capital itself... That's what I'm afraid they're doing. Of course, then it's going to collapse." Later the caller stated: "They were hiding information [on the low number of employees] to give the idea that the company was big you know. Various other things you know that I came across like this, so I was just concerned that they were doing this. That there is a possibility that the money was being paid from the capital. Now, of course, that is illegal. They can't do that. It's no better than a pyramid scam and it will collapse. But I can't believe [a senior person at LCF] would do that, but I haven't found any evidence to show that what he said he's doing, he is doing" (see: *Ibid.*, at page 26).

<sup>1217</sup> *Ibid.*, at page 15. The caller stated: "I don't see how it can possibly be done because their model doesn't work, their business model doesn't work. They're offering you know, on these loans they're offering between 11 and 20% interest to the SME's which is way above the market. I mean, most companies [of] good standing can get a 25,000 pound unsecured business loan for 4%"

<sup>1218</sup> *Ibid.*, at pages 11 and 12. The caller stated: "...my problem is that I can't find any evidence at all of the lending side. And they have no loan interface with anyone, no email address or phone number or website for any person to apply for a loan... if you are a medium, if I wanted to apply for a loan, I would have to send an email to the marketing team, which is

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

- (d) The rate of LCF's growth was suspicious;<sup>1219</sup>
- (e) LCF was using bondholder's capital for its promotions whereas LCF had stated that bondholders capital was to be used to lend to businesses;<sup>1220</sup>
- (f) There were questions as to whether the trustee company associated with LCF was performing its functions;<sup>1221</sup>
- (g) It was not possible to speak to LCF directly;<sup>1222</sup> and
- (h) LCF's marketing appeared designed to target unsophisticated investors.<sup>1223</sup>

3.24 The call-handler noted in the course of the call that LCF's issuing bonds was not regulated activity but that LCF's marketing was regulated.<sup>1224</sup> The call-handler also stated that they would send the caller details which the FCA had on LCF so the caller could examine LCF's

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*very unusual. And so, I can't see any evidence in relationship to the lending side, so I'm thinking that they're not lending directly themselves to companies, but actually brokering..."*

<sup>1219</sup> *Ibid.*, at pages 12 and 13. The caller stated: "I mean, they're saying they lent out to what, 250 small and medium enterprises and so I think there's 200, they've got 250 million in assets from them... And they've lent out 50 million or something, out, something like that. But all of this has only taken place in a matter of months... And they, they don't have a track record of doing this you see. They don't have any track record of doing this at all. So, I don't see how they've managed to, I mean to get this kind of money is extremely hard indeed in the way the economy is, to do this kind of results. To get millions in a matter of months is, I don't know how they can do it. I mean, you can't possibly do this kind of work with just two employees who are operators, students in an office. And there's only chief executive officer and the directors, the other directors are coming and going, and they have their own companies that they're working in."

<sup>1220</sup> *Ibid.*, at pages 16 and 17. The caller stated: "Now, judging from their, their last return they've already spent 8.5 million on contractors. Now, that, does worry me a bit because the company's not allowed to actually spend the bond holder's capital on promotion... Stated purpose is that the money from the bond holders, the bond holders' capital is to be used for loans, interest bearing loans to small and medium enterprises. Now, if it's taken, if the promotion is taken out from that, then of course that's not right"

<sup>1221</sup> *Ibid.*, at pages 17 and 18. The caller stated: "unfortunately it's not possible for the bond holders to get accounts relating to what the money is being used for and the trustees are not every efficient at all regarding this. In fact, the trustee to this company has been a director with the chief executive officer on many companies... Now, the trustees, they have to give out monthly reports of this [money not being used for its stated purpose], but nothing was mentioned about this in any of their reports. They're not doing their duty"

<sup>1222</sup> *Ibid.*, at page 5. The caller stated: "It's not possible to be put through to the company directly. You can only speak to the marketing people in relation to the bond. They won't put you through to the company and there is no number to actually speak to them or email address."

<sup>1223</sup> *Ibid.*, at pages 21 and 22. The caller stated: "FCA Call Handler: is the company aware that they're not sophisticated investors? Caller: Well they, they, it's self-assessment. It's self-assessment, they don't check. They just give them the document and they just sign it. It's as simple as that. They take whatever the person says and if the person wants to invest in the company, he's going to lie... I've spoken to them and they're not sophisticated investors. They're just people who are coming out of the bank because they're getting pathetic rates of interest... That's retail marketing. You, if you look at that site, the [LCF] site that's geared for retailers."

<sup>1224</sup> *Ibid.*, at page 10.

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

permissions. The call-handler stated: *"If you have further concerns just give us a call back. But as I repeated before, this wouldn't be regulated activity so our rules and regulations wouldn't apply."*<sup>1225</sup>

3.25 Despite the considerable number of concerns which the caller had raised, the Contact Centre call-handler did not refer the case to the wider Supervision Division. This is despite the fact that the call-handler's notes on INTACT recorded the caller's concerns as to the way LCF was using its capital.<sup>1226</sup>

*20 July 2018 call*

3.26 On 20 July 2018, the FCA received a further call which alleged irregularities in respect of LCF. The caller's concerns and allegations included the following:

- (a) LCF refused to provide information;<sup>1227</sup>
- (b) LCF was *"full of lies"* and that its business did not appear to be genuinely set up to lend to businesses;<sup>1228</sup>
- (c) LCF's rate of growth was suspicious in the light of its low staff numbers and the balance of staff being weighted to marketing personnel;<sup>1229</sup> and

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<sup>1225</sup> *Ibid.*, at page 27.

<sup>1226</sup> The Contact Centre call-handler's notes stated: *"Call attached. Consumer called as he had concerns about [LCF] and the interest rates they are charging in relation to bonds. He believes money is coming from Capital itself. Explained not regulated. Consumer also wanted to know if mortgages for commercial is regulated, or lending to business, explained it's not... Will email consumer details of company from register and what is a regulated mortgage"* (see: FCA Response to Information Request – LCF\_JUN\_017).

<sup>1227</sup> Transcript of call to the FCA Contact Centre 20 July 2018, at pages 4, 5, 7 and 8. For example, the caller stated: *"I would never dream in a million years of investing my money in this company. Why? Because they will not provide any information as to the very fundamentals that an investor looks to when its evaluating an investment."*

<sup>1228</sup> *Ibid.*, at page 20. The caller stated: *"Well [LCF], their website is just to do with the marketing of the bond. It's nothing to do with [LCF's] business that they, you know, applied to you for. There is no evidence that the business exists and I mean recently it's started to get a bit better but for two, three years there was nothing, absolutely nothing. No physical evidence existed. That was the thing and when you, again and now they've got more, well they've got premises last year and they've got, you know, more staff but still it's full of lies. You phone them and say, "Can you give me the names of the lending scheme please?" "No". "Can you tell me where they're based?" "No". "Is there any information about the business of the commercial side that you can give me to show that it exists?" "No". "And can you give me a name of one of the persons that you've lent with?" "No". "Why?" "Because data protection"."*

<sup>1229</sup> *Ibid.*, at pages 22 and 33. For example, the caller stated: *"If I phone up... and say to them, "How many employees are there in [LCF]", they'll say, "50", when actually 48 members or so, whatever of that company of, they say are members, workforce of [LCF] they're all Surge Financial, which is just a bond marketing team that [LCF] have contracted."*

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

- (d) The relationship between Global Security Trustees and LCF was suspicious.<sup>1230</sup>
- 3.27 The Contact Centre call-handler's notes recorded the call in detail.<sup>1231</sup> This time, the call-handler also referred the case to the Supervision Division.
- 3.28 However, despite the concerns which the caller raised, and the extensive notes written by the Contact Centre call-handler, the Supervision Division failed to appreciate the risk which LCF posed. The case was closed as being "*Within risk tolerance.*" The closure notes stated: "*Concerns relate to firm's unregulated activities. Reg history checked. Considered as within risk tolerance.*"<sup>1232</sup> In reaching this conclusion, the Supervision Division does not appear to have considered LCF's financial information for evidence of irregularity.
- 3.29 Section 3 above summarised calls to the Contact Centre which alleged that LCF was engaged in fraud or serious irregularity, and the FCA's response to those calls. Section 4 below considers a separate category of calls, namely calls to the Contact Centre which enquired whether LCF was operating a scam.

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<sup>1230</sup> *Ibid.*, at pages 29 and 30. The caller stated: "*So there are sometimes off the shelf directors. The new guy there, he was fired from this last director, the director for Global Security Trustees...*" Later the caller stated: "*on the website of [LCF] they used to say all kinds of inaccuracies. One of them was... 'Our trustee, GST, they are a very popular 200-year-old company' okay? ... That's just plain wrong...*" (see: *Ibid.*, at pages 31 and 32).

<sup>1231</sup> The call-handler's case notes stated: "[20 July 2018 at 11:47] *Mini Bonds offered by Regulated Companies Wants to make commercial companies to due diligence Offered a bond at 8% but firm wont provide enough information. Being lost to ordinary people Feels this firm is being miss-led firm refuse to discuss. The website is just advertising the bond and no evidence the commercial lending business existed*" and "[20 July 2018 at 12:26] *Updated note for a call: Consumer is concerned about the activities and lack of transparency of the firm. Unregulated Mini Bonds offered by Regulated Companies Wants FCA to force firms to be transparent even on unregulated investments Wants to make commercial companies do and provide due diligence and disclosure of holding the assets Offered a bond at 8% but firm wont provide enough information. Being lost to ordinary people Feels this firm is miss-leading consumers. firm refuse to discuss unregulated bonds and their processes. The website is just advertising the bond and no evidence the commercial lending business exists or any due diligence by the firm on the bonds, Firm does not respond to e-mails and wont go into details of the bonds. No evidence to show the firm primary business is as a lender. No protection for the bond holders as the money is not segregated as once in the hands of the issuer can do what ever they want with the funds, and firm refuse to disclose the business practises and where the investment from the bondholders are going Trustee of London Capital has been suspended for a year due to loss money in dubious Carbon Credit schemes and was director of the trust Global Security Trustees... Dismissed accountant when wanted to disclose details of interest payments, The track record of paying interest was only one loan to a member of the firm in 2015. Where is the money coming from for the interest payments firm will not disclose. Going to speak to solicitor and advise of concerns*" (see: FCA Response to Information Request – LCF\_JUN\_017 and Case Detail 20 July 2018 (Document with Control Number 125069)).

<sup>1232</sup> Case Detail, 20 July 2018 (Document with Control Number 125069).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

**4. Calls to the Contact Centre which made enquiries as to whether LCF was operating a scam**

4.1 Some calls to the FCA enquired whether LCF was operating a scam, but did not allege that LCF was in fact doing so. Some of these calls are summarised below. As also explained below, a feature of some, but not all, of these calls is reassurance by Contact Centre call-handlers that if LCF was FCA-authorised it was unlikely to be operating fraudulently.

*23 January 2017 call*

4.2 On 23 January 2017 a caller, aged over 70, requested information on LCF prior to investing on the basis that the interest rate offered of 8% “*seems rather a lot*”.<sup>1233</sup> She wanted to find out whether the firm was “*legit*”.<sup>1234</sup> The call-handler provided reassurance that if LCF was FCA-authorised it was unlikely to be operating a scam.<sup>1235</sup>

*6 March 2017 call*

4.3 On 6 March 2017, a caller phoned the FCA regarding an investment made by a relative in LCF and enquired whether there was a cooling-off period during which they could withdraw from the investment.<sup>1236</sup> After the caller had noted that the investment was not covered by the FSCS, the call-handler advised the caller to consult the Terms and Conditions of the caller’s relative’s investment with LCF to see if there was a cooling off period.<sup>1237</sup>

4.4 During the call, the Contact Centre call-handler also made statements to the effect that because LCF was FCA-authorised it was unlikely to be operating a scam. For example, in

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<sup>1233</sup> Transcript of a call to the FCA Contact Centre, 23 January 2017, at page 5.

<sup>1234</sup> *Ibid.*, at page 6.

<sup>1235</sup> For example, the caller stated after having been given LCF’s phone number by the Contact Centre call-handler “*If I phone this company, they’re to do with you, are they?*” The call-handler responded “*Yes. If you phone this company, you just, you just make sure that it is, in fact, the company that you have been dealing with up until now...*” *Ibid.* p. 12. Later in the call the following exchange occurred. The call-handler stated: “*So just to save you, if they are a scam... just to save you from that hassle, from that trouble, just to be on the safe side, if you contact the number that is directly on our register... and communicate to them via this, and just discuss your options about the bond... and see if they are, in fact, the same company you have been dealing with up until now*”. The caller stated “*...to see if the, to see if it’s legit for the firm*” to which the call-handler replied “*Yes. Yes, that’s correct*” (see: *Ibid.*, at pages 12 and 13).

For completeness, following the call, the call-handler did not refer the case to the wider Supervision Division although given the nature of an enquiry this is unsurprising.

<sup>1236</sup> Transcript of a call to the FCA Contact Centre, 6 March 2017, at page 2.

<sup>1237</sup> *Ibid.*, at pages 11 and 12

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

the course of explaining what an “*asset-backed bond*” was, the call-handler stated “[s]o you’re effectively investing in a business and you’re going to see a return. Now, the business appears to be regulated, so it doesn’t appear from the information you’ve given to me and the information that I’ve found, it doesn’t appear to be a scam or anything along those lines, so it may actually have a cancellation or cooling-off period with regards to the money” (emphasis added).<sup>1238</sup>

*1 July 2016 call*

4.5 The Investigation has also seen examples of calls where Contact Centre call-handlers did *not* assume that, simply because LCF was FCA-authorized, it was unlikely to be a scam.

4.6 For example, on 1 July 2016 a caller stated that “*certain products... seem to be too good to be true. I just wanted to check*”.<sup>1239</sup> After conducting brief investigations on LCF’s website, the call-handler advised the caller to “*be very cautious of what you have found*”.<sup>1240</sup> The call-handler also said, “*I mean, firms can provide non-regulated investment, but then the information needs to be provided very clearly. So, I would solemnly advise to be very cautious...*”<sup>1241</sup> The call-handler also advised the caller to report LCF to Action Fraud.<sup>1242</sup>

4.7 On this occasion, the call-handler raised a risk event with the Supervision Division. His notes recorded that he advised the consumer to be very cautious.<sup>1243</sup> However, the Supervision

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<sup>1238</sup> *Ibid.*, at pages 11 and 12. The Contact Centre call-handler also made similar statements elsewhere on the call: (1) “*the good news is, it doesn’t appear to be a scam, so it doesn’t appear that you’ve lost your money from what you’ve said to me so far, and the information that I hold on the business*” (see: *Ibid.*, at page 12); (2) “*some asset-back bonds aren’t regulated and it’s very unclear right now as to the type of asset-backed bond your [relative] may have invested in but the **key thing here to remember is that the business is, indeed, regulated, okay? So, you haven’t lost your money to a scam. However, if you want to find out about the cancellation side of things, you would need to contact the business***” (see: *Ibid.*, at page 13); and (3) “*Yeah, I mean, if there’s any good bit of news from what this is, right now it doesn’t appear the money has been lost to a scam, okay, but the next steps available for you would be to get in contact... with the company on the number I’ve provided, okay, to find out if there is any cooling-off period*” (emphasis added) (see: *Ibid.*, at page 16).

<sup>1239</sup> Transcript of a call to the FCA Contact Centre, 1 July 2016.

<sup>1240</sup> *Ibid.*, at page 7.

<sup>1241</sup> *Ibid.*, at page 8.

<sup>1242</sup> *Ibid.*, at pages 8 and 9.

<sup>1243</sup> The case notes stated: “[01 July 2016 at 12:44] *Please ignore the other notes they are incorrectly attached. Consumer was concerned if this firm is authorised to provide investments. consumer did point out the interest rates advertise on the firm's website as <https://www.londoncapitalandfinance.co.uk/>. I could not find investment permission on the firm's file also there is not clear information about the investment I felt. My understanding is that firm might be referring to peer-to-peer investments however they don't have permission for this service either. I advise consumer to be very cautious.*” Other notes stated: “[01 July 2016 at 13:15] *Consumer was concerned that if firm is authorised to provide investment service. Consumer*



*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

Division closed the case on the basis it had been raised in error.<sup>1244</sup> They emailed the call-handler stating, “*there is an article on Knowledge... which identifies that we are already aware of this issue and the firm is not in breach of its scope of permission.*”<sup>1245</sup>

4.8 Section 5 below explains a further category of communications to the Contact Centre, namely communications which suggested that LCF's financial promotions were misleading.

**5. Communications to the Contact Centre and the Financial Promotions Team which suggested that LCF's financial promotions were misleading**

5.1 The Contact Centre received a number of communications from third parties suggesting that LCF's financial promotions were misleading. Sometimes, third parties also communicated directly with the Financial Promotions Team (for example, by emails to the financial promotion team's email address) rather than by going through the FCA's Contact Centre.<sup>1246</sup> Such communications came in a variety of forms such as via phone call, email, webform as well as communications from the Advertising Standards Agency (“ASA”).

5.2 The first occasion on which the FCA intervened in respect of a financial promotions breach by LCF was by letter dated 18 January 2016.<sup>1247</sup> The letter followed a consumer's email to the FCA regarding LCF's website.<sup>1248</sup> In the event, the FCA's letter to LCF, among other things, alleged a breach of the FCA's financial promotions rules by LCF regarding inadequate risk warnings and a “*protection 100%*” claim used on LCF's website.

5.3 Similarly, the FCA's intervention in respect of LCF's financial promotions by its letter dated 5 April 2017 was precipitated by a member of the public emailing the Financial Promotions

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*referred to the firm website where <https://www.londoncapitalandfinance.co.uk/> I could not understand clearly the nature of investment mentioned on the website. I got the impression that investment is possibly a crowdfunding service, however the concerns I have are that I could not find any investment permissions neither peer-to-peer lending. I advise consumer to be very cautious of” (see: FCA Response to Information Request – LCF\_JUN\_017).*

<sup>1244</sup> Case Detail, 4 July 2016 (Document with Control Number 122188).

<sup>1245</sup> Email Message Detail 5 July 2016 (Document with Control Number 122190). This was a reference to “*Knowledge Article 4102*” regarding how Contact Centre call-handers should deal with permissions queries regarding LCF (see: Knowledge Article 4102, London Capital & Finance plc, 6 June 2016 to 8 July 2016).

<sup>1246</sup> Case Detail 22 June 2017 (Document with Control Number 123793).

<sup>1247</sup> Letter from FCA Financial Promotions Team to LCF, 18 January 2016 (Document with Control Number 214259). Further detail regarding this intervention is provided in **Chapter 3** (Key Events).

<sup>1248</sup> Email Message Detail 13 December 2015 (Document with Control Number 121481).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

Team in March 2017.<sup>1249</sup> Furthermore, as already explained above, the FCA's intervention against LCF's financial promotions in September 2017 was also precipitated by calls from Individual A alleging fraud or irregularity on 15 July 2016 (see paragraphs 3.2 to 3.5 above).

5.4 Where communications regarding misleading financial promotions came to the Contact Centre, such communications were consistently referred from the Contact Centre to the wider FCA, and in particular to the Financial Promotions Team.<sup>1250</sup> However, as explained elsewhere in this Report, LCF's multiple financial promotions breaches never resulted in the FCA considering LCF's business in a holistic way. For example, the FCA never considered whether LCF's business model was designed to exploit LCF's FCA-authorized status in its financial promotions to promote its (unregulated) bond business.

**6. Calls to the Contact Centre which made general enquiries about LCF's permissions**

6.1 In many of the calls which the Investigation has reviewed, callers did not allege possible fraud, irregularities of financial promotions breaches in respect of LCF at all. Rather, many callers contacted the Contact Centre to determine whether by issuing its bonds LCF was conducting regulated activity and whether they would, in consequence, benefit from the protection of the FSCS.

*Advice regarding FSCS coverage*

6.2 In many instances, the Contact Centre generally correctly<sup>1251</sup> advised callers that LCF's issuing bonds was unlikely to constitute regulated activity and was unlikely to benefit from

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<sup>1249</sup> Email Message Detail 20 March 2017 (Document with Control Number 123602). Further detail regarding this intervention is provided in **Chapter 3** (Key Events). As already explained in **Chapter 9** (Appropriateness of LCF's Permissions) and **Chapter 10** (Adequacy of the FCA's Supervision of LCF), while the FCA intervened with respect to concerns regarding LCF's website, the FCA failed to investigate the allegation that LCF might have been engaged in fraud (the member of the public's email stated "*I feel that this has to be a scam*").

<sup>1250</sup> See for example (1) Case Detail 15 December 2015 (Document with Control Number 121491); (2) Case Detail 7 September 2016 (Document with Control Number 122506); and (3) Email Message Detail 2 August 2018 (Document with Control Number 125080). Thereafter, the FCA in some cases took action while in other cases it did not. For example, in one case, the Financial Promotions Team followed up on concerns raised by a consumer regarding LCF's website but did not locate the issue the consumer was complaining about and there had, in any event, recently been an intervention by the FCA in respect of LCF's website (see: Case Detail 19 October 2016 (Document with Control Number 123011)).

<sup>1251</sup> As explained in **Chapter 9** (Appropriateness of LCF's Permissions) and **Appendix 5** above, the Investigation's view is that LCF's issuing bonds did not constitute regulated activity. Accordingly, LCF's issuing bonds, which was the main activity LCF undertook, was outside the FCA's perimeter. The Investigation is, however, aware that judicial review proceedings are ongoing which raise the question whether LCF's issuing bonds constituted regulated activity. The

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

the protection of the FSCS.<sup>1252</sup> In a more limited number of instances, however, FCA call-handlers incorrectly advised callers that an investment in LCF's bonds would benefit from FSCS protection.

- 6.3 For example, on 15 April 2016, a caller stated that, in respect of LCF, he was *"looking at taking out a bond, it's got quite a bit of money going into it"*. The FCA call-handler stated *"I've managed to locate the firm, yes, and [LCF] are registered with us, and they are also, these, the products that they're offering, in other words their website... is approved as a financial promotion by another firm called Sentient Capital London Limited, which is also registered with us. So, yes, both firms are regulated by us, which means you would be protected up to a certain limit if you were to use their services, by the FSCS, the Financial Services Compensation Scheme"* (emphasis added). The caller then stated *"Right, so we would be protected?"* to which the FCA call-handler responded *"Yes, that's correct, yes."*<sup>1253</sup>
- 6.4 On 24 June 2016 a caller stated they were looking to invest in a fixed three-year income bond at 8% per annum. The caller stated *"[i]t does sound too good to be true doesn't it"* to which the FCA call handler replied *"Let's have a look"*. The call handler then stated, *"[LCF]... So that's coming up as authorised and regulated, so that's absolutely fine. That means if you wanted to invest with them, you'd be protected by up to £50,000 by the Financial Compensation Scheme."*<sup>1254</sup>
- 6.5 Similarly, on 1 July 2016, a caller phoned up regarding LCF and said, *"they're offering three year bond paying 8%"*. The FCA call-handler stated that the *"they are authorised and they are regulated"*. The call-handler added that *"if they're dealing investments, they're also covered by the Financial Services Compensation Scheme"* up to a level of £50,000 if the

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Investigation's view is not binding or legally determinative of this issue which can ultimately only be resolved by the Courts rather than this Investigation.

<sup>1252</sup> See (1) Transcript of a call to the FCA Contact Centre, 4 April 2016, at page 10; and (2) Transcript of a call to the FCA Contact Centre 3 October 2016, at page 5.

<sup>1253</sup> Transcript of a call to the FCA Contact Centre 15 April 2016, at pages 1 to 3.

<sup>1254</sup> Transcript of a call to the FCA Contact Centre 24 June 2016, at pages 2 to 3.

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

company were to fail.<sup>1255</sup> The FCA call-handler also reassured the caller that LCF was unlikely to be a scam based on its FCA authorised status.<sup>1256</sup>

6.6 The Investigation has seen further similar examples of the FCA reassuring callers that LCF benefited from FSCS coverage on 27 June 2016,<sup>1257</sup> 24 July 2017,<sup>1258</sup> 26 July 2017,<sup>1259</sup> 7 August 2017,<sup>1260</sup> and 6 September 2018.<sup>1261</sup>

*Reassurance regarding LCF's reputability*

6.7 Sometimes call-handlers reassured callers that LCF was likely to be a reputable company on the basis of its FCA-authorised status. This occurred in calls on 3 October 2016,<sup>1262</sup> 8 June 2016,<sup>1263</sup> 24 June 2016 (paragraph 6.4 above) and 1 July 2016 (paragraph 6.5 above). In some other calls, however, call-handlers warned investors about investing in LCF.<sup>1264</sup>

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<sup>1255</sup> Transcript of a call to the FCA Contact Centre 1 July 2016, at pages 1, 3 and 5.

<sup>1256</sup> *Ibid.*, at pages 4 and 5. In response to the caller's statement "...I've never heard of them before, you see, so I wasn't certain, you know, if they were real or if it's a scam." On the basis of LCF's FCA authorised status the FCA call-handler reassured the caller "I mean as long as you speak to their main details on their website... and not anybody randomly calling you, then, then should be fine, okay..."

<sup>1257</sup> Transcript of a call to the FCA Contact Centre 27 June 2016, at page 3.

<sup>1258</sup> Transcript of a call to the FCA Contact Centre 24 July 2017, at pages 2 to 5.

<sup>1259</sup> Transcript of a call to the FCA Contact Centre 26 July 2017, at pages 3 and 4.

<sup>1260</sup> Transcript of a call to the FCA Contact Centre 7 August 2017, at pages 3 and 4.

<sup>1261</sup> Transcript of a call to the FCA Contact Centre, 6 September 2018, at pages 3 to 4.

<sup>1262</sup> In this call, the Contact Centre call-handler reassured a potential investor on the basis of LCF's FCA authorisation. After the call-handler noted LCF's issuing bonds were unlikely to constitute regulated activity and were unlikely to benefit from the protection of the FSCS, the caller asked "getting regulated by FCA, is it quite an in-depth thing?" The call-handler responded: "Oh, yes. No, no. So, basically when a company is being, applying for authorisation from us, they have to provide us with pretty much everything about the company itself. So, including, we need, obviously the full business plan of the business that they're looking to carry out, because that, just as an example, that is something that we would use to balance off, so understand what they're applying for. So, we will only expect them to be applying for permissions that they're going to be using. In addition to that, not only is there, kind of, a full in-depth look into the actual company itself, but then individuals carrying out significant roles, so if there's a director of the company, if there's somebody going to be carrying out, you know, business as a money laundering reporting officer for the company, each of those individuals, whilst they would already work for the firm essentially need to apply for the job that they're going to be carrying out within that company." Transcript of a call to the FCA Contact Centre 3 October 2016, at pages 5 to 8. See also the calls on 24 June 2016 and 1 July 2016 referred to above.

<sup>1263</sup> In this call, the caller asked "[s]o am I safe to invest with them then?". The FCA call-handler responded "[y]ou yourself are safe, they are registered with us, okay?" (see: Transcript of a call to the FCA Contact Centre 9 June 2016, at page 3).

<sup>1264</sup> In one call the call-handler noted "And what's the, I know you said to me, you know, the old saying, if it looks too good to be true it probably is and that often is a pretty fair assessment" (see: Transcript of a call to the FCA Contact Centre 23 May 2016, at page 8).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

6.8 Sections 3 to 6 above have summarised calls which the FCA received in its Contact Centre regarding LCF, and the FCA's response. Section 7 below summarises other information that the FCA received from third parties, and the FCA's response.

**7. Other information the FCA received from third parties**

7.1 Aside from calls to its Contact Centre, the FCA also received other information from third parties regarding LCF during the Relevant Period. A non-exhaustive summary of such information appears below.

7.2 At the outset, however, the Investigation reiterates that it has been unable to determine definitively whether the FCA received the Liversidge Letter, which has received much attention from the Bondholders and the media in the wake of LCF's collapse.<sup>1265</sup> Consequently, that letter (which has already been described in **Chapter 3** (Key Events)) is not referred to further below.

*Anonymous Letter in early 2017*

7.3 A further item of information that the FCA received from a third party was the Anonymous Letter sent to the FCA in early 2017. That letter, which was copied to the police, alleged that LCF was engaged in fraud. The Anonymous Letter, and the response by the FCA's Authorisation and Supervision Divisions to it are considered in **Chapter 9** and **Chapter 10** of this Report.<sup>1266</sup>

*Communication from a journalist in late 2018*

7.4 The FCA also received a warning from a newspaper journalist in late 2018 that LCF and a price comparison site were in some way linked and that the risk which LCF's products posed were not properly advertised.<sup>1267</sup> The sequence of events by which the journalist raised these concerns with the FCA was as follows.

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<sup>1265</sup> See **Chapter 3** (Key Events), at paragraphs 4.2 to 4.11.

<sup>1266</sup> Further detail is also provided in **Chapter 3** (Key Events), at paragraph 4.1.

<sup>1267</sup> Email from the Evening Standard to the FCA Press Office, 2 November 2018 at 12:01pm (Document with Control Number 214367).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

- 7.5 The journalist raised the above concerns with the FCA's Press Office on 2 November 2018. At this stage, the journalist had anonymised his comments and so the FCA would not have been able to tell whether they referred to LCF or some other firm. The FCA press officer forwarded it on to the FCA's Unauthorised Business Department the same day saying the email was "*about a boiler room scam*". The same day, the FCA's Unauthorised Business Department requested the FCA Press Office to ask the journalist to share further details with the FCA.<sup>1268</sup>
- 7.6 The further information was provided to the Unauthorised Business Department on 6 November 2018 by an internal email which did not copy the journalist. At this point, the information named LCF. The FCA's Unauthorised Business Department responded the same day noting that, as LCF was FCA-authorized, the concerns were matters for the FCA's Supervision Division. The Unauthorised Business Department copied the FCA's Financial Promotions Team and the Flexible Event Team within the Supervision Division.<sup>1269</sup>
- 7.7 On 7 November 2018, the Flexible Event Team forwarded the email chain to a lead associate in the FCA's Corporate Finance Team noting that it concerned a "*boiler room scam*" and that "*I can see you have an open case against the firm.*"<sup>1270</sup> The chain was subsequently forwarded to a staff member in the Intelligence Team,<sup>1271</sup> which had independently already begun considering LCF in around October 2018 (see **Chapter 13** (Other Matters of Importance to the Investigation)).
- 7.8 On 3 December 2018, the journalist chased the FCA for information. Various FCA staff members discussed how to respond in the light of the fact that, by this stage, the FCA was undertaking covert investigations against LCF and considering enforcement action. It appears that the FCA did not pass on any information to the journalist because, on 31 January

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<sup>1268</sup> Email from the FCA Press Office to the Unauthorised Business Department, 2 November 2018 at 5:35pm (Document with Control Number 214367).

<sup>1269</sup> *Ibid.*

<sup>1270</sup> Email chain from the Flexible Event Team to the Corporate Finance Associate, 7 November 2018 at 14:17 (Document with Control Number 222243).

<sup>1271</sup> The Intelligence Team sits within the Enforcement Division (see: Slides for the meeting between Independent Investigation Team & FCA, 20 September 2019, at slides 5 to 7).

*Appendix 6: Information Which the FCA Received from Third Parties During the Relevant Period Regarding LCF's Conduct*

2019, the journalist contacted the FCA and expressed in forceful terms his displeasure that he had not been provided with information regarding LCF sooner.<sup>1272</sup>

7.9 The Investigation has concluded that the FCA's response to this information was appropriate. The FCA efficiently shared the information internally. Furthermore, the FCA was correct in not disclosing information to the journalist given the FCA was contemplating action against LCF.

**8. Conclusion**

8.1 This appendix provided a detailed summary of information provided by third parties to the FCA. The appendix supports the Investigation's criticisms of the FCA expressed elsewhere in the Report (in particular in **Chapters 9 to 13**). Of particular relevance is **Chapter 12** where the Investigation explains the serious failings by the FCA in respect of information provided by third parties. Those failures include the FCA's failure to respond to the specific and detailed allegations made to the FCA by third parties that LCF was engaged in fraud or irregularity, which were summarised in this **Appendix 6**.

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<sup>1272</sup> Email from the FCA Press Office forwarding the second email from the Evening Standard, 31 January 2019 at 15:58.

## **APPENDIX 7: SUMMARY CHRONOLOGY**

### **1. Introduction**

1.1 Set out in this Appendix are some of the events which occurred between 2012 and 2020 which the Investigation Team considers key to the Investigation. A more detailed chronology is included at **Appendix 8**.

### **2. Summary Chronology**

<b>Date</b>	<b>Event</b>
<b>2012</b>	
12 July 2012	LCF was incorporated under the name of South Eastern Counties Finance Limited.
3 September 2012	LCF obtained a consumer credit licence from the OFT.
21 September 2012	LCF changed its name to Sales Aid Finance (England) Limited.
<b>2013</b>	
2013	At some point in 2013, LCF carried out its first, small private debt issue which was repaid in 2014 and is described by LCF as the Series 1 Bond issue (the “ <b>Series 1 Bonds</b> ”).
September 2013	Between September 2013 and January 2016, LCF issued and sold a number of 8.5% Bonds (the “ <b>Series 2 Bonds</b> ”) with a term of either one year, two years or three years, bearing interest at 8.5% per annum.
<b>2014</b>	
In or about February 2014	LCF began issuing invitations to subscribe for up to £700,000 Series 9, 2 and 5-year 11% Income Bonds (the “ <b>Series 9 Bonds</b> ”) which were sold between February 2014 and September 2015.
1 April 2014	The FCA took over the regulation of consumer credit firms from the OFT and LCF, as a transferring consumer credit firm, was granted FCA interim permission.
<b>2015</b>	



Appendix 7: Summary Chronology

31 March 2015	LCF's annual accounts for the period 2014-15 described its principal activity as raising and lending funds.
1 July 2015	LCF finally settled on the name 'London Capital & Finance Limited'.
21 October 2015	LCF submitted its application to the FCA for authorisation under Part 4A of FSMA to carry on credit broking. This was the Initial Authorisation Application.
11 November 2015	LCF was re-registered as a public company, becoming London Capital & Finance plc.
On or about 11 November 2015	<p>LCF issued four information memoranda (“<b>IMs</b>”) inviting subscriptions for four new Bond Series:</p> <ul style="list-style-type: none"> <li>• up to £25 million in principal amount of Series 3, 1-year 3.9% Income Bonds (the “<b>Series 3 Bonds</b>”) which were sold between December 2015 and October 2018;</li> <li>• up to £25 million in principal amount of Series 4, 2-year 6.5% Income Bonds (the “<b>Series 4 Bonds</b>”) which were sold between November 2015 and December 2018;</li> <li>• up to £25 million in principal amount of Series 5, 3-year 8% AER Growth Bonds (the “<b>Series 5 Bonds</b>”) which were sold between December 2015 and February 2017;</li> <li>• up to £25 million in principal amount of Series 7, 3-year 8.0% Growth Bonds (the “<b>Series 7 Bonds</b>”) which were sold between January 2016 and December 2018.</li> </ul>
On or about 14 December 2015	LCF issued an IM inviting subscriptions for up to £25 million in principal amount of Series 6, 2-year 6.5% Growth Bonds (the “ <b>Series 6 Bonds</b> ”) which were sold between February 2016 and December 2018.
<b>2016</b>	
18 January – 11 March 2016	The FCA Financial Promotions team had a series of contacts with LCF during 2016 relating to its financial promotions.
2 September – 3 October 2016	
3 February 2016	In the course of considering LCF's application, FCA Authorisations obtained confirmation from the General

Appendix 7: Summary Chronology

	Counsel's Division that LCF's bond issuance business was not a regulated activity.
30 April 2016	LCF's annual accounts for the year ending on this date stated that its principal activities continue to be raising funding for the issuance of private bonds and then lending the proceeds to medium sized businesses. The value of bonds issued during that year was £9,952,194. As yet LCF had only one customer.
7 June 2016	LCF's authorisation application for credit broking (i.e. the Initial Authorisation Application) was approved by the FCA.
14 October 2016	LCF submitted a Variation of Permission application to the FCA to allow it to carry on corporate finance business. This was the First VOP Application.
18 October 2016	LCF listed a £100,000,000 bond issuance programme (the " <b>Programme</b> ") on the European Wholesale Securities Market, a regulated market operated by the Malta Stock Exchange. Under the Programme, LCF could issue bonds for a period of 12 months with any issues thereafter requiring further approval. As at 30 April 2018, no such bonds had been issued.
<b>2017</b>	
On or about 22 February 2017	LCF issued an IM inviting subscriptions for up to £25 million Series 8, 3-year 8% Growth Bonds (the " <b>Series 8 Bonds</b> ") which were sold from February to September 2017.
5 – 6 April 2017; 1 June 2017; 12 – 3 June 2017; 18 August – 4 September 2017	The Financial Promotions Team had further contact with LCF regarding its financial promotions.
30 April 2017	LCF's annual accounts for the period ending on this date show that during 2016/17 it issued bonds with an aggregate par value of £53,397,157 while redeeming bonds with an aggregate par value of £2,944,954. LCF

Appendix 7: Summary Chronology

	now had 11 corporate borrowers. The closing par value of all its issued and outstanding bonds was £60,792,994.
13 June 2017	LCF's First VOP Application was approved, giving it permission to carry on corporate finance business as an Exempt CAD firm.
25 August 2017	LCF issued an IM inviting subscriptions for up to £50 million Series, 10 3-year 8% Bonds (the " <b>Series 10 Bonds</b> ") which were sold between August 2017 and December 2018.
1 November 2017	HMRC granted LCF ISA Manager status.
29 November 2017	LCF issued an IM inviting subscriptions for up to £50 million Series 1 ISA, 3-year 8% Bonds (the " <b>Series 1 ISA Bonds</b> ") which were sold between December 2017 and July 2018.
	LCF issued an IM inviting subscriptions for up to £50 million Series 2 ISA, 2-year 6.5% bonds (the " <b>Series 2 ISA Bonds</b> ") which were sold between December 2017 and December 2018.
<b>2018</b>	
30 May 2018	LCF issued an IM inviting subscriptions for up to £50 million Series 11, 5-year 8.95% Bonds (the " <b>Series 11 Bonds</b> ") which were sold between June and December 2018.
	LCF issued an IM inviting subscriptions for up to £50 million Series 3 ISA, 5-year 8.95% Bonds (the " <b>Series 3 ISA Bonds</b> ") which were sold between June and December 2018.
11 June 2018	LCF issued an IM inviting subscriptions for up to £50 million nominal of Series 4 ISA, 3-year 8% Bonds (the " <b>Series 4 ISA Bonds</b> ") which were sold between June and December 2018.
10 September 2018	LCF submitted a second Variation of Permission application in which asked for permission to provide investment advice to retail clients. This is the Second VOP Application.

Appendix 7: Summary Chronology

10 December 2018	The FCA Enforcement and Supervision Divisions conducted an unannounced visit to LCF's offices. On the same day the FCA issued a First Supervisory Notice directing LCF immediately to withdraw its promotional material as it was misleading, unfair and unclear.
13 December 2018	A Voluntary Requirement VREQ notice was issued, prohibiting LCF from dealing with or disposing of its assets or communicating financial promotions.
<b>2019</b>	
17 January 2019	FCA issued a Second Supervisory Notice stating that the ISAs sold by LCF were not qualifying investments and that undue prominence was given by LCF to its FCA authorisation, despite the bonds not being regulated or having FSCS protection.
30 January 2019	LCF went into administration and four members of Smith & Williamson LLP, Finbarr O'Connell, Adam Stephens, Colin Hardman and Henry Shinnars, were appointed as its joint administrators.
18 March 2019	The SFO confirmed that it had arrested four individuals associated with LCF.
25 March 2019	As at 25 March 2019 the principal amount of LCF's issued and outstanding bonds was:  Series 2            £286,040 Series 3            £7,393,900 Series 4            £16,972,300 Series 5            £24,910,300 Series 6            £5,088,500 Series 7            £14,257,800 Series 8            £24,998,800 Series 9            £408,000 Series 10           £32,219,900

Appendix 7: Summary Chronology

	<p>Series 11      £2,514,700</p> <p>Total:            £129,050,240</p> <p>ISA Series 1   £50,002,900</p> <p>ISA Series 2   £20,671,435</p> <p>ISA Series 3   £7,294,940</p> <p>ISA Series 4   £30,187,982</p> <p><b>Total:            £108,157,257</b></p> <p><b><u>Grand total</u>    <u>£237,207,497</u></b></p> <p>At the same point in time the outstanding loans made by LCF to borrowers totalled £237,854,124 distributed among 12 borrowers.</p>
<b>2020</b>	
9 January 2020	FSCS declared that LCF had failed.

## **APPENDIX 8: DETAILED CHRONOLOGY**

### **1. Introduction**

1.1 For the avoidance of doubt, the chronology is not an exhaustive list of all events and interactions involving the FCA and/or LCF. The Investigation Team has used its judgment to identify the events that are relevant to the issues set out in the Direction. The Investigation Team has provided a description and relevant background for some of these events to highlight the key points and to explain their relevance to the wider issues.

### **2. Chronology**

<b>Date</b>	<b>Event</b>
12 July 2012	South Eastern Counties Finance Limited (which later became LCF) was incorporated.
3 September 2012	South Eastern Counties Finance Limited obtained a consumer credit licence from the OFT to carry on “ <i>consumer credit (lending)</i> ” and “ <i>consumer hire</i> ”.
21 September 2012	South Eastern Counties Finance Limited changed its name to Sales Aid Finance (England) Limited.
28 January 2013	Sales Aid Finance (England) Limited changed its name back to South Eastern Counties Finance Limited.
18 February 2013	South Eastern Counties Finance Limited changed its name back to Sales Aid Finance (England) Limited.
6 January 2014	Sales Aid Finance (England) Limited extended its accounting reference period from 31 July 2013 to 30 November 2013.
	Sales Aid Finance (England) Limited filed accounts (for the year ending 30 November 2013) at Companies House stating that the company was dormant.
1 April 2014	Sales Aid Finance (England) Ltd was granted Interim Permission (with Interim Permission reference number 651992) following the transfer of regulation of consumer credit firms from the OFT to the FCA.
21 January 2015	LCF contacted the FCA’s Contact Centre to discuss whether its Interim Permission covered lending to consumers.

Appendix 8: Detailed Chronology

19 June 2015	Sales Aid Finance (England) Limited shortened its end of accounting reference period from 30 November 2014 to 31 March 2014.
25 June 2015	<p>Sales Aid Finance (England) Limited filed abbreviated accounts (for the period 1 December 2013 to 31 March 2014) at Companies House.</p> <p>These accounts were subsequently amended (see entry for 28 November 2015 below).</p> <p>Sales Aid Finance (England) Limited filed abbreviated accounts (for the year ended 31 March 2015) at Companies House.</p> <p>These accounts were subsequently amended (see entry for 15 November 2015 below).</p>
1 July 2015	Sales Aid Finance (England) Limited changed its name to London Capital & Finance Limited.
21 October 2015	LCF submitted its application to the FCA for authorisation under Part 4A of FSMA for consumer credit-related permissions.
3 November 2015	London Capital & Finance Limited shortened its accounting reference period from 31 March 2016 to 30 April 2015.
11 November 2015	Companies House issued a certificate confirming that London Capital & Finance Limited had re-registered as a public company, London Capital & Finance plc.
15 November 2015	LCF submitted amended accounts for the period up to 31 March 2015 to Companies House.
23 November 2015	<p>LCF's CEO called the FCA's Contact Centre to ask: (i) whether he needed to amend LCF's application for authorisation given that LCF had changed from a private limited company to a public limited company; and (ii) whether the disclaimer on LCF's website could say "<i>authorised and regulated by the Financial Conduct Authority</i>".</p> <p>An individual in the FCA's Consumer Credit Supervision Team explained to LCF's CEO that, as LCF was not authorised, the disclaimer on the website should say "<i>registered with the FCA</i>" and should refer to LCF's interim permission number.</p>
26 November 2015	LCF submitted an annual report for the period ended 30 April 2015 to Companies House.

Appendix 8: Detailed Chronology

28 November 2015	LCF submitted House amended accounts for the period up to 31 March 2014 to Companies House.
29 November 2015	Date of the Liversidge Letter raising concerns regarding LCF. The Liversidge Letter is considered in <b><u>Chapter 3</u></b> .
13 December 2015	A member of the public emailed the FCA Customer Contact Centre with a query regarding the scope of LCF's permissions. The customer asked whether LCF could " <i>borrow and pay dividends (on a savings program)</i> ".
15 December 2015	In the light of the consumer query on 13 December 2015, the FCA Customer Contact Centre referred a case to the Consumer Credit Supervision Team and Financial Promotions Team noting that LCF was advertising products for which it did not have permission.
16 December 2015	Following a different consumer query regarding LCF, the FCA Customer Contact Centre referred a case to the FCA's Unauthorised Business Division raising concerns about LCF conducting business for which it did not have the relevant permissions.
17 December 2015	The FCA's Unauthorised Business Division emailed the Consumer Credit Supervision Team and Supervision Triage Team stating that the case arising from the consumer query on 16 December 2015 was probably not a clone and was perhaps best dealt with by one of the Supervision teams since LCF had a pending application for authorisation (i.e. the application submitted on 21 October 2015).
23 December 2015	<p>An individual in the Financial Promotions Team conducted an initial assessment of LCF's website and financial promotions.</p> <p>The assessment form filled in by the individual assessed the risk as "<i>Medium/High</i>" based on the scoring methodology set out in the form. The individual also noted: "<i>also need to speak to Consumer Contact Centre who are telling consumers the firm do not have permission for this activity, which is misleading.</i>"</p> <p>The Consumer Credit Supervision Team created a file on the FCA's case management system for the Authorisations Division which stated: "<i>To note two cases on [the FCA's case management system] that [LCF] (now a PLC) may be engaging in unauthorised investments/bond trading. You will wish to query this aspect with firm as part of your review of their application.</i>"</p>



Appendix 8: Detailed Chronology

18 January 2016	The FCA’s Financial Promotions Team sent LCF a letter in connection with the concerns over LCF’s website identified in the review conducted on 23 December 2015.
19 January 2016	<p>An individual in the FCA’s Financial Promotions Team spoke to LCF’s CEO regarding the issues identified in the letter of 18 January 2016.</p> <p>According to a memorandum of the conversation prepared by the individual, LCF’s CEO stated that he had received legal advice and agreed with the issues identified in the 18 January 2016 letter (the memorandum of the conversation noted that the individual from LCF “<i>now appreciates that, in a worst case scenario, client’s loans would not be 100 per cent protected</i>”). LCF’s CEO also stated that LCF would take steps to rectify the issues and appoint a compliance officer.</p>
26 January 2016	An individual in the Consumer Credit Supervision Team emailed a colleague to highlight that, given the spike in consumer queries suggesting LCF was engaged in “ <i>unauthorised investment activities</i> ” and the fact that an individual had not yet been appointed to review LCF’s application for authorisation, the Consumer Credit Supervision Team would approach the firm regarding this issue.
29 January 2016	<p>LCF sent a formal response to the Financial Promotion Team’s letter of 18 January 2016 regarding LCF’s financial promotions.</p> <p>The letter explained that LCF had: (i) removed various statements from its website to make clear that investor’s capital was at risk; (ii) added wording on the home page of LCF’s website and to the disclaimer to highlight the risk of loss of investor capital and that payment of interest on the bonds was dependent on the performance of LCF’s loan book; (iii) replaced the term “<i>Protection 100%</i>” with “<i>Assets secured</i>”; and (iv) confirmed that Sentient Capital had approved the website for the purposes of Section 21 of FSMA.</p>
2 February 2016	The Consumer Credit Supervision Team emailed the General Counsel’s Division to ask for advice regarding whether LCF was engaged in activities outside the scope of its permissions.
3 February 2016	The General Counsel’s Division responded to the query from the Consumer Credit Supervision Team on 2 February 2016 to explain that: (i) section 21 of FSMA restricts financial promotions but LCF would be able to rely on the exception that Sentient Capital (an authorised firm) had approved its financial promotions; and (ii) LCF issuance of its own bonds fell within an exception to the

Appendix 8: Detailed Chronology

	<p>general requirement to be authorised to deal in investments as principal.</p> <p>On the basis of the advice from the General Counsel’s Division, the Consumer Credit Supervision Team decided to close all open cases that related to whether LCF was engaged in activities outside the scope of its permissions.</p>
11 February 2016	The Customer Contact Centre received a query regarding LCF. The FCA employee referred the email to the Financial Promotions Team stating, <i>“I wanted to refer this case to you for your awareness as it is not transparent to consumers.”</i>
15 February 2016	<p>An individual in the Financial Promotions Team emailed LCF as a follow up to LCF’s letter of 29 January 2016. The email raised an outstanding issue regarding LCF’s website.</p> <p>The email stated: <i>“We do however have a remaining concern regarding the prominence of the capital at risk warning that you have added to your homepage...We would therefore not view the risk warning on the homepage as being sufficiently prominent.”</i></p>
17 February 2016	LCF submitted an amended regulatory business plan as part of an amended Part 4A application for authorisation to include corporate finance permissions.
7 March 2016	LCF emailed a letter to the Financial Promotions Team responding to the Team’s outstanding concerns (set out in the email of 15 February 2016). LCF’s letter also confirmed the changes that had been made to LCF’s website.
10 March 2016	An individual in the Financial Promotions Team emailed LCF to confirm that LCF had sufficiently addressed the issues with its website and that the FCA was closing its file. The email included template wording explaining that, if the FCA had not commented on other promotions, it should not be taken that those promotions were compliant. The email also explained that responsibility for compliance with the financial promotions rules remained with the firm.
11 March 2016	An individual in the Financial Promotions Team filed a checklist confirming the closure of the file for the issues concerning LCF’s website (i.e. the issues identified in the letter from the FCA of 18 January 2016).

Appendix 8: Detailed Chronology

21 March 2016	An email update was sent to members of the Authorisations Division (i.e. the team reviewing LCF’s application for authorisation) stating that a case officer had been appointed and that the process of reviewing LCF’s application was underway.
8 April 2016	The individual reviewing LCF’s application spoke to an individual acting on behalf of LCF. The FCA employee explained that LCF’s request for corporate finance permissions was not proper and, if LCF proceeded with the request for those permissions, the application would be assigned to a different team within the FCA rather than the Authorisations Division.
12 April 2016	The individual reviewing LCF’s application emailed LCF noting that proceeding with the consumer credit and corporate finance permissions could jeopardise the timing of the review of LCF’s application. The FCA employee said that going ahead with the consumer credit permissions alone, on the basis that LCF would apply for corporate finance permissions by a later Variation of Permission application, “ <i>would seem the most logical.</i> ”
	LCF responded to the FCA employee to ask the latter to proceed with the consumer credit permissions. LCF said that it would apply for the corporate finance permissions by a later Variation of Permission application.
	<p>The individual reviewing LCF’s application emailed LCF to request further information in order to assess LCF’s application for consumer credit permissions.</p> <p>These requests related to the “<i>Fitness and Propriety</i>” of LCF’s CEO, given that the firm had stated in its application that the CEO had previously been involved in companies that were: (i) subject to a judgment debt; (ii) involved in civil proceedings that resulted in an order against the company; (iii) put into liquidation/wound up/ceased trading; and (iv) subject to an investigation.</p> <p>The FCA also asked generic questions about LCF’s: (i) business model; (ii) reasons for the permissions sought; (iii) loans arrears policy; and (iv) methods of advertising.</p>
19 April 2016	LCF responded to the FCA employee’s questions. In relation to the “ <i>Fitness and Propriety</i> ” questions, LCF explained that the CEO’s former business went into liquidation over a year after he left and that the initial answers indicating that his companies had been subject to investigation were incorrect.

Appendix 8: Detailed Chronology

<p>9 May 2016</p>	<p>The individual reviewing LCF's Initial Authorisation Application and an individual acting on behalf of LCF had a call which covered the scope of LCF's regulated business and the application for authorisation. LCF also emailed the FCA employee to narrow the scope of its consumer credit permissions so as to cover credit broking alone.</p> <p>The individual reviewing LCF's Initial Authorisation Application filed various case notes on the FCA's case management system to evidence the review they had completed of LCF's application for authorisation.</p> <p>These case notes included:</p> <ul style="list-style-type: none"> <li>• a note which stated that LCF's estimated income from the consumer credit business was £20,000, which it explained was "<i>reasonable for the size of the business</i>";</li> <li>• a Risk Assessment Check which showed that no concerns were identified from reviewing the FCA's intelligence database;</li> <li>• confirmation that the FCA employee did not have any concerns regarding LCF's name; and</li> <li>• an "<i>Enhanced Case Note</i>" which indicated that, as the firm would only have credit broking permissions, there would need to be a manual update so that LCF would be a limited permission rather than a full permission firm. The note also stated that there "<i>are no other obvious anomalies in the permissions applied for given that the firm's primary business of financial adviser.</i>"</li> </ul>
<p>10 May 2016</p>	<p>The FCA employee filed an additional case note and completed the Case Assessment Tool.</p> <p>The additional case note considered further risk issues (e.g. a search of LCF's intelligence database in connection with LCF's CEO) and identified no issues.</p> <p>The Case Assessment Tool explained that:</p> <ul style="list-style-type: none"> <li>• given LCF was only applying for credit broking permissions, the firm's business model was considered to be "<i>lower risk</i>";</li> </ul>

Appendix 8: Detailed Chronology

	<ul style="list-style-type: none"> <li>the FCA employee described LCF’s business as: “[s]mall financial advisor, is a lending avenue for small/medium businesses. They raise money via a corporate bond issuance and lend said monies to various small and medium sized businesses. Their revenue is £1,149,620”;</li> <li>the FCA employee referred to intelligence in the FCA’s intelligence database that LCF was “selling bonds and not being regulated to do so” but added that “Supervision investigated and [the General Counsel’s Division] are happy with this”; and</li> <li>In response to the question “[a]ny issues with financial promotions or trading names” on the Case Assessment Tool, the FCA employee answered “[n]o”. This was despite the fact that the Financial Promotions Team had raised concerns about LCF in January 2016 (see entry for 18 January 2016).</li> </ul>
11 May 2016	The FCA employee completed their review of LCF’s application and submitted it to their manager for approval. That approval was granted the same day. The FCA employee confirmed by email to LCF that it was “now considered a ‘limited’ permissions firm, as the credit broking will be secondary to your firm’s main business.”
7 June 2016	The FCA emailed LCF to confirm that LCF was “now FCA authorised with effect from 11/05/2016” and that LCF’s CEO had been approved for the CF8 (Apportionment and oversight function) role.
10 June 2016	LCF’s Compliance Officer called the FCA’s Contact Centre to ask whether it could use the FCA logo on its website next to the wording “Authorised and regulated”. The individual in the Contact Centre stated that use of the FCA’s logo on a firm’s website would not be permitted.
15 July 2016	<p>Individual A contacted the Customer Contact Centre twice and raised concerns about LCF’s business model and whether LCF was engaged in fraud or serious irregularity.</p> <p>Individual A was concerned that LCF might be operating a “pyramid scam” rather lending out the money to SMEs as it claimed.</p>

Appendix 8: Detailed Chronology

	<p>The Contact Centre referred the case to the Consumer Credit Supervision Team who, in turn, referred the case to the Financial Promotions Team.</p> <p>The Financial Promotions Team conducted another review of LCF’s website following the consumer query of 15 July 2016 (see above).</p> <p>The assessment form filled in by the Financial Promotions Team assessed the risk as “<i>Medium/High</i>” based on the scoring methodology set out in the form. This score was based on the assessment that the LCF’s breach was fairly major and the product was considered by the FCA to pose significant risk. Other relevant comments on the assessment form were:</p> <ul style="list-style-type: none"> <li>• the form noted that LCF was regulated “[b]ut not for the purpose of mini bond issuance”;</li> <li>• the form indicated that there had been previous financial promotions issues; and</li> <li>• the identified rule breaches were: <ul style="list-style-type: none"> <li>○ “Regulatory disclosure does not make it clear they are not regulated for the purposes of issuing mini bond.”</li> <li>○ “Capital at risk not sufficiently prominent compared to prominence of benefits.”</li> </ul> </li> </ul>
<p>18 July 2016</p>	<p>Individual A contacted the Customer Contact Centre and raised concerns about LCF’s permissions and its business model.</p> <p>Individual A pointed out the statement on LCF’s website to the effect that it was regulated by the FCA for the purpose of consumer credit lending. In fact, LCF only had credit broking permissions.</p> <p>The Customer Contact Centre escalated the point about LCF’s permissions to the Consumer Credit Supervision Team (see entry for 28 July 2016 for the outcome of the Supervision Team’s review) but did not mention the concerns raised by Individual A regarding LCF’s business model.</p>
<p>22 July 2016</p>	<p>Individual A called the Customer Contact Centre to raise further concerns regarding LCF.</p> <p>Individual A pointed out that: (i) LCF was not authorised by the FCA to lend money; (ii) Global Security Trustees Limited, the</p>

Appendix 8: Detailed Chronology

	<p>security holder, claimed to have “<i>been in business for eight years</i>”, but it did not appear on the FCA Register; (iii) Global Security Trustees Limited was only established in 2015, it had never filed any accounts and it had only £50 in share capital.</p> <p>Individual A reiterated his concern that LCF’s previous company accounts suggested that the company only had one customer which shared the same director. However, Individual A highlighted that, in the space of a year, LCF claimed to have lent £30 million to 160 companies with only four employees. Individual A also said that the director of Global Security Trustees Limited “<i>has had directorship with the directors of London Capital over many years... they’re all kind of related in some way</i>”.</p>
28 July 2016	<p>A member of the Consumer Credit Supervision Team reviewed the concerns regarding LCF’s permissions, which had been escalated by the Customer Contact Centre following Individual A’s call of 18 July 2016. The Consumer Credit Supervision Team member closed the case with no further action.</p>
2 September 2016	<p>The Financial Promotions Team sent Sentient Capital a letter (copying LCF’s CEO) raising concerns regarding LCF’s financial promotions.</p> <p>It appears this letter arose out of the review conducted by the Financial Promotions Team on 15 July 2016 (following the consumer contact of the same date). It is unclear why the letter was not sent out sooner.</p>
6 September 2016	<p>Sentient Capital responded to the Financial Promotions Team’s concerns of 2 September 2016.</p> <p>Sentient Capital’s letter stated: “<i>Sentient has previously approved the [LCF] website and we have been confident that the website complies with the rules, having checked against COBS 4 specifically. We were satisfied with the verification provided and are confident that the website did not breach any rules.</i>”</p> <p>The letter went on to say that, in the light of the Financial Promotions Team’s concerns, Sentient Capital had worked with LCF to make some changes to LCF’s website.</p> <p>The letter from Sentient was signed by Sentient Capital’s CEO and its Compliance Officer. Sentient Capital’s Compliance Officer was also LCF’s Compliance Officer, which the Financial Promotions Team did not identify.</p>

Appendix 8: Detailed Chronology

8 September 2016	<p>The Financial Promotions Team sent a further letter (copying LCF’s CEO) to Sentient Capital stating that the changes to LCF’s website had not addressed the Team’s concerns sufficiently.</p>
9 September 2016	<p>LCF’s CEO called a member of the Financial Promotions Team to ask questions about the 8 September 2016 letter.</p> <p>LCF’s CEO asked whether LCF’s regulatory statement needed to be moved or completely removed. He also stated that he had received advice that the statement should refer to credit lending. The member of the Financial Promotions Team explained that LCF would need to take legal advice but the regulatory statement must be accurate and LCF was (at that time) only authorised for credit broking.</p> <p>LCF’s CEO also asked whether LCF’s bonds would be covered by the FSCS if LCF was regulated “<i>for corporate bonds</i>”. He said that LCF was putting together an application for additional permissions. The member of the Financial Promotions Team explained that LCF would need to take legal advice.</p>
15 September 2016	<p>Sentient Capital sent a letter responding to the Financial Promotions Team’s additional concerns of 8 September 2016.</p> <p>The letter said that LCF’s statement that it was regulated for consumer credit lending was sufficiently clear and accurate. However, the letter stated that LCF would need to change the statement to reflect the fact that LCF was only authorised for credit broking.</p> <p>In relation to the comments about LCF’s “<i>100% track record</i>”, the letter stated that the past performance provisions were not triggered as this was simply a reference to LCF’s “<i>adherence to a contractual agreement.</i>”</p> <p>The letter from Sentient Capital was signed by Sentient Capital’s Compliance Officer and its Director. Again, the Financial Promotions Team did not identify that Sentient Capital’s Compliance Officer was also LCF’s Compliance Officer.</p>
16 September 2016	<p>The Financial Promotions Team sent a further letter (copying LCF’s CEO) to Sentient Capital explaining that the FCA did not agree that the past performance obligations were not triggered by the wording used on LCF’s website.</p>
19 September 2016	<p>Sentient Capital sent a letter in response to the Financial Promotions Team’s additional concerns of 16 September 2016. The</p>



Appendix 8: Detailed Chronology

	<p>letter confirmed that amendments had been made to address the FCA’s concerns.</p> <p>This letter was also signed by Sentient Capital’s Compliance Officer.</p>
21 September 2016	<p>The Financial Promotions Team sent a further letter to Sentient Capital (copying LCF’s CEO) which explained that, while reviewing the response regarding past performance, the FCA had identified a further concern regarding illiquidity.</p> <p>The letter stated: “[w]hilst reviewing your response it also came to our attention that the risk of illiquidity of the bond lacks prominence. The bond is a non-readily realisable security and illiquidity is one of the main risks associated with a product of this nature. Although this information appears on the page entitled ‘Security’, in our view it should be provided to consumers alongside the description of the benefits of the bond.”</p>
27 September 2016	<p>Sentient Capital sent a letter in response to the Financial Promotions Team’s additional concern of 21 September 2016.</p> <p>The letter confirmed that the phrase “<i>Bond series 3 to 7 are non-transferable</i>” had been added to LCF’s website. This letter was also signed by Sentient Capital’s Compliance Officer.</p>
3 October 2016	<p>In the light of Sentient Capital’s letter of 27 September 2016, the Financial Promotions Team closed the case.</p>
14 October 2016	<p>LCF submitted a Variation of Permission application requesting corporate finance permissions including permissions to hold and control client money. The application included a regulatory business plan.</p>
31 October 2016	<p>LCF filed accounts for the period up to 30 April 2016 at Companies House.</p>
11 November 2016	<p>LCF contacted the Contact Centre to ask whether a firm with limited permissions could approve its own financial promotions. The Contact Centre explained that a firm with limited permissions could approve its own financial promotions and that the promotions needed to be clear, fair and not misleading.</p>
12 December 2016	<p>An individual in the Authorisations Division was assigned to review the First VOP Application emailed LCF with various queries regarding the application. The email included questions aimed to understand whether LCF required client money</p>

Appendix 8: Detailed Chronology

	<p>permissions given the nature of its business. The FCA employee also flagged that an error in the FCA’s systems meant that LCF was categorised as a full permission firm rather than a limited permission firm. Accordingly, LCF had been directed to fill in the wrong form for the purposes of the First VOP Application.</p>
<p>20 December 2016</p>	<p>LCF submitted an amended application form, responded to the FCA employee’s queries and submitted further information, including company accounts for the year ending 30 April 2016.</p> <p>The amended application form and responses to the FCA employee’s questions included the following:</p> <ul style="list-style-type: none"> <li>• in the section of the amend application form covering outsourcing of functions, LCF referred to various firms including: <ul style="list-style-type: none"> <li>○ “<i>Global Security Trustees – custodial services</i>”;</li> <li>○ “<i>Surge Financial Ltd – investor communication services</i>”;</li> </ul> </li> <li>• in response to the question as to whether the applicant had external funding, LCF stated that it had £28 million in external funding (the box for the name of the funding provider was left blank) and that this funding came from “<i>non-transferable bonds</i>” with repayment terms: “<i>bonds in series 2 to 7; 1-3 years; interest rates 3.9% to 8%</i>”;</li> <li>• regarding a query as to the overlap between the corporate finance business and the unregulated corporate lending business, LCF stated: <ul style="list-style-type: none"> <li>○ “<i>...Corporate lending is the lending for own account, to companies. LC&amp;F borrows funds, which it lends out again at higher interest rates. The current loan book is ± £28m, secured at ±£60m worth of assets. Loans are structured – each is bespoke - as a facility, at a specific interest rate for a fixed duration – typically 1-3 years in total. Specific loans under the facility (funds drawn) are for periods less than one year. There are no allowances for bad debt, as the loan is secured with a charge over the assets of the borrower at no more than 75% loan to value. These are callable immediately should the borrower defaults</i>”; and</li> </ul> </li> </ul>

Appendix 8: Detailed Chronology

	<ul style="list-style-type: none"> <li>the accounts submitted with the application stated that LCF had two employees (including non-executive directors) and that they were paid £8,681 for the year ending 30 April 2016.</li> </ul>
23 December 2016	<p>The FCA employee reviewing LCF’s Variation of Permission application emailed LCF with further queries regarding the application.</p> <p>The email included the following queries:</p> <ul style="list-style-type: none"> <li><u>“please confirm what persons invest in these bonds [i.e. the bonds funding LCF’s corporate lending] and how these are marketed (including what costs arise from the marketing)”</u>; and</li> <li><u>“There appears to be a difference in the period over which the bonds will run and the period over which the loans these funded will be repaid. The balance sheet as at 30 April 2016 shows bonds to be repaid within 1 year as £2,556,357 while the loans payments receivable in the same period appear to be £585,568.”</u> The FCA employee asked for confirmation of how LCF <u>“intends to fund (or has funded since 30 April) the repayment of bonds as they fall due”</u>.</li> </ul>
17 January 2017	<p>LCF called the Contact Centre on two occasions on the same day to check whether LCF still needed to use an authorised firm (i.e. Sentient Capital) for its financial promotions. Both times, individuals in the Contact Centre explained that, as LCF was an authorised firm, it was permitted to approve its own financial promotions.</p>
19 January 2017	<p>LCF emailed the FCA asking for an extension to provide responses to the financial information. The email enclosed responses to some of the FCA employee’s queries.</p> <p>In response to the question of how LCF would be holding client money, LCF responded: <i>“LC&amp;F borrows funds by selling non-transferable bonds. It then lends to other companies...It is foreseen that firm clients would raise funds in the same way as the firm (LC&amp;F) – i.e. by selling bonds.”</i></p>
26 January 2017	<p>LCF submitted additional information, including a <i>“profit &amp; loss document”</i>. LCF explained that the firm was awaiting further financial information from its accountant.</p> <p>The <i>“profit &amp; loss document”</i> included the following information:</p> <ul style="list-style-type: none"> <li>the assumptions in the spreadsheet included:</li> </ul>

Appendix 8: Detailed Chronology

	<ul style="list-style-type: none"> <li>○ “Cost of funds is calculated on sheet 2 at 25.5% for online fundraising and 10% for network fundraising. This is charged to borrowers on a see through basis added on to their loans. As such it has been eliminated from this forecast”;</li> <li>○ “Interest income on the existing loan book will double over next 12 months (spread evenly)”;</li> <li>○ “£60m new loans split evenly over the next 12 months with the associated interest split evenly”;</li> <li>• LCF predicted an operating profit of over £7 million for 2017. The annual accounts for the year ending 30 April 2016 had an operating profit in the region of £150,000 (up from £2,000 for the previous financial year); and</li> <li>• the second sheet listed all of LCF’s bonds with their term, coupon and coupon payment intervals. It also listed various fees and costs of funds: “loan fees 2%”; “LCM network COF 10%”; “Online COF 25.5%”; “LCF interest 1.75%”.</li> </ul>
30 January 2017	<p>On or around 30 January 2017, the FCA received an anonymous letter addressed to a Detective Constable in the Metropolitan Police. The letter was copied to an individual in the FCA’s Unauthorised Business Department (the “<b>Anonymous Letter</b>”). The letter raised concerns of wrongdoing at the “<i>London Capital and Finance Group</i>” (see: <b>Chapter 3</b>).</p> <p>The recipient of the Anonymous Letter in the Unauthorised Business Department forwarded the letter to the Consumer Credit Supervision Team (copying the FCA’s Intelligence Team).</p> <p>The covering email said: “[The letter] refers to ‘<i>London Capital and Finance Group</i>’. After some digging around, I believe it relates to <i>London Capital &amp; Finance PLC (IP 651992 / FRN 722603 – Authorised)</i>. The allegation in the letter is that the authorised firm is acting outside the scope of its consumer credit permission... When I spoke with [a member of the Consumer Credit Supervision Team] earlier, she explained that the issue has been looked at before and it was considered that the authorised firm was not acting outside of its scope.”</p>
31 January 2017	<p>An individual in the Consumer Credit Supervision Team emailed the Intelligence Team regarding the Anonymous Letter and copying</p>

Appendix 8: Detailed Chronology

	<p>the FCA employee who was reviewing LCF’s Variation of Permission application.</p> <p>The email stated that the individual had “<i>raised a risk event against [LCF] but we are not (so far) able to establish a link with the names mentioned by the anonymous sender.</i>” He also noted that he had found “<i>no trace of the ‘Group’ firm on either Intact or at Companies House.</i>”</p> <p>The individual in the Consumer Credit Supervision Team asked the Intelligence Team for assistance in contacting the relevant Detective Constable in the Metropolitan Police who had also received the letter in case he was able to “<i>provide any additional evidence which may prove there is a link.</i>”</p> <p>The email also explained that in late 2015/early 2016 the FCA “<i>had received a number of queries about [LCF] advertising investments when not authorised for that activity</i>” but the General Counsel’s Division had advised at the time that LCF “<i>was able to benefit from the exclusion contained in Article 18(1) RAO 2011.</i>”</p> <p>The email also asked the FCA employee not to approve the Variation of Permission application until the investigation into the Anonymous Letter had been completed.</p>
21 February 2017	<p>An individual in the Consumer Credit Supervision Team asked the Intelligence Team if they had contacted the relevant Detective Constable in the Metropolitan Police regarding the Anonymous Letter.</p>
23 February 2017	<p>The case file for the Anonymous Letter was closed with an entry that stated there had been contact from the relevant Detective Constable at the Metropolitan Police and that there was “[n]o reason to believe entities are the same” and “[n]ames/addresses and DOB’s do not marry up.”</p> <p>The risk assessment conducted by an individual in the Consumer Credit Supervision Team who closed the case scored the case as “[w]ithin Risk Tolerance”.</p>
14 March 2017	<p>In relation to the ongoing Variation of Permission application, LCF provided a further response to the FCA employee’s queries, attaching Management Accounts for the seven months ending 30 November 2016.</p> <p>The management accounts included the following information:</p>

Appendix 8: Detailed Chronology

	<ul style="list-style-type: none"> <li>• the issuing of bonds and on-lending of the bond proceeds continued to be the primary business of LCF and “[d]uring the year there were bond additions of £24,308,200 and bond redemptions of £918,173”;</li> <li>• operating profit for the period was £10,694. This was made up of £282,050 gross profit and £271,367 of administrative expenses; and</li> <li>• the finance costs for the seven-month period was just under £2.3 million. This was made up of commissions of just under £1.4 million and interest payable of just under £900,000.</li> </ul>
20 March 2017	<p>A member of the public submitted an online report of a misleading financial promotion. This online report was picked up solely by the Financial Promotions Team.</p> <p>The concerns raised by the member of the public were as follows: <i>“This limited liability partnership is claiming to charge small businesses 10-20% interest on loans, and offers up to 8% interest for 3 year bonds of a minimum of £5,000. I feel that this has to be a scam. I checked the FCA register and the company has been registered since July last year – a big red flag in my opinion that they are such a new company. They are not covered by the [FSCS] and do not adhere to anti-money laundering regulations. They claim to offer asset backed securities that will give people the impression that the ‘bonds’ they are buying are safe investments, yet a quick look at the risks they state at the bottom of their page reveal these are highly risky investments with no guarantees, no assets (or at least quality ones) to back them up so far as I can tell. My guess is that they will take peoples money and will go out of business before the bonds are redeemable...There are red flags all over their literature.”</i></p>
31 March 2017	<p>A consumer made a complaint to the ASA about an LCF advert. The ASA transferred the complaint to the Financial Promotions Team.</p> <p>The complaint related to an advertisement for LCF’s products on a price comparison website. The complaint stated: <i>“The advert has no mention that capital is at risk and makes it seem like this is a deposit account. It isn’t, it’s a loan to the company when the investor could lose all their money. There is nothing to indicate that to the viewer.”</i></p>

<p>3 April 2017</p>	<p>The FCA employee reviewing LCF's Variation of Permission application responded to the information provided by LCF on 14 March 2017 and set out the outstanding information he required along with some further queries regarding LCF's application.</p> <p>The additional queries included the following:</p> <ul style="list-style-type: none"><li>• the FCA employee noted that a monthly cashflow projection had not been provided and stated that this was required to show how the bonds would be repaid. He said:<ul style="list-style-type: none"><li>○ “[t]his will also need to show the full cash effect of the cost of funds payments which you noted were omitted from the profit and loss forecast as they have no net effect on profits. They appear likely to effect cashflow as there will be a discrepancy between the date of payment by borrowers and the date of payment to the bond holders. I also need to see the projected amounts of this as this will be relevant in relation to your answer to [one of the other questions] – the costs allowed for non-performing loans need to allow for the effect of non-payment of the cost of finance, the principle and the interest that would have been retained by the applicant (and any additional costs resulting from any short term finance needed to repay bonds as they fall due)”;</li></ul></li><li>• the FCA employee asked how LCF intended to fund the repayment of the bonds given that the bonds due to be repaid within 12 months of 30 April 2016 were £2.5 million whereas loan payment receivables for the same period only amounted to £585,568;</li><li>• the FCA employee noted that the projections made no allowance for repayment of existing finance and asked LCF to provide an explanation of when the existing finance was due to be repaid; and</li><li>• the FCA employee noted that LCF was assuming £60 million of new lending but it was sourcing £177 million of financing from new bond issuances. He asked for an explanation of this discrepancy. He also asked how LCF would cover interest payments on the bonds when the interest on the loans was likely to be much lower.</li></ul>
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Appendix 8: Detailed Chronology

	<p>A member of the public submitted an online report of a misleading financial promotion by LCF to the Financial Promotions Team. The advert had appeared in the press. The member of the public said that the advert was “<i>unclear and misleading.</i>”</p>
5 April 2017	<p>In the light of the concerns raised by members of the public in March and early April 2017 regarding LCF’s financial promotions, the Financial Promotions Team conducted a further review of LCF’s website. The Financial Promotions Team found that the changes that had been made following their contact with LCF and Sentient Capital in September/October 2016 were no longer in place. The Financial Promotions Team wrote a letter to LCF raising concerns about this.</p> <p>The letter pointed out that the website no longer stated that it was approved by Sentient Capital. The letter asked if Sentient Capital was still the approver of the website.</p> <p>LCF responded on the same date to confirm that the changes had been reversed due to a technical issue and that LCF had contacted the technical provider to get them to revert to the previous version.</p> <p>The email from LCF also explained that the firm was confident that, as it was an authorised firm, it could approve its own financial promotions pursuant to Section 21 of FSMA.</p>
6 April 2017	<p>The Financial Promotions Team emailed LCF to confirm the closure of the case in light of LCF’s response on 5 April 2017.</p>
1 May 2017	<p>LCF responded in writing to some of the FCA employee’s queries (in connection with the ongoing Variation of Permission application) but stated that the firm was still waiting for further information from its accountant.</p> <p>LCF further confirmed that, as at 1 May 2017, LCF’s loans amounted to around £62 million. In response to a question about the source of investors’ funds and their suitability assessment, LCF responded:</p> <p><i>“Investors are obtained predominantly via a network of IFAs and other regulated entities by means of financial promotions, whom we have agreed to be Registered Agents. We would rely on their process of appropriateness assessment.”</i></p>
8 May 2017	<p>The FCA employee responded to LCF’s 1 May 2017 email with further queries. These queries concerned LCF’s application for permission to hold client money. The FCA employee also queried</p>



Appendix 8: Detailed Chronology

	<p>why the management accounts were not used for monthly capital resources compliance monitoring.</p> <p>LCF's responded to some of the FCA employee's queries, attaching a monthly income statement forecast, monthly trial balance sheet forecast and a confirmation statement filed in July 2016.</p> <p>Responding to the FCA employee's query about how LCF planned to address the deficit between its bonds due to be repaid within one year (£2,556,357) and its loan payments receivable for the same period (£585,568), LCF stated that <i>"the loan agreement with clients has an agreement that, if bond holders do not wish to roll over (reinvest), LC&amp;F can request repayment of the loan amounts"</i>.</p>
11 May 2017	<p>As a result of proactive monitoring, the Financial Promotions Team opened a case in connection with a press promotion by LCF which appeared in <i>The Times</i> on 3 May 2017.</p>
15 May 2017	<p>The FCA employee responded with further queries regarding LCF's financial information.</p> <p>The further comments and queries included the following:</p> <ul style="list-style-type: none"> <li>• the FCA employee noted the lack of a detailed cash-flow projection, breakdown of which income related to regulated activities and requested management accounts showing actual performance from November 2016;</li> <li>• they also noted that the management accounts submitted did not provide a breakdown of the "pre-payments" and "other receivables"; and</li> <li>• the FCA employee asked for further information regarding LCF's ability to request immediate repayment from the companies to which it lent funds.</li> </ul>
22 May 2017	<p>LCF provided further financial information and responded to the FCA employee's outstanding queries in connection with the Variation of Permission application.</p> <p>The response explained that:</p> <ul style="list-style-type: none"> <li>• LCF stated that it no longer required CASS permissions;</li> <li>• in response to the query about the doubling of interest income, LCF stated: <ul style="list-style-type: none"> <li>○ <i>"[w]e're expecting our loan book to double. Our demand for funds exceeds supply, so we're working</i></li> </ul> </li> </ul>

	<p><i>to expand our bond book considerably. At present, our funds are loaned out as soon as it is raised. We are currently working on 2 bonds to be listed of £100m each: ORB on LSE and the EWS Market (Malta) which we expect to be filled by institutional investors. In addition, while we're on our series 8 bond, we've prepared series 9-11 additionally. Also, most investors (last month c. 75% of bondholders) reinvest upon maturity”;</i></p> <ul style="list-style-type: none"> <li>• in response to the queries on assumption for non-payment of debts, LCF stated: <ul style="list-style-type: none"> <li>○ <i>“[c]urrently we are maintaining a beneficial loan-to-value ratio, holding assets of c. £222[m] against loans of c. £65m. In the unlikely event of non-performance of a borrower, we would be able to liquidate said assets. We have intimate knowledge of the assets, our borrowers and their ability to repay”;</i></li> </ul> </li> <li>• in response to the query about sourcing new finance against new lending, LCF said that the earlier projections were out of date and that its updated financial projections indicated <i>“a bond book of c. £142m and a loan schedule of c.£166[m]”</i>. LCF further stated that <i>“all costs are passed through to the borrower (client), including raising costs”;</i></li> <li>• in response to queries of the repayment of existing finance, LCF said that <i>“repayment of bonds is also passed through to the borrowers”</i>. LCF’s response also explained that borrowers were informed three months in advance of repayment and <i>“then repay such bond amounts as we require”</i>. This was stated to be <i>“part of the loan agreement”;</i></li> <li>• a similar explanation was given for LCF’s ability to meet its debts as they fell due. As to this, LCF stated that <i>“all borrowers must adhere to the bond repayment schedule”</i> and that <i>“each loan mirrors the bond maturity date and interest – there is no discrepancy or mismatch between lenders and borrowers”</i>. LCF considered that its <i>“requirement to repay bondholders have [sic] been passed through to the borrowers”</i>. According to LCF, <i>“borrowers have all complied and returned funds”</i> and <i>“when bondholders reinvest, funds are then made available to borrowers again”</i>.</li> </ul>
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Appendix 8: Detailed Chronology

	<ul style="list-style-type: none"> <li>• in response to the query of what would happen in the event of a default, LCF stated: <i>“The loan agreements with each borrower stipulates that the Borrower shall repay when the Firm so requests – within 14 days. In the event of a default, we may turn to the guarantor, or directly effect the security (in terms of the Deed, full title of all assets are already assigned) immediately. Bondholders will be repaid out of other funds available. The Firm may also request amounts from other Borrowers (even those not in default) based on that specific clause in the loan agreements, in order to meet a Bond repayment.”</i></li> </ul>
<p>1 June 2017</p>	<p>The Financial Promotions Team wrote to LCF about its press promotion that appeared in <i>The Times</i> on 3 May 2017.</p> <p>The letter stated that:</p> <p><i>“We consider that this promotion does not comply with our rules and is not in line with our guidance because we consider that the statement ‘Authorised and regulated by the Financial Conduct Authority for credit purposes’ could be misleading in the context of the financial promotion. As the promotion is for investment activity that is not regulated by the FCA, including a statement regarding your regulatory status could be misleading for customers.”</i></p> <p>LCF emailed the Financial Promotions Team stating that the firm did not consider the financial promotions rules to be applicable to a <i>“general advertisement”</i>. In any event, LCF agreed to remove reference to LCF being authorised by the FCA in future advertisements.</p> <p>In advance of LCF sending this email, a phone conversation between LCF’s CEO and a member of the Financial Promotions Team took place. The file note of the call states: <i>“[LCF’s CEO] said he had anonymously referred other mini bonds to us that he believe to be non compliant/fraudulent...”</i></p> <p>In the light of the response from LCF, the Financial Promotions Team closed the case. In their response to LCF, the Financial Promotions Team stated their disagreement with LCF’s assertion that the advert was not a financial promotion.</p>
<p>2 June 2017</p>	<p>The FCA employee sent further queries to LCF in connection with the ongoing Variation of Permission application. The email noted that he had not received LCF’s projections of financial resources requirements and he asked for confirmation that the firm was no longer applying for permission to hold client monies.</p>

Appendix 8: Detailed Chronology

<p>5 June 2017</p>	<p>Individual A called the FCA Customer Contact Centre again to raise further concerns regarding LCF's business.</p> <p>Individual A explained that he had previously raised issues regarding LCF to the FCA and had noticed that LCF had amended its website, in line with recommendations the caller had made. Individual A pointed out that LCF had very few assets. He said that LCF <i>"had two employees and they were being paid 800 pounds a year, so they were probably the two directors"</i>. Therefore, he believed that interest payments to bondholders were being funded from capital contributions. Individual A also noted that LCF had no assets to provide security for the bonds as all its assets were already mortgaged. He also flagged issues regarding the security trustee for LCF's bonds noting that <i>"The company that's doing it [i.e. acting as the security trustee] was set up one week before that they set the security up. And these people are all in each other's pockets."</i></p>
<p>6 June 2017</p>	<p>LCF submitted a CCR007 (Consumer Credit data: Key data for credit firms with limited permissions) which showed that its total revenue from regulated activities for the financial year ending 30 April 2017 was £0 whereas its total revenue for unregulated activity was £6,678,685. It also stated that the firm had entered into zero transactions that constituted regulated activities in this period.</p>
<p>8 June 2017</p>	<p>A consumer complaint received by the ASA in connection with an LCF promotion that appeared in the <i>Daily Telegraph</i> was escalated to the Financial Promotions Team.</p>
<p>9 June 2017</p>	<p>LCF responded to the FCA employee's queries of 2 June 2017 and confirmed some additional points, including that it would no longer be requesting permission to hold client monies.</p> <p>The response also stated that:</p> <ul style="list-style-type: none"> <li>• LCF would only require <i>"corporate finance and credit lender permissions"</i>; and</li> <li>• the prudential category <i>"has changed and we conclude we would be BIPRU or exempt CAD, but would *not* be MiFID exempt"</i>.</li> </ul> <p>A call took place between LCF's Compliance Officer and the FCA employee in light of LCF's email (of 9 June 2017).</p> <p>The FCA employee's note of this call states: <i>"I called [LCF's Compliance Officer] in relation to his email of today. Following a discussion he consulted his CEO and called back. The firm will now be applying for the exempt CAD firm requirement as it does not qualify as an article 3 exempt firm. There is no intention to</i></p>

Appendix 8: Detailed Chronology

	<i>passport.”</i>
12 June 2017	<p>Following the escalation of the consumer complaint from the ASA to the Financial Promotions Team on 8 June 2017, the Financial Promotions Team emailed LCF to raise concerns regarding the press promotion identified in the consumer complaint.</p> <p>The email from the Financial Promotions Team stated: “<i>With a mini bond a consumer’s capital is at risk. However the risk warning on the press promotion states “<u>your capital may be at risk</u>”. Firms should ensure that a financial promotion for a product or service that places a client’s capital at risk makes this clear... In our opinion saying capital “may” be at risk does not make this clear...</i>” (Emphasis in original.)</p>
13 June 2017	<p>The FCA employee filed their internal recommendation memo outlining the reasons for approving LCF’s Variation of Permission application.</p> <p>The memo explained that:</p> <ul style="list-style-type: none"> <li>• LCF’s Variation of Permission application had initially been “<i>assessed as enhanced</i>” due to the “<i>inclusion of the client money permission</i>” but was ultimately assessed as “<i>standard</i>” due to the request for that permission being withdrawn. The FCA employee noted that LCF’s management accounts (provided on 22 May 2017) confirmed its net assets of £161,343 and together with the bank statement provided, he considered this represented sufficient financial resources; and</li> <li>• the FCA employee also noted that during the application a Supervision case was raised concerning a “<i>similarly named entity</i>” that was “<i>raising funds and misappropriating them</i>” (i.e. the Anonymous Letter received on or about 30 January 2017) but that “<i>the case was closed due to confirmation from police contact... that there was no reason to believe the entities were the same</i>”. He further stated that “<i>as the applicant has withdrawn the request for client money permissions...there are no further concerns with this</i>”.</li> </ul> <p>In his assessment of the LCF business model, the FCA employee concluded that LCF has “[the] <i>applicant has provided financial projections and further information in its responses demonstrating that both the current business issuing its own bonds and providing business lending and its intended corporate finance business is sustainable and run in a manor [sic] that is expected to be in the</i></p>

Appendix 8: Detailed Chronology

	<p><i>interests of customers</i>". The FCA employee did not identify that the regulated corporate finance business was to represent a miniscule proportion of the LCF's income.</p>
	<p>The FCA employee emailed LCF to confirm that LCF's <i>"application has been granted and the variation of Part 4A Permission has effect from 13 June 2016 [sic]."</i> LCF's Compliance Officer responded to the FCA employee just over an hour later: <i>"I assume we can now state 'Authorised and regulated by the FCA' on our website and marketing material, without any qualification added?"</i></p>
	<p>LCF responded to the 12 June email from the FCA's Financial Promotions Team stating that the advert would be amended immediately and there would be an internal disciplinary procedure.</p>
<p>14 June 2017</p>	<p>The FCA employee responded to the query from LCF's Compliance Officer regarding what it could say on its marketing materials about its regulatory status. The response from the FCA employee said:</p> <p><i>"I note that your website refers to the approval of the marketing material for your bonds by a regulated third party. Once you are approving your own marketing material this should no longer be necessary. However as the business issuing your own bonds is not part of your regulated business you should consider what information needs to be included to make clear that customers for this do not benefit from FOS or FSCS cover. You should also consider how much of the remainder of the disclaimer continues to be necessary. The statement that the firm is regulated by the Financial Conduct Authority for credit broking activities should be amended to the "authorised and regulated" wording."</i></p>
<p>16 June 2017</p>	<p>Individual A called the Customer Contact Centre again to raise concerns regarding LCF.</p> <p>Individual A noted that LCF had no apparent platform to market the loans it was lending to SMEs. Individual A also raised concerns about the role of the marketing company for LCF. He highlighted a shortfall in the security provided by LCF and also noted that, whilst there may be some sophisticated investors involved, most investors would not be sophisticated. The individual in the Customer Contact Centre told Individual A, <i>"the thing is if I've got this all in writing and then if I do need to go and seek some further assistance and further guidance, I'll be able to do that and then I can get back to you via email."</i></p>

Appendix 8: Detailed Chronology

	<p>The Customer Contact Centre does not appear to have escalated the concerns expressed by Individual A in this call to the Supervision Division.</p>
<p>19 June 2017</p>	<p>Individual A called the FCA Customer Contact Centre again to request clarity on the information he could obtain as a consumer from LCF.</p> <p>Individual A stated that LCF was offering bonds and asked whether the FCA’s Principles of Business empowered a consumer to request evidence of how LCF was using bondholder funds. Individual A noted that historic failures of bond providers were due to bondholder capital being “<i>siphoned off in one way or another.</i>”</p>
<p>21 June 2017</p>	<p>Individual A called the FCA Customer Contact Centre again to raise concern that he could not identify how LCF was using Bondholders’ funds. He also reiterated some of the issues that he had previously identified.</p> <p>Individual A raised concerns about the retail marketing of the mini-bonds. He said that LCF claimed to have a big team but most of the staff were actually employed by a marketing company involved in marketing the bonds.</p> <p>Individual A also said that it was unclear how LCF was identifying SMEs for lending purposes as there was no public interface inviting SMEs to apply for loans. In relation to his previous concerns he said:</p> <p><i>“I mean, at the moment they say they’ve got 400, £415 million worth of securities from SMEs and this is, what, 250 or something loans lent out. And this is all in a matter of months with no evidence at all that they were doing this before. I mean, when you look in Companies House there’s only one lender that they lent to for the whole year in 2014 to 2015, and this was the first public offering that they’ve ever done so they’ve got no track record. But they say, of course, that, you know, well they can say things which just aren’t true, basically, like, for example, ‘We’ve got a track record of paying out interest since 2012 to the present date, 2017’, but they haven’t because there was no interest paid before 2014. So, that’s two years missing because there were no loans. And, as I said before, in 2014 to 2015 there was only one loan so that isn’t evidence, is it, of interest being paid as a track record, one?”</i></p>

Appendix 8: Detailed Chronology

	<p>The FCA employee in the FCA Customer Contact Centre who received Individual A’s call on 21 June 2017 raised a risk event with the Consumer Credit Supervision Team. This risk event was closed after a desk-based review without any action.</p> <p>The description of the risk event states: “[c]onsumer contacted us as he has concerns that this firm won’t disclose how they would spend the money into his asset backed bond...There hasn’t been any detriment, as the consumer hasn’t invested, however, the firm appears to be in breach of [Principle 7] [i.e. “A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.”]”</p> <p>While deciding to close the case, the FCA employee in the Consumer Credit Supervision Team referred to the wording on LCF’s website explained that LCF’s ability to pay bond interest “depends on the performance of loans made by [LCF] to various small and medium-sized enterprises.” The individual in the Consumer Credit Supervision Team stated that this “seems to explain what the firm will do with any investment they received therefore there does not appear to be a breach.”</p>
<p>7 July 2017</p>	<p>Individual A called the FCA Customer Contact Centre to ask about a statement in LCF’s accounts that it was registered with the FCA. He asked about the difference between “registered” and “regulated”.</p> <p>Individual A asked whether a prospectus had to be registered with the FCA as he had found a prospectus for LCF’s bond programme that was registered in Malta.</p>
<p>10 July 2017</p>	<p>Individual A called the FCA Customer Contact Centre to ask about LCF’s permissions and to raise concerns about LCF’s business.</p> <p>Individual A asked questions about LCF’s permissions and its regulation by the FCA, particularly in relation to secondary lending and mortgage broking. Individual A expressed similar concerns as he had raised in previous calls about the unsustainable company structure of LCF and his inability to access financial information regarding LCF’s business.</p>
<p>2 August 2017</p>	<p>A chartered financial planner emailed the FCA’s Whistleblowing Team raising the concern that LCF was conducting business without necessary permissions. He said that he had come across</p>



Appendix 8: Detailed Chronology

	<p>LCF when one of his retail clients asked him for guidance about LCF's bonds.</p> <p>The email stated: <i>"Taking a look I note [LCF] is acting like a bank but on the FCA website is not authorised to hold client money and can only deal with professional investors or counterparties. The accounts, audited by Price Waterhouse show substantial deposits and loans."</i></p>
3 August 2017	The FCA's Whistleblowing Team referred the email from the chartered financial planner to the Contact Centre.
4 August 2017	An FCA employee from the Contact Centre asked the chartered financial planner for further information regarding his client's contact with LCF and their knowledge and experience in investments so that the case could be referred to the appropriate team within the FCA's Supervision Division.
10 August 2017	The chartered financial planner sent a letter (dated 7 August 2017, received by the Contact Centre on 10 August 2017) which provided the information requested by the FCA on 4 August 2017. The covering letter stated: <i>"I request that this is referred to management at FCA who are responsible for unauthorised dealing."</i>
11 August 2017	A member of the public submitted an online report of a misleading financial promotion in connection with LCF's website. The complaint stated: <i>"[LCF's website] fails to warn that the capital is at risk – it flaunts its FCA membership and misleads consumers that their deposit is protected under the FSCS"</i> .
14 August 2017	An FCA employee from the Contact Centre emailed the chartered financial planner to thank him for the additional information he had provided in his letter of 7 August 2017. The email explained that the matter had been referred to the FCA's Unauthorised Business Department. No further action appears to have been taken in relation to the concerns raised by the chartered financial planner.
18 August 2017	<p>The FCA's Financial Promotions Team wrote to LCF to raise concerns about LCF's website and a sponsored search result on Google. The letter also pointed out that the Financial Promotions Team had written to LCF on <i>"three other occasions [over the past year] concerning deficiencies in [LCF's] promotions"</i> and, as such, if there was a further breach, the FCA would seek a formal attestation from an approved person.</p> <p>The concerns raised in the letter were the following:</p>

Appendix 8: Detailed Chronology

	<ul style="list-style-type: none"> <li>• LCF appeared to be using its regulatory status as a promotional tool (“As previously raised with you [a statement that LCF is authorised and regulated by the FCA] is misleading in the context of the financial promotion as the promotion is for investment activity that is not regulated by the FCA”); and</li> <li>• the sponsored promotion on Google failed to contain a warning regarding investor capital being at risk and, in addition, the wording (“100% track record”) triggered the past performance requirements.</li> </ul> <p>The letter stated that an attestation may be necessary if there were further deficiencies in LCF’s financial promotions:</p> <p><i>“[w]e are particularly concerned that our records show that over the past year we have had to write to you on three other occasions concerning deficiencies in your promotions. We do not expect to see any further breaches. Should this occur we will seek a formal attestation by an approved person conducting a significant influence function from within your firm that there are adequate systems and controls in place for the approval of compliant financial promotions.”</i></p>
31 August 2017	<p>LCF’s Compliance Officer sent a letter to the Financial Promotions Team confirming that it had made changes to address the concerns identified in the Financial Promotions Team’s letter of 18 August 2017.</p> <p>The letter explained that LCF had “no intention of utilising its regulatory status as a marketing tool”. In response to the point about a potential attestation, LCF stated that its “promotional material undergoes a full approval process at all times...”</p>
4 September 2017	<p>The FCA’s Financial Promotions Team emailed LCF noting the changes set out in the letter of 31 August 2017 and confirming the closure of the case.</p>
12 September 2017	<p>LCF’s Compliance Officer called the Contact Centre to ask whether the firm needed additional permissions to be able to manage ISAs. LCF’s Compliance Officer explained that “the objective is not that the individual investor is the client, it is that we manage the ISA as a, as a product for a firm who is then going to do the peer-to-peer lending”. The individual in the Contact Centre explained that LCF may need to vary its permissions depending on exactly what it would be doing.</p>

Appendix 8: Detailed Chronology

<p>9 November 2017</p>	<p>PwC sent a letter notifying the FCA of its resignation as LCF’s auditors. The letter stated: <i>“we confirm that there were no matters connected with our ceasing to hold office that we consider should be brought to your attention”</i>.</p> <p>The letter enclosed a copy PwC’s letter to LCF on 17 October 2017, which stated that the reason why PwC had ceased to act as LCF’s auditors was because <i>“[LCF’s directors] have indicated that they wish to appoint another firm of auditors”</i>.</p>
<p>29 November 2017</p>	<p>LCF’s Compliance Officer notified the FCA that LCF filing of accounts to Companies House would be late due to a change in auditors. This set of accounts was ultimately filed on 19 February 2018</p>
<p>19 December 2017</p>	<p>The Contact Centre received a query from a consumer requesting information on LCF and verification that LCF was FCA registered, prior to investing in a fixed term bond.</p> <p>The caller understood that <i>“there’s no, sort of, it’s not, it’s not going to, eligible for any, you know, the Financial Services Compensation Scheme or anything like that”</i> but requested clarification as to what FCA registration entailed.</p> <p>The FCA employee gave an overview of the FCA's powers and noted that LCF had various permissions regarding investments but declined to comment on the integrity of LCF or advise on the risk entailed in the LCF investment.</p>
<p>3 January 2018</p>	<p>A consumer contacted the Contact Centre to request additional information regarding investing in LCF’s ISA bond.</p> <p>The caller noted that they had <i>“looked up this company before...it was actually for a bond, and a lot of people said, don’t go there because they’re not protected, or anything. This time they have an ISA, and it’s a couple of years later, so I’m thinking, well the company still exists...because I don’t know who these people are who are saying don’t take it out. I know that you have to be protected by the Financial Conduct Authority, I didn’t know they had a register... and it’s saying ... [LCF is] not registered. So I’m a bit confused.”</i></p> <p>The FCA employee first asked if the caller was a <i>“sophisticated investor or high-net worth individual”</i>. The FCA employee checked if the ISA involved asset-backed bonds and stated that <i>“these</i></p>

Appendix 8: Detailed Chronology

	<p><i>should not be advertised to retail investors</i>” as they would not carry FSCS or FOS protection.</p> <p>The FCA employee suggested the caller should contact the Money Advice Service or a financial adviser and request further information for LCF. No further action was taken.</p>
1 February 2018	<p>A consumer connected to the Contact Centre to request additional information regarding investing in LCF’s two-year 6.5% ISA bond and whether LCF were registered with the FCA, after being cut off from a previous call.</p> <p>The FCA employee noted that LCF did not have permission to offer a cash ISA, but may be able to offer “<i>an investment ISA</i>”. The FCA employee also highlighted that LCF may use “<i>asset-backed products</i>” which might not be protected. No further action was taken after the FCA employee referred the caller to LCF for further information.</p>
19 February 2018	<p>A consumer connected to the Contact Centre noting that LCF products were “<i>not covered by FSCS</i>” and requested further information.</p> <p>The FCA employee noted that LCF mentioned on their website that the bonds are “<i>not authorised by the Financial Conduct Authority</i>”. The FCA employee stated that as LCF bonds were “<i>corporate bonds</i>” they fell “<i>outside of [the FCA’s] scope</i>”. The FCA employee provided contact details for LCF, the FSCS and the Money Advice Service for further information.</p> <p>LCF’s Compliance Officer called the FCA’s Contact Centre twice to enquiring about LCF’s authorisation status.</p> <p>The FCA employee provided a status update of LCF’s application to LCF’s Compliance Officer.</p> <p>A consumer connected to the Contact Centre to request additional information prior to investing in LCF’s Innovative Finance ISA.</p> <p>The FCA employee explained that the LCF ISA would likely be investing in a bond not a cash investment and therefore the caller may not benefit from the protection offered by the FSCS.</p> <p>The FCA employee provided the caller with contact details for LCF to provide further information regarding the ISA.</p>

Appendix 8: Detailed Chronology

<p>22 February 2018</p>	<p>Individual A called the Contact Centre to raise further concerns regarding LCF. He stated that LCF was selling mini-bonds directly to members of the public who were not sophisticated investors or high-net worth individuals. Individual A also explained that he had been unable to find any proof that LCF had lent money to any company. He noted that LCF did not appear to have any staff on the lending side of the business.</p> <p>Individual A explained that he had tried to obtain information from LCF but the firm had refused on the basis of data protection concerns (which Individual A believed to be unfounded). He had also tried to obtain information regarding LCF from Sentient Capital, but they were unable to assist. Individual A stated that he had also tried to obtain information regarding LCF from Surge Financial Limited but they had been unable to do so purportedly on the basis of data protection concerns.</p> <p>Individual A said that the reason why LCF was reluctant to provide information was because it was “<i>basically, just a Ponzi scam.</i>” He said that if LCF was involved in wrongdoing then it would “<i>collapse anyway, and even more bond holders will suffer...</i>”</p> <p>The FCA employee noted that LCF’s bonds were unregulated and that “[the FCA’s] <i>rules and guidelines wouldn’t apply to unregulated investments.</i>” He said that, if the activity was regulated, then he could escalate the case to the appropriate team within the FCA’s Supervision Division. In the circumstances, the FCA employee suggested Individual A should contact the Citizens Advice Bureau to seek legal advice.</p> <p>The case was closed and the FCA did not take any further action.</p>
<p>27 February 2018</p>	<p>A consumer contacted the Contact Centre requesting verification that LCF was a FCA registered company due to having previously invested in LCF bonds.</p> <p>The FCA employee noted that the LCF website stated that bonds offered by LCF were not regulated by the FCA and therefore would not be protected by the FSCS. The caller claimed to have previously checked with the FCA that LCF was regulated but did not have any knowledge that the investment needed to be separately regulated.</p> <p>The FCA employee provided contact details for LCF for the caller to confirm details of their investment.</p>
<p>15 March 2018</p>	<p>A consumer contacted the Contact Centre to request additional information prior to investing in LCF’s fixed term ISA. The caller</p>

Appendix 8: Detailed Chronology

	<p>noted that LCF’s website “<i>appeared contradictory</i>” as it stated that LCF were regulated by the FCA but that LCF’s bonds were not covered by FSCS and not regulated by the FCA. The caller also requested a definition of a “<i>high-net worth individual</i>” and a “<i>sophisticated investor</i>”.</p> <p>The FCA employee stated that the bonds being offered by LCF were “<i>asset-backed bonds would not be [FCA] regulated</i>” and therefore any investment would not benefit from FSCS protection. The FCA employee provided a definitions of a “<i>high-net worth individual</i>” and a “<i>sophisticated investor</i>” from the FCA Handbook to the caller.</p> <p>The case was closed and the FCA did not take any further action on the complaint.</p>
21 March 2018	<p>LCF’s Compliance Officer was provided confirmation by the FCA Authorisation Division that LCF’s application for CF30 Customer-Dealing Functions for an LCF individual had been approved.</p> <p>In response to a further application for FCA Authorised Person approval, LCF’s Compliance Officer withdrew an application for CF10a Controlled Functions but continued an application CF30 Customer-Dealing Functions regarding a second LCF individual.</p> <p>LCF’s Compliance Officer contacted the Contact Centre via Connect webchat querying whether LCF may amend a submitted Form A Application regarding approved persons.</p>
28 March 2018	<p>LCF’s Compliance Officer was provided confirmation by the FCA Authorisation Division that LCF’s application for CF30 Customer-Dealing Functions regarding a third LCF individual had been approved. This approval was initially delayed due to the need for further clarifications from LCF regarding the relevant individual.</p>
5 April 2018	<p>In response to a consumer query on 2 April 2018 about whether LCF’s ISA and bond products were covered by the FSCS, an FCA employee in the Contact Centre emailed the consumer stating that the bonds offered by LCF would not be covered by the FSCS. However, the email went on to say: “[w]ith regards to the ISAs the firm offers, these will be covered by the FSCS. The level of protection will depend on whether the ISAs are cash ISAs or stocks and shares ISA. Again, [LCF] and the FSCS will be able to give you more information about this.”</p>
18 April 2018	<p>LCF’s Compliance Officer was provided confirmation by the FCA Authorisation Division that LCF’s application for CF30 Customer</p>

Appendix 8: Detailed Chronology

	<p>Functions regarding the second LCF individual had been approved, further to the LCF Compliance Officer's email on the 21 March 2018.</p>
25 April 2018	<p>A consumer contacted the Contact Centre to request additional information regarding LCF's three-year 8% ISA bond. The FCA employee explained that an ISA was a tax matter and the fact that LCF's products were ISAs did not necessarily mean they were regulated by the FCA. The FCA employee also explained that some of LCF's products were unlikely to be regulated and, as such, an investor would not have access to the FSCS or recourse to the FOS.</p> <p>During the course of the conversation, the FCA employee read to the caller certain sections from the terms of LCF's three-year 8% ISA bond as set out on LCF's website. This included references to the fact that LCF's bonds were non-transferable ("<i>[t]here's a disclaimer bit there that goes through quite a lot about the bonds not being transferable</i>").</p> <p>The FCA employee suggested the caller should contact the Money Advice Service or a financial adviser. No further action was taken.</p>
27 April 2018	<p>A consumer emailed the Contact Centre asking: (i) whether it was legal for LCF to offer corporate bonds; and (ii) where to find information regarding fraudulent corporate bond cases.</p> <p>The FCA employee in the Contact Centre emailed the consumer to explain that individuals in the Contact Centre were not legally trained and, accordingly, the consumer would need to seek independent legal advice in relation to the first of their queries. In relation to the second query, the FCA employee in the Contact Centre said: "<i>[c]orporate Bonds fall outside our remit, and as a result we don't have any information on fraudulent cases. However, you may want to contact Action Fraud, which is the UK national cybercrime and fraud reporting centre for further guidance.</i>"</p>
30 April 2018	<p>A consumer contacted the Contact Centre to request verification that LCF was a "<i>bona fide outfit</i>", prior to investing in an LCF ISA.</p> <p>The FCA employee noted that LCF did not have permission to provide "<i>cash based saving accounts</i>". The FCA employee also stated that the ISA and bonds being offered by LCF were "<i>asset-backed for security</i>" and would not benefit from FSCS protection. The FCA employee also noted that the ISA was "<i>not authorised by the [FCA]</i>".</p>

Appendix 8: Detailed Chronology

	No further action taken after the FCA employee referred the caller to the Money Advice Service.
2 May 2018	The consumer who received a response on 27 April 2018 (see above) followed up on 30 April 2018 to ask whether the corporate bonds offered by LCF were regulated and he also explained that he wanted to make sure the bonds were not a scam. The FCA employee in the Contact Centre responded to confirm that the bonds offered by LCF appeared to be unregulated. He also added: “[i]f you have concerns this is a scam, you will need to contact Action Fraud as discussed in my last email.”
15 May 2018	<p>A consumer contacted the Contact Centre to request information on how to navigate the FCA Register to check if companies and investments were regulated.</p> <p>The caller noted that LCF did not have FSCS protection and wanted to find further information on LCF. The FCA employee noted that the bonds and ISAs being offered by LCF were not FCA regulated and therefore any investments would not benefit from “<i>coverage of the Financial Services Compensation Scheme if something was to go wrong, nor would [the caller] be able to approach the Financial Ombudsman Service generally if the firm [were] not regulated</i>”.</p> <p>The FCA employee provided an explanation to the consumer on how to search the FCA Register and understand permissions granted to firms.</p>
16 May 2018	<p>A consumer had raised a concern regarding an advert he had seen on Facebook for an ISA offered by LCF because it appeared to suggest the ISA was FCA-authorized. The FCA employee in the Contact Centre explained the regulation of ISA products as follows: “[w]e don’t regulate ISAs as a product. [HMRC] regulate ISA managers, that is, firms that provide ISAs, and set the rules for them to follow. We regulate firms that advise on and sell ISAs, and also that provide them, but this is because these firms are typically banks or investment companies.”</p> <p>The FCA employee explained that she had shared the screenshot of the advert provided by the consumer “<i>with my colleagues in the team that look into potentially cloned firms.</i>”</p>
21 May 2018	The Facebook advert handled by an FCA employee in the Contact Centre (see entry for 16 May 2018 above) was considered by an FCA employee in the Unauthorised Business Department. The FCA employee in the Unauthorised Business Department noted that



Appendix 8: Detailed Chronology

	<p>the information in the advert largely matched the information on the Register regarding LCF, other than the address details. The FCA employee asked for the Contact Centre to refer the case to Supervision Division and suggested that, if they confirmed it was a clone, it should be referred back to the Unauthorised Business Department.</p>
23 May 2018	<p>The Consumer Credit Supervision Team reviewed the Facebook advert escalated by the Contact Centre (see entry for 21 May 2018 above). The FCA employee in the Consumer Credit Supervision Team noted the discrepancy between LCF’s address in the advert as against the address on the Register. However, the FCA employee closed the case stating that:</p> <p><i>“I will be closing this case within risk tolerance, as there are not any risk events to suggest there has been any detriment caused to the consumer, nor has this issue affected any other consumer. The firm is also a Credit Broker so is considered a low risk firm.”</i></p>
11 June 2018	<p>A consumer contacted the Contact Centre to request information on LCF and requested verification that LCF was authorised and regulated by the FCA, prior to investing in a fixed term ISA. In particular the caller wanted to confirm that their investment would be covered by the FSCS.</p> <p>The FCA employee noted that LCF were regulated and authorised by the FCA. No further action, case closed after the FCA sent the caller an email confirming that LCF is regulated by the FCA. No Supervisory interest noted.</p>
13 June 2018	<p>The ASA referred a consumer complaint regarding Top-ISA-Rates.co.uk to the Financial Promotions Team. The consumer said that a Facebook advert for this website was <i>“entirely misleading.”</i> The complaint further stated: <i>“[t]he product being offered is an extremely high risk, non-mainstream financial product with the risk of 100% loss of capital, yet they are being advertised in a way that makes them sound like cash ISAs with zero risk of loss of capital.”</i> The Financial Promotions Team logged the case against LCF. For this reason, and although this is not clear from the materials provided by the ASA, it is likely that the advert included, or was focused on, a product offered by LCF.</p>
6 July 2018	<p>The Contact Centre received a query from an individual, whose complaint was summarised as follows:</p>

Appendix 8: Detailed Chronology

	<p><i>“The firms customer type shows Retail – Investment but contradicts the requirement placed ‘the firm must not conduct designated investment business other than corporate finance business’”.</i></p> <p>The query was forwarded to an FCA employee in the Authorisations Division who closed the case stating that <i>“it is entirely possible to carry out corporate finance business for retail customers”</i>.</p>
20 July 2018	<p>The Contact Centre received a call from an individual seeking information concerning regulated and non-regulated products. The caller asked about mini-bonds specifically as LCF refused to provide information about them on the basis of data protection concerns. The caller asked about what activities the FCA regulated for LCF. He said, <i>“when a person phones them [i.e. LCF] up and asks them for details about their business they refuse to give any information about it”</i>. The Contact Centre employee noted that the FCA only regulate certain products. When asked about the mini-bonds issued by LCF, the FCA employee said <i>“it’s not in our remit and there’s nothing we can do about that”</i>. The FCA employee confirmed that LCF was authorised. The FCA employee recommended that the caller speaks to the ICO. The case was escalated to Risk Event.</p>
6 August 2018	<p>UK Listing Authority (the <b>“UKLA”</b>) emailed the Supervision Team about LCF. The UKLA wanted to know if there were any <i>“material issues with the firm, including non-public or price sensitive information”</i>.</p> <p>A member of the Supervision Team replied the same day stating that he had <i>“identified no open risk events or on-going concerns with the firm”</i>.</p>
3 September 2018	<p>Following up on the 06 August 2018 email, an FCA employee in the UKLA notified the Supervision Team that LCF had submitted and updated prospectus. The FCA employee noted: <i>“In general I’m still concerned about the cash management policy of the company and also their speed of growth. I wanted to ask you for view on cash management of the Company, have you had any concerns, or have they ever reviewed this aspect of the company s business? Also has the speed of growth raised any red flags at all?”</i></p>
7 September 2018	<p>An FCA employee in the UKLA notified the Supervision Team that LCF <i>“may pose significant risks to the FCA as a whole”</i>. The FCA employee said that he would like to <i>“explore whether there is the</i></p>

Appendix 8: Detailed Chronology

	<i>possibility of us we can (sic) work with you as the firm’s supervisors to address some of these risks”.</i>
10 September 2018	<p>LCF submitted a Variation of Permission application with a view to becoming a financial advisor for retail clients.</p> <p>A representative of the Supervision Team asked the FCA employee from UKLA to send an email to the Retail Lending Supervision Inbox to set up an Intact case to investigate LCF. He also asked what UKLA’s concerns were and what evidence/supporting information they had.</p>
11 September 2018	<p>The employee in the Listing Transactions Team emailed the FCA identifying a number of concerns and risks regarding LCF for a “<i>potential INTACT case to be raised</i>”.</p> <p>The FCA employee for LCF’s Variation of Permission application requested the following information from LCF:</p> <p><i>“(1) Does the firm require retail clients for its advising permission - this is referred to in the business plan, but not in the application</i></p> <p><i>(2) How have the individual's carrying out the advising activity been deemed competent to carry out the activity? Please provide a breakdown of the advisor's experience and qualifications as necessary</i></p> <p><i>(3) What oversight arrangements are in place to supervise the individuals providing advice”</i></p>
26 September 2018	<p>The FCA employee asked further questions regarding LCF’s application for Permission for Variation dated 10 September 2018. In particular, queries were raised regarding the:</p> <p>(i) suitability test and any scoring methodology used by LCF;</p> <p>(ii) individuals’ CVs, SPS and evidence of qualifications provided by LCF; and</p> <p>(iii) experience and/or qualifications of LCF’s Compliance Officer.</p>
4 October 2018	<p>LCF submitted further documents in support of its Permission for Variation Application, including management accounts and its last audited accounts.</p>
15 October 2018	<p>The FCA employee emailed LCF regarding its Permission for Variation Application. Among other matters, he pointed out that</p>

Appendix 8: Detailed Chronology

	<i>“there are still some sections and wording which are not suitable for retail clients”.</i>
19 October 2018	LCF’s Compliance Officer responded to the FCA employee’s 15 October email providing further information regarding LCF’s Permission for Variation Application.
22 October 2018	<p>An employee in the Supervision Team emailed the General Counsel’s Division asking the following questions about a <i>“regulated corporate finance firm.... offering mini bonds to retail consumers”</i>:</p> <p>(i) <i>“What our regulatory touch points are (or might be)?”</i></p> <p>(ii) <i>“Whether SYSC 6.1.1R applies?”</i></p> <p>(iii) <i>“Which principles apply?”</i></p> <p>(iv) <i>“Assuming Fin Proms apply, whether there are any Fin Proms Issues?”</i></p> <p>(v) <i>“Whether the firm acting as Innovative Finance ISA manager brings this back within our perimeter?”</i></p> <p>(vi) <i>“According to the intel there may be a conflict of interests between the bond issuer and the recipients of the onward loans Do we have any touch points here?”</i></p>
30 October 2018	An employee in the General Counsel’s Division responded to the Supervision Team’s email of 22 October. The email noted that the main issue to consider was whether the issuance of bonds constituted execution of orders on behalf of clients for the purposes of MiFID. If this was the case then LCF may have been acting outside its permission.
31 October 2018	The FCA Contact Centre received a call requesting clarification regarding the difference between being FCA regulated and covered by the FSCS. The FCA employee confirmed that the FCA and FSCS were two separate organisations and that LCF were listed on the FCA register for specific permissions. The FCA employee noted that LCF were not regulated for bonds and therefore any investment in their bonds were not covered under the FSCS.
2 November 2018	A journalist emailed the Press Office of the FCA setting out a number of anonymised allegations.
	A consumer interested in purchasing an ISA from LCF called the Contact Centre check if LCF was regulated by the FCA. The

Appendix 8: Detailed Chronology

	<p>Contact Centre employee noted that LCF had “<i>an entry on the FS register, however it doesn’t appear that they have the permissions</i>”. The Contact Centre representative raised an “<i>ancillary case</i>” to the main cases regarding LCF.</p>
12 November 2018	<p>An employee in the General Counsel’s Division provided advice on how LCF’s unregulated activities might be caught by FCA’s Perimeter. She said:</p> <p>(i) LCF’s financial promotions for mini-bonds and ISAs/ISA bonds and its approval of these promotions were subject to FCA’s financial promotion rules;</p> <p>(ii) LCF, a manager of Innovative Finance ISAs (IFISA), claimed on its website that customers would not have to pay income tax on its ISA bonds’ interest. However, mini-bonds did not fall within the definition of a qualifying investment that could be held in an IFISA. On this basis, the firm’s promotions were not clear or fair and were misleading;</p> <p>(iii) This was also likely to have tax implications for investors. Strictly, the tax issue was for HMRC rather than FCA, but the FCA should consider liaising with HMRC on this;</p> <p>(iv) FCA’s financial promotions rules applied to LCF communications and approval of its financial promotions about the bonds.</p>
16 November 2018	<p>An employee in the General Counsel’s Division emailed Supervision to provide a summary of a discussion with HMRC as to what would happen if customers had invested their bonds in an ISA wrapper under the misapprehension that they would be entitled to tax relief. The employee reported that her contact at HMRC had said that the investments would need to be taken out of the ISA wrapper and that “<i>it may be a question of pursuing the ISA manager in relation to the incorrectly claimed tax relief rather than the investors.</i>”</p>
4 December 2018	<p>FCA’s Supervision and Enforcement Teams made arrangements to conduct an unannounced visit to LCF’s office.</p>
10 December 2018	<p>The FCA wrote a letter to LCF requesting LCF to provide documents and information relating to the 30 categories of information set out in Annex 1 of the letter.</p> <p>FCA Enforcement and Supervision carried out an unannounced visit of LCF’s offices.</p>

Appendix 8: Detailed Chronology

	FCA issued a First Supervisory Notice directing LCF immediately to withdraw its promotional material as it was misleading, unfair and unclear.
11 December 2018	The FCA Contact Centre received a complaint from a caller who stated that LCF had created a different website to that on the FCA register. The FCA employee referred the information to the ongoing investigation.
13 December 2018	The FCA Contact Centre received a call from a consumer who had been told by LCF that they are unable to invest his money since the FCA are auditing LCF. The FCA employee referred the information to the ongoing investigation.  A Voluntary Requirement (“ <b>VREQ</b> ”) notice was issued, prohibiting LCF from dealing with or disposing of its assets or communicating financial promotions.
19 December 2018	The Contact Centre received a call from a consumer complaining that LCF were not paying the consumer's interest which was due on their ISA. The FCA employee referred the information to the ongoing investigation.
21 December 2018	The FCA convened an internal Prudential Crisis Management Group (“ <b>PCMG</b> ”) meeting to discuss LCF.
27 December 2018	The Contact Centre received a call asking why the FCA were auditing LCF. The caller had invested in an ISA and wanted to know whether and how LCF was safeguarded as an FCA-regulated entity. The FCA representative stated that LCF’s asset-backed bonds were not regulated by the FCA and had no protection under the FSCS. The FCA employee noted that the FCA had directed LCF to withdraw all of their marketing material but could not provide any details about the FCA’s ongoing investigation.
8 January 2019	The FCA Contact Centre received a call from consumer regarding LCF. The caller said that LCF had called him to ask if he wanted to purchase “ <i>an ISA Bond Product offering a 5 (five) years duration at 8.95% (or thereabouts) with the option to only hold it for a year and cash in after same, but only getting, 3.95% (or thereabouts) Interest</i> ”. The caller said that LCF may have been using the new customer's deposits/funds to pay their existing customer's interest/capital payments. The FCA employee referred the information to the ongoing investigation.
9 January 2019	The Contact Centre received a call from an individual who said that he had regularly contacted the FCA regarding LCF. The caller

*Appendix 8: Detailed Chronology*

	<p>provided information regarding some individuals associated with LCF.</p> <p>The FCA employee directed the caller to check the FCA website for relevant updates and that the FCA were unable to provide updates on the investigation.</p> <p>The FCA convened an internal PCMG meeting to discuss LCF.</p>
17 January 2019	FCA's Enforcement and Market Oversight division wrote to LCF regarding the appointment of investigators to conduct an investigation into LCF.
17 January 2019	FCA issued a Second Supervisory Notice stating that the ISAs sold by LCF were not qualifying investments and that undue prominence was given by LCF to its FCA authorisation, despite the bonds not being regulated or having FSCS protection.
23 January 2019	FCA's SIWS RiskCo Committee decided to add LCF to the Watchlist.
30 January 2019	LCF entered into administration and four members of Smith & Williamson LLP: Finbarr O'Connell, Adam Stephens, Colin Hardman and Henry Shinnars, were appointed as LCF's joint administrators.
18 March 2019	The SFO confirmed that it had arrested four individuals associated with LCF.
9 January 2020	FSCS declared that LCF had failed.

## **APPENDIX 9: RECENT DEBATE AND REFORMS IN RESPECT OF THE FINANCIAL PROMOTIONS REGIME**

- 1.1 The financial promotions regime has been the subject of recent reform. However, it is not within the Investigation’s remit to consider the merits or otherwise of such reforms, particularly in circumstances where the reforms occurred outside the Relevant Period. Furthermore, there have been recent consultations in respect of proposed changes to the financial promotions regime.
- 1.2 Nonetheless, the reforms, and the period of debate which preceded them, are summarised for completeness in this **Appendix 9** below.
- 1.3 In a speech on 4 September 2019, Charles Randall, FCA chair, suggested that “[a] *well-functioning financial promotions regime would label a high-risk unquoted and unregulated investment as exactly that*” and suggested that the issue or approval of financial promotions should be made a regulated activity.<sup>1273</sup>
- 1.4 Further, the House of Commons Treasury Committee, the FCA and the Government engaged in dialogue regarding potential reforms to the financial promotions regime in mid-to-late 2019.<sup>1274</sup>

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<sup>1273</sup> Speech by Charles Randell, Chair of the FCA, delivered at the Cambridge Economic Crime Symposium, 5 September 2019 (see: <https://www.fca.org.uk/news/speeches/fight-against-skimmers-and-scammers> (accessed on 6 October 2020)).

<sup>1274</sup> The House of Commons Treasury Committee 35<sup>th</sup> Report of Session 2017-2019, The work of the Financial Conduct Authority: the perimeter of regulation, 2 August 2019, at page 14, at paragraph 4, recommended that where regulated financial institutions undertake unregulated activity, the regulatory system should ensure that clear and explicit warnings are provided at that point, with the potential consequences of the lack of regulatory cover clearly explained, with sanctions for firms that fail to do so (see: <https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/2594/2594.pdf> (accessed on 6 October 2020)).

In its response (FCA response to the Committee’s Thirty-Fifth Report of Session 2017–19, 17 October 2019, at pages 1 and 2 (see: <https://publications.parliament.uk/pa/cm201919/cmselect/cmtreasy/132/132.pdf> (accessed on 6 October 2020))), the FCA noted that: (i) such rules were in place but did not require in all cases a proactive explanation or warning to consumers; and (ii) the FCA was exploring what more it could do to ensure firms were more actively disclosing where their activities were unregulated and in the meantime had published a “Dear CEO” letter which set out the FCA’s expectations in this regard. FCA, Dear CEO Letter, 9 January 2019 (see: <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-promotions-regulated-unregulated-business.pdf> (accessed on 6 October 2020)).

The Government Response (Government Response to the Committee’s Thirty-Fifth Report, 10 October 2019, paragraph 2.5) to the Treasury Committee’s 35<sup>th</sup> Report noted that it was working with the FCA including in the light of the failure of LCF (see: <https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/2674/2674.pdf> (accessed on 6 October 2020)).



- 1.5 In November 2019, the FCA exercised powers under a variety of FSMA provisions including section 137D of FSMA to enact the “*Conduct of Business (Speculative Illiquid Securities) Instrument 2019*.” The accompanying FCA paper, “*Temporary intervention on the marketing of speculative mini-bonds to retail investors*”, explained that the relevant instrument brought in a range of temporary rules: (i) to restrict the marketing of “*speculative illiquid securities*” to individual retail investors who had been categorised as sophisticated or high-net worth and where the product had been initially assessed as likely to be suitable for them; and (ii) mandating specific risk warnings and disclosures.<sup>1275</sup>
- 1.6 The FCA paper stated that these changes were temporary in nature although the FCA planned to consult on further changes during 2020 with a view to enacting permanent rules.<sup>1276</sup> While the temporary instrument would only apply to financial promotions issued from 1 January 2020, in respect of pre-existing financial promotions the FCA issued in November 2019 further guidance.<sup>1277</sup> The FCA’s intervention arose out of the events of LCF.<sup>1278</sup>
- 1.7 In June 2020, the FCA issued its consultation paper “High-risk investments: Marketing speculative illiquid securities (including speculative mini-bonds) to retail investors.” The paper stated that the FCA “proposed to make the [temporary intervention] permanent, with a small number of changes... generally based on feedback we have received since publishing.”<sup>1279</sup> This consultation closed shortly before delivery of this Report and the Policy Statement is awaited.<sup>1280</sup>

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<sup>1275</sup> FCA, Temporary intervention on the marketing of speculative mini-bonds to retail investors, November 2019, paragraphs 1.8 and 1.40 (see: <https://www.fca.org.uk/publication/tpi/temporary-intervention-marketing-speculative-mini-bonds-retail-investors.pdf> (accessed on 6 October 2020)).

<sup>1276</sup> *Ibid.*, paragraph 1.60 and 1.61.

<sup>1277</sup> FCA Guidance, Approving financial promotions, 26 November 2019 (see: <https://www.fca.org.uk/firms/financial-promotions-and-adverts/approving-financial-promotions> (accessed on 6 October 2020) and FCA, Dear CEO Letter, 11 April 2019 (see: <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-firms-approvals-financial-promotions-fcas-expectations.pdf> (accessed on 6 October 2020)).

<sup>1278</sup> FCA, Temporary intervention on the marketing of speculative mini-bonds to retail investors, November 2019, paragraphs 1.19 to 1.21.

<sup>1279</sup> FCA Consultation Paper CP20/8\*\*\*, High-risk investments: Marketing speculative illiquid securities (including speculative mini-bonds) to retail investors, June 2020, at paragraph 1.3 (see: <https://www.fca.org.uk/publication/consultation/cp20-8.pdf> (accessed on 6 October 2020)).

<sup>1280</sup> Separately, in July 2020, the Treasury launched a consultation regarding the “*Regulatory Framework for Approval of Financial Promotions*.” The consultation proposes a new regulatory gateway “so that the general ability of authorised firms to approve financial promotions of unauthorised firms is removed.” The consultation proposes: (i) restricting the approval

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of financial promotions of unauthorised firms through the imposition of requirements by the FCA; or (ii) specifying the approval of financial promotions communicated by unauthorised persons as a “regulated activity” under FSMA. The proposal would not, however, affect the way in which authorised firms such as LCF communicate or approve their own promotions. Consequently, its relevance to this Investigation is limited. (Treasury Consultation, Regulatory Framework for Approval of Financial Promotions, July 2020, at paragraphs 6.2, 6.5 and 6.6 (see: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/902101/Financial\\_Promotions\\_Unauthorised\\_Firms\\_Consultation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/902101/Financial_Promotions_Unauthorised_Firms_Consultation.pdf) (accessed on 6 October 2020)).

## **APPENDIX 10: THE FCA'S ASSIGNMENT OF RESPONSIBILITIES**

### **2. Introduction**

2.1 As stated in Section 11 of **Chapter 1**, in their representations to the Investigation, the FCA and other participants in the representations process asked the Investigation not to make findings about individual responsibility for the FCA's deficiencies in regulating LCF.

2.2 As part of this Report's response to those representations noted above, reference is made to the "FCA Statements of Responsibility" and the "FCA Management Responsibilities Map" contained within "Applying the Senior Managers Regime to the FCA 2016" and "Applying the Senior Managers Regime to the FCA 2018".

2.3 This Appendix sets out, so far as material, extracts from those Statements of Responsibility, which state the responsibilities attributed to following senior management roles and bodies:

- (a) The Chief Executive Officer of the FCA;
- (b) The Executive Director of Supervision – Investment, Wholesale and Specialist;
- (c) Executive Director of Supervision – Retail and Authorisations;
- (d) The FCA Board of Directors; and
- (e) The Executive Committee of the FCA.

2.4 Where titles, page references or language has been provided in this Appendix, these replicate, to the extent possible, relevant parts of "Applying the Senior Managers Regime to the FCA 2016" and "Applying the Senior Managers Regime to the FCA 2018".

### **3. Applying the Senior Managers Regime to the FCA 2016**

3.1 Responsibilities of the Chief Executive Officer of the FCA:

- (a) The following responsibilities are set out at pages 11 to 15 under the heading "*Prescribed Responsibilities*", and are repeated at page 38 under the heading "*Chief Executive Officer*":

Appendix 10: The FCA's assignment of responsibilities

- (i) *“responsibility for the FCA’s performance of its obligations under the senior management regime;*
  - (ii) *responsibility for compliance with the requirements of the regulatory system about the management responsibilities map;*
  - (iii) *responsibility for overseeing the adoption of the FCA’s culture in the day-to-day management of the FCA; and*
  - (iv) *responsibility for the development and maintenance of the FCA’s business model by the governing body.”*
- (b) The following responsibilities are set out at pages 16 to 19 under the heading *“Overall Responsibilities”* and are repeated at page 38 under the heading *“Chief Executive Officer”*:
- (i) *“responsibility for secretariat function for the Executive Committee; and*
  - (ii) *responsibility for coordination with the Prudential Regulation Authority.”*
- (c) The following responsibilities are set out at pages 39 to 40 under the heading *“Chief Executive Officer”*:
- (i) *“The Chief Executive Officer is responsible for implementing the strategy agreed by the Board, in the formulation of which they will have played a major part. They are also responsible for the leadership of the organisation and managing it within the authorities delegated to them by the Board. All FCA staff other than the Chair’s immediate staff, the Director of Internal Audit and the Company Secretary, ultimately report to the Chief Executive Officer.”*
  - (ii) *“The responsibilities include:*

*Appendix 10: The FCA's assignment of responsibilities*

- (A) *reporting regularly to the Board with appropriate timely and quality information so the Board can discharge its responsibilities effectively;*
- (B) *informing and consulting the Chair on all matters of significance to the Board so that the Chair and the Board can properly discharge their responsibilities;*
- (C) *developing and delivering the strategic objectives agreed with the Board;*
- (D) *recommending to the Board significant operational changes and major capital expenditures where these are beyond the Chief Executive's delegated authority;*
- (E) *assigning responsibilities clearly to senior management and overseeing the establishment of effective risk management and control systems;*
- (F) *recruiting, developing and retaining talented people to work at the FCA and, in particular, establishing a strong management team which is fairly and fully evaluated;*
- (G) *communicating throughout the FCA the strategic objectives and the values of the FCA agreed with the Board, and ensuring that these are achieved in practice;*
- (H) *sharing with the Chair and with other members of the FCA senior management the responsibility for communicating the FCA's messages externally;*
- (I) *representing the FCA on particular national and international financial institutions; and*

- (J) *taking such steps as are necessary to ensure that the PSR is, at all times, capable of exercising its statutory functions."*

3.2 Responsibilities of the Executive Director of Supervision – Investment, Wholesale and Specialist:

- (a) The following responsibilities are set out at pages 16 to 19 under the heading "*Overall Responsibilities*" and are repeated at page 47 under the heading "*Executive Committee Directors Supervision – Investment, Wholesale & Specialists*":
- (i) *"responsibility for supervision of firms participating in the conduct of business in capital markets;*
  - (ii) *responsibility for supervision of the wholesale banking sector;*
  - (iii) *responsibility for supervision of the investment management sector;*
  - (iv) *responsibility for supervision of the pensions and retirement income sector;*
  - (v) *responsibility for supervision of the retail investments sector;*
  - (vi) *responsibility for specialist supervision – prudential, financial crime, events and client assets;*
  - (vii) *responsibility for regulatory policy – financial crime and CASS; and*
  - (viii) *responsibility for the supervision of exchanges and trading venues."*
- (b) The following responsibilities are set out at page 48 under the heading "*Executive Committee Directors Supervision – Investment, Wholesale & Specialists*":
- (i) *"Role main purpose*
    - (A) *responsible for the supervision of the following financial sectors: wholesale banking, capital markets, investment*

*management, retail investments, and pensions and retirement income;*

(B) *responsible for the provision of specialist supervision and operations functions which support the supervision of all firms under the FCA's remit. The specialist supervision function consists of event supervision, financial crime, client assets supervision and prudential supervision (including the function of resolution). This includes the engagement of these functions where relevant to firms under the individual's supervision remit; and*

(C) *responsible for ensuring effective input into authorisation decisions for all firms transactions and individuals relating to firms under the individual's supervision remit."*

### 3.3 Responsibilities of the Executive Director of Supervision – Retail and Authorisations:

- (a) The following responsibilities are set out at pages 16 to 19 under the heading "*Overall Responsibilities*" and are repeated at page 45 under heading "*Executive Committee Directors Supervision – Retail & Authorisations*":
- (i) *"responsibility for specialist supervision – conduct;*
  - (ii) *responsibility for supervision of the general insurance and protection sector;*
  - (iii) *responsibility for supervision of the retail lending sector;*
  - (iv) *responsibility for supervision of the retail banking sector;*
  - (v) *responsibility for authorisations of all firms, transactions and individuals; and*
  - (vi) *responsibility for the FCA Contact Centre."*

Appendix 10: The FCA's assignment of responsibilities

- (b) The following responsibilities are set out at page 46 under the heading “*Executive Committee Directors Supervision – Retail & Authorisations*”:
- (i) “*Role main purpose*
- (A) *responsible for the supervision of the following financial sectors: general insurance and protection, retail lending and retail banking;*
- (B) *responsible for establishing and overseeing processes for the authorisation of all firms, transactions and individuals;*
- (C) *responsible for ensuring effective input into authorisation decisions for all firms transactions and individuals relating to firms under the individual’s supervision remit;*
- (D) *responsible for the FCA Contact Centre; and*
- (E) *responsible for the engagement of specialist supervision functions where relevant to firms under the individual’s supervision remit.”*

3.4 Responsibilities of the FCA Board of Directors:

- (a) The following responsibilities are set out at page 26 under the heading “*FCA Committee Structures*”:
- (i) “*The Board is the governing body of the FCA. It sets the FCA’s strategic direction and ensures the long term success of the FCA. It ensures that the necessary financial and human resources are in place for the FCA to meet its statutory objectives. It provides leadership of the organisation within a framework of prudent and effective controls which enables risk to be assessed and managed. It also reviews management performance.”*



The following responsibilities are set out at pages 73 to 78 under Appendix 2.1 "Terms of Reference for the Board and its Committees". Relevant sections of the Terms of Reference regarding the discharge of the FCA Board's responsibilities have been repeated below:

- (ii) *"4. Review performance against the FCA's strategy, objectives, business plan and budget and ensure any necessary corrective action is taken.*
  
- (iii) *7. Oversee the discharge of the FCA's operations by executive management ensuring:*
  - (A) *competent and prudent management*
  - (B) *sound planning*
  - (C) *adequate accounting and other records*
  - (D) *compliance with statutory obligations*
  
- (iv) *12. Ensure maintenance of a sound system of internal controls and internal risk management including:*
  - (A) *receiving reports on and reviewing the effectiveness of the FCA's internal risk and controls processes to support its strategy and objectives (Audit Committee).*
  - (B) *undertaking an annual assessment of these processes (Audit Committee).*
  - (C) *approving an appropriate statement on internal controls and risk management (Audit Committee).*
  
- (v) *13. Ensure the maintenance of an effective risk management system which both identifies and, where feasible, seeks to mitigate risks to the FCA's statutory objectives (Risk Committee).*

- (vi) *14. Undertake an annual assessment of the effectiveness of internal control and risk management processes (including financial, operational, and compliance controls and risk management systems) (Audit Committee and Risk Committee).*
- (vii) *41. On an annual basis undertake a formal and rigorous review of its own performance, its committees and individual Executive and Non-Executive Directors (or report on why this has not occurred in any particular year)."*

3.5 Responsibilities of the Executive Committee of the FCA:

- (a) The following language is produced at page 28 under the heading "*FCA Committee Structures*":
  - (i) *"The Executive Committee (ExCo) is the highest ranking executive decision making body of the FCA, and discusses issues across all areas of the organisation. It oversees the strategy, direction and activity of the FCA in general, including delivery of the FCA's annual Business Plan. It is responsible for monitoring the direction and performance of the organisation within the strategic framework set by the Board."*

**4. Applying the Senior Managers Regime to the FCA 2018**

4.1 Responsibilities of the Chief Executive Officer of the FCA:

- (a) All responsibilities outlined in "Applying the Senior Managers Regime to the FCA 2018" regarding the Chief Executive Officer of the FCA are identical to those expressed in "Applying the Senior Managers Regime to the FCA 2016".

4.2 Responsibilities of the Executive Director of Supervision – Investment, Wholesale and Specialist:

Appendix 10: The FCA's assignment of responsibilities

- (a) The following responsibilities are set out at pages 16 to 19 under the heading “Overall Responsibilities” and are repeated at page 49 under the heading “Executive Committee Directors Supervision – Retail & Authorisations”:
- (i) “responsibility for supervision of firms in the wholesale banking sector;
  - (ii) responsibility for supervision of firms in the asset management sector;
  - (iii) responsibility for supervision of firms in the pensions and retirement income sector;
  - (iv) responsibility for supervision of firms in the retail investments sector;
  - (v) responsibility for supervision of firms in the wholesale markets sector;
  - (vi) responsibility for the delivery and quality of execution of specialist supervision programmes in relation to financial crime, client assets, resolution, prudential, and technology, resilience and cyber;
  - (vii) responsibility for regulatory policy in financial crime and client assets;
  - (viii) with respect to non-routine cases involving firms in the wholesale banking, asset management, pensions and retirement income, retail investments and wholesale markets sectors, including (re-)authorisation of such firms in the context of the UK's withdrawal from the EU, responsibility for implementation of framework for assessment of and decision-making for such non-routine cases; and
  - (ix) responsibility for authorisations of funds in the asset management sector.”
- (b) The responsibilities set out at page 50 under the heading “Executive Committee Directors Supervision – Investment, Wholesale and Specialist” are identical to those expressed in ‘Applying the Senior Managers Regime to the FCA 2016’. Please see section 2.2(b) of this Appendix for further information.

4.3 Responsibilities of the Executive Director of Supervision – Retail and Authorisations:

- (a) The following responsibilities are set out at pages 16 to 19 under the heading “*Overall Responsibilities*” and are repeated at page 47 under the heading “*Executive Committee Directors Supervision – Retail & Authorisations*”:
- (i) *“responsibility for delivery and quality of execution of specialist supervision programmes and activities in conduct, remuneration, consumer contracts and financial promotions;*
  - (ii) *responsibility for supervision of firms in the general insurance and protection sector;*
  - (iii) *responsibility for supervision of firms in the retail lending sector;*
  - (iv) *responsibility for supervision of firms in the retail banking sector;*
  - (v) *responsibility for authorisations of firms, transactions and individuals for all routine cases;*
  - (vi) *responsibility for direct contact with consumers and firms via telephone and email correspondence to the agreed SLAs and the maintenance of the Financial Services Register; and*
  - (vii) *with respect to non-routine cases involving firms in the wholesale banking, wholesale markets, asset management, pensions and retirement income and retail investment sectors, including (re-) authorisation of such firms in the context of the UK's withdrawal from the EU, responsibility for design of framework for assessment of such non-routine cases.”*
- (b) The responsibilities set out at page 48 under the heading “*Executive Committee Directors Supervision – Retail & Authorisations*” are identical to those expressed in ‘Applying the Senior Managers Regime to the FCA 2016’. Please see section 2.3(b) of this Appendix for further information.

4.4 Responsibilities of the FCA Board of Directors:

- (a) All responsibilities outlined in 'Applying the Senior Managers Regime to the FCA 2018' regarding the FCA Board of Directors of the FCA are identical to those expressed in 'Applying the Senior Managers Regime to the FCA 2016'. Please see section 2.4 of this Appendix for further information.

4.5 Responsibilities of the Executive Committee of the FCA:

- (a) The following language is produced at page 28 under the heading "*FCA Committee Structures*":
  - (i) *"The Executive Committee (ExCo) is one of the 2 highest ranking executive decision making bodies of the FCA, and discusses significant operational issues across all areas of the organisation. It oversees the strategy, direction and activity of the FCA in general, including delivery of the FCA's annual Business Plan. It is responsible for monitoring the direction and performance of the organisation within the strategic framework set by the Board."*

**APPENDIX 11: STONETURN REPORT ON LCF'S FINANCIAL  
INFORMATION**

**IN THE MATTER OF AN INDEPENDENT INVESTIGATION INTO THE FINANCIAL  
CONDUCT AUTHORITY'S ("FCA") REGULATION OF LONDON CAPITAL &  
FINANCE PLC (LCF")**

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**REPORT OF**

**STONETURN**

**DATED 23 NOVEMBER 2020**

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## CONTENTS

<b>1</b>	<b>INTRODUCTION AND BACKGROUND .....</b>	<b>1</b>
<b>2</b>	<b>EXECUTIVE SUMMARY .....</b>	<b>4</b>
<b>3</b>	<b>QUALITY AND RELIABILITY OF THE FINANCIAL INFORMATION SUBMITTED BY LCF TO THE FCA .....</b>	<b>6</b>
<b>4</b>	<b>THE ABILITY OF LCF TO MEET ITS FINANCIAL OBLIGATIONS AS THEY FALL DUE ...</b>	<b>20</b>
<b>5</b>	<b>THE ACTUAL AND FORECAST GROWTH OF LCF.....</b>	<b>28</b>
<b>6</b>	<b>THE REASONABLENESS AND CREDIBILITY OF THE LCF BUSINESS MODEL.....</b>	<b>32</b>



# 1 INTRODUCTION AND BACKGROUND

## INSTRUCTIONS

- 1.1 Dechert LLP (“**Dechert**”) are members of the independent investigation team (“**the Investigation Team**”) headed by Dame Elizabeth Gloster who has been appointed by the FCA, pursuant to a Direction from the Economic Secretary to the Treasury dated 22 May 2019, to undertake an independent investigation into issues connected with the FCA’s regulation of LCF.
- 1.2 The Investigation Team identified a number of financial issues within the documentation provided and wanted a “sense check” from a chartered accountant. We have been instructed by Dechert to undertake a review of such relevant financial documentation of LCF, during its regulatory lifecycle, as was made available to the FCA. In particular we have been asked to identify any ‘red flags’ and concerns within the financial documentation submitted by LCF and the answers provided to the FCA in response to various requests.
- 1.3 For the avoidance of doubt, we have not had access to any of the underlying accounting books and records of LCF and our review has been restricted solely to the information and data that is shown on the face of each individual document provided to us. Should further information be brought to our attention after service of this report, we reserve the right to revise our conclusions, if appropriate, and will advise the Investigation Team as soon as practicable.
- 1.4 The work undertaken in carrying out our instructions and preparing this report does not constitute an audit in accordance with auditing standards.

## SOURCES OF INFORMATION

- 1.5 We have been provided by Dechert with an introductory document (“**the Introductory Document**”) which sets out a brief chronology of the relevant documentation submitted to the FCA by LCF during its regulatory lifecycle. Accompanying the Introductory Document are:
  - i Twelve separate financial documents (“**the Financial Documents**”) each setting out LCF’s historic and/or forecast financial results that were submitted by LCF to the FCA at varying intervals between 21 October 2015 and 22 May 2017;
  - ii Three documents showing the various questions and answers between the relevant FCA staff member and LCF in connection with the financial documentation submitted by LCF as part of its Variation of Permission application (this application was considered between December 2016 and June 2017) being:

- a. FCA Response dated 12 December 2016 and LCF Response dated 19 December 2016 (“**the First Set of Queries**”);
  - b. FCA Response dated 23 December 2016 and LCF Response dated 10 January 2017 (“**the Second Set of Queries**”); and
  - c. FCA Response dated 3 April 2017 and LCF Response dated 30 April 2017 and FCA Response dated 15 May 2017 and LCF Response dated 16 May 2017 (“**the Third Set of Queries**”);<sup>1</sup> and
- iii The various regulatory returns submitted by LCF insofar as they include financial information (“**the Financial Regulatory Returns**”). The financial information covers the quarters ending 31 July 2017 to 31 October 2018.<sup>2</sup>

## RESTRICTION ON CIRCULATION

- 1.6 This report has been prepared solely for the use of the Investigation Team and no responsibility or liability is accepted to anyone other than Dechert. This report is strictly private and confidential and must not be used, reproduced or circulated for any other purpose, in whole or in part, without our written consent. Such consent will only be given after full consideration of the circumstances at the time.<sup>3</sup> For the avoidance of doubt, this report does not constitute an Expert Report suitable for service within any proceedings.

## FORMS OF REPORT

- 1.7 This report may have been made available to the Investigation Team in both hard copy and electronic format. In the event that any discrepancy between these versions may exist the final signed hard copy should be regarded as definitive. A signed hard copy of this report will be provided to the Investigation Team, if required.

## STRUCTURE OF REPORT

- 1.8 In the remainder of this report, we have:
- i Provided an Executive Summary of our findings in **Section 2**;

<sup>1</sup> The Third Set of Queries contains 2 sets of requests and responses.

<sup>2</sup> Being FSA029 - all periods (balance sheet information), FSA030 – all periods (profit and loss account information) and FSA031 – all periods (capital adequacy information).

<sup>3</sup> This restriction on circulation clause does not apply to the inclusion of this report, in part or in whole, within the report of the Investigation Team.

- ii Set out and described our concerns over the quality and reliability of the financial information submitted, and responses provided, by LCF to the FCA in **Section 3**;
- iii Set out and described our concerns over the ability of LCF to meet its financial obligations as they fall due on the basis of the financial information submitted, and responses provided, by LCF to the FCA in **Section 4**;
- iv Set out and described our concerns over the actual and forecast rapid growth of LCF on the basis of the financial information submitted, and responses provided, by LCF to the FCA in **Section 5**; and
- v Set out and described our concerns over the reasonableness and credibility of the LCF business model on the basis of the financial information submitted, and responses provided, by LCF to the FCA in **Section 6**.

## 2 EXECUTIVE SUMMARY

2.1 A review of the relevant financial documentation submitted by LCF and the answers provided to the FCA in response to various requests during its regulatory cycle indicates a significant number of 'red flags' and concerns. These 'red flags' and concerns are in each of the documents in one form or another and are demonstrated by:

- i Incomplete and inaccurate financial projections such that without further enquiries being made, limited, if any, reliance could be placed upon the document in question as constituting a reasonable or reliable projection of the results of LCF for the projected period;
- ii Inconsistencies between the financial information set out in one document when compared to the financial information in a previously submitted document;
- iii The net current liabilities position of LCF at a significant number of points in time during which the Financial Documents and Financial Regulatory Returns were submitted to the FCA indicates that LCF did not have sufficient current assets and liquidity to meet its liabilities in the following twelve month period and as they fall due. Consequently, it would appear that LCF would have been in the position of having to continually raise significant funds from either issuing further bonds or other external sources of funding;
- iv The actual and projected financial information provided by LCF to the FCA during its regulatory lifecycle shows a picture of rapid growth of the business and in particular in respect of the loans advanced and bonds payable by LCF. Whilst, in isolation, the concept of rapid growth is not in itself a 'red flag' and concern, taken together with the other 'red flags' and concerns addressed in this report it could be seen as further evidence of enhanced risk prevailing within LCF; and
- v A review of the relevant financial documentation submitted, and responses provided, to the FCA by LCF during its regulatory lifecycle indicates a significant number of 'red flags' and concerns over the reasonableness and credibility of the LCF business model. In particular, it is unclear why, with LCF reporting such low loan to secured asset ratios, borrowers of LCF would be prepared to accept such high costs and terms of borrowing.<sup>4</sup>

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<sup>4</sup> Interest rates potentially in excess of 29%, arrangement fees of 2% and between 10% and 25.5% of the amounts advanced are deducted such that for every £10,000 borrowed the borrower only receives between £9,000 and £7,450 but is charged interest on the full £10,000. In addition, the loans advanced by LCF, based on its responses

This would give cause for concern as to the quality of the lending being made by LCF, the true loan to secured assets ratios and LCF's ability to fully recover the interest and capital on the loans advanced in a timely fashion such that it can service the contractual interest costs and repayment demands of its bondholders without the need to raise further funds from new bondholders to repay the liabilities due to existing bondholders.

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to requests for further information from the FCA would appear to repayable on demand. See paragraphs 6.4 to 6.21 below.

### 3 QUALITY AND RELIABILITY OF THE FINANCIAL INFORMATION SUBMITTED BY LCF TO THE FCA

3.1 A review of the relevant financial documentation submitted to the FCA by LCF during its regulatory lifecycle indicates a significant number of 'red flags' and concerns over the quality and reliability of that financial information.<sup>5</sup>

3.2 These 'red flags' and concerns fall into the following two main categories:

- i Incomplete and inaccurate financial projections such that without further enquiries being made, limited, if any, reliance could be placed upon the document in question as constituting a reasonable or reliable projection of the results of LCF for the projected period; and
- ii Inconsistencies between the financial information set out in one document when compared to the financial information in an accompanying or previously submitted document.

3.3 For ease of reference we set out our comments on the relevant documentation as grouped by the dates on which the relevant documents were submitted by LCF to the FCA.

#### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 21 OCTOBER 2015

3.4 The LCF financial information provided to the FCA on 21 October 2015 consisted of the following Financial Documents:

- i A balance sheet as at 31 March 2015 and a projected balance sheet for each month thereafter for the next 12 months ("**the projected monthly balance sheet for the 12 months ended 31 March 2016**");<sup>6</sup>
- ii A monthly cash flow forecast for the 12 months commencing 1 April 2015 ("**the monthly cash flow forecast for the 12 months commencing 1 April 2015**");<sup>7</sup>

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<sup>5</sup> For the avoidance of doubt if no reference is made in this report to one of the Financial Documents then it is on the basis that a review of that document does not indicate any 'red flags' or concerns.

<sup>6</sup> The figures in the column headed '0' agree to the balances in the Abbreviated Accounts for the year ended 31 March 2015.

<sup>7</sup> The starting cash balance of £1,000 in the column headed '1' agrees to the cash at bank figure in the Abbreviated Accounts for the year ended 31 March 2015.

- iii The Abbreviated Accounts for the year ended 31 March 2015<sup>8</sup> with comparatives for the period ended 31 March 2014 (“the Abbreviated Accounts for the year ended 31 March 2015”); and
- iv A document headed ‘Regulatory Business Plan’ which includes, within section 5 ‘Financials’, a limited summary of the financial projected results for the year ended 31 March 2016 (“the February 2015 Regulatory Business Plan”).<sup>9</sup>

### Projected monthly balance sheet for the 12 months ended 31 March 2016

- 3.5 Whilst not expressly stated on the document, by reference to the figures in the column headed ‘0’, which agree to the balances in the Abbreviated Accounts for the year ended 31 March 2015, it can be deduced that the document is a projected monthly balance sheet for the 12 months ended 31 March 2016.
- 3.6 However, except for the monthly figures for ‘Bank’ and ‘Retained Earnings’ all other monthly balances remain unchanged. Consequently, it can be assumed from this document that LCF were projecting that no loans would be advanced or repaid and similarly no liabilities would be incurred or repaid over the forecast period.
- 3.7 The increase in the retained earnings over the 12 months of £528,556<sup>10</sup> represents solely the increase in the bank balance of £528,556<sup>11</sup> and therefore all the projected cash flows in and out of LCF are classified as profit and loss account transactions as opposed to balance sheet transactions.<sup>12</sup>
- 3.8 Clearly given the nature of the trading activity and business model of LCF this would appear to be wholly unrealistic and as such, without further enquiries being made, limited, if any, reliance

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<sup>8</sup> The Abbreviated Accounts for the year ended 31 March 2015 are in respect of Sales Aid Finance (England) Limited which changed its name on 1 July 2015 to London & Capital Limited, which in turn on 11 November 2015 re-registered as a public company becoming London Capital & Finance Plc.

<sup>9</sup> The February 2015 Regulatory Business Plan is not formally dated but on the basis of the footer of the document (*Version 1 02/15*) is assumed to have been prepared at some time in February 2015.

<sup>10</sup> Being £628,904 - £100,348.

<sup>11</sup> Being £529,556 - £1,000. See also the monthly cash flow forecast for the 12 months commencing 1 April 2015.

<sup>12</sup> By way of example and clarification, funds received into LCF from loans repaid by debtors or funds advanced by creditors would result in changes to the balances of debtors and creditors in the balance sheet as would funds advanced to debtors or funds repaid to creditors.

could be placed upon the document as constituting a reasonable projection of the financial position of LCF over the forecast period.

- 3.9 Further, on the basis of the above comments, given this document was submitted to the FCA in October 2015, and the projections start with the opening balances as per the Abbreviated Accounts for the year ended 31 March 2015, it does not appear that the projections incorporate any actual financial results in the intervening period. This absence of actual figures would also cause concern and mean that without further enquiries being made limited, if any, reliance could be placed upon the document as constituting a reasonable projection of the financial position of LCF over the forecast period.

#### **Monthly cash flow forecast for the 12 months commencing 1 April 2015**

- 3.10 As in the case of the projected balance sheet for the 12 months ended 31 March 2016<sup>13</sup>, whilst not expressly stated on the document, by reference to the figure of £1,000 for '*starting cash*' in the column headed '1', which agrees to the balance in the Abbreviated Accounts for the year ended 31 March 2015, it can be deduced that the document is a monthly cash flow forecast for the 12 months commencing 1 April 2015.
- 3.11 There are similar concerns in connection with this document that the forecast does not appear to incorporate any actual financial results in the intervening period between 1 April 2015 and say August or September 2015; not least given that each of the figures in the forecast are for exactly the same values each month. This absence of actual figures in the intervening period together with the artificial projection of the same values included in each month of the forecast would also cause concern and mean that without further enquiries being made, limited, if any, reliance could be placed upon the document as constituting a reasonable projection of the cash position of LCF over the forecast period.
- 3.12 Notwithstanding the comments above, taking into account the absence of any monthly movements in the figure for monthly trade debtors<sup>14</sup> in the projected monthly balance sheet, all of the projected '*Cash in*', amounting to £1,149,620<sup>15</sup> is therefore presented as constituting revenue of LCF. However, on the basis that the business of LCF is the lending of funds then revenue for the 12 months ended 31 March 2016 of £1,149,620 on an unchanged trade

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<sup>13</sup> See paragraph 3.5 above.

<sup>14</sup> See paragraph 3.6 above.

<sup>15</sup> See '*Year 1*' total of the monthly cash flow forecast for the 12 months commencing 1 April 2015.



debtors balance of £1,279,535 would equate to an annual interest rate of 90%<sup>16</sup> which on the face of it appears to be wholly unrealistic.

3.13 Further, there are no values recorded against the category '*Finance cost*' in the cash flow forecast which would appear inconsistent with both the inclusion as at 31 March 2015, and each month thereafter, of '*Trade Creditors Due After One Year*' of £1,132,015 and the business model of LCF.<sup>17</sup>

#### **The February 2015 Regulatory Business Plan**

3.14 The February 2015 Regulatory Business Plan is not formally dated but on the basis of the footer of the document (*Version 1 02/15*) is assumed to have been prepared at some time in February 2015.

3.15 Section 5 of the February 2015 Regulatory Business Plan is headed '*Financials*', and sets out, in tabulated form, a limited summary of the projected profit for the year ended 31 March 2016.

3.16 Whilst the figure for '*Total Revenue*' of £1,149,620 agrees to the '*Year 1*' total in the monthly cash flow forecast for the 12 months commencing 1 April 2015 and the figure for '*Shareholders Equity*' of £629,904 agrees to the corresponding figure for '*Total Capital and Reserves*' in the projected monthly balance sheet for the 12 months ended 31 March 2016, the '*Expenses*' figure of £296,425 does not agree to the total '*Year 1*' projected '*Cash out*' figure of £488,925.<sup>18</sup>

3.17 Consequently, the inclusion in the summary table in section 5 of the February 2015 Regulatory Business Plan of a figure for '*Expenses*' of £296,425 means that '*Profit before Tax*' of £660,695 is not simply the mathematical difference between the '*Total Revenue*' of £1,149,620 and the '*Expenses*' of £296,425 but the reader is required to identify from the other financial documentation submitted to the FCA that the correct projected expenses are £488,925.

3.18 Further, given the February 2015 Regulatory Business Plan is assumed to have been prepared at some time in February 2015, it was submitted to the FCA in October 2015. This would also cause concern that the projections included are out of date, do not reflect actual figures in the

<sup>16</sup> Being  $\frac{£1,149,620}{£1,279,535} \times 100\%$ .

<sup>17</sup> See the projected monthly balance sheet for the 12 months ended 31 March 2016 and the statement "[w]e raise money via a corporate bond issuance..." in section 4 '*Business Model*' of the February 2015 Regulatory Business Plan.

<sup>18</sup> See '*Year 1*' total of the monthly cash flow forecast for the 12 months commencing 1 April 2015.

intervening period and that without further enquiries being made, limited, if any, reliance could be placed upon the document as constituting a reasonable projection of the financial results of LCF for the year ended 31 March 2016.

#### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 17 FEBRUARY 2016

- 3.19 The LCF financial information provided to the FCA on 17 February 2016 consisted of a further 'Regulatory Business Plan' dated 14 February 2016, ("**the February 2016 Regulatory Business Plan**") which includes, under the heading '*Financials*', an updated limited summary of the projected profit for the year ended 31 March 2016.<sup>19</sup>
- 3.20 Aside from the absence of any underlying financial documentation in support of the updated projected profit, a comparison of the figures in the February 2016 Regulatory Business Plan to the February 2015 Regulatory Plan<sup>20</sup> indicates that:
- i The '*Regulated Revenue*' is projected to increase by £250,000 such that the '*Total Revenue*' now amounts to £1,379,620; and
  - ii The projected '*Operating profit*' is shown as £1,083,195 as compared to the projected '*Profit before Tax*' of £660,695 shown in the February 2015 Regulatory Plan.
- 3.21 However, the projected '*Operating profit*' of £1,083,195 is not directly comparable to the projected '*Profit before Tax*' of £660,695 as the '*Profit before Tax*' of £660,695 is after the deduction of projected expenses of £488,925<sup>21</sup> whereas the '*Operating profit*' of £1,083,195 is after the deduction of projected expenses of only £296,425.
- 3.22 Therefore, if the financial information in the February 2016 Regulatory Business Plan had been compared to the February 2015 Regulatory Plan the reader would have identified a difference in the presentation of the financial information, and notwithstanding any other 'red flags' and concerns would have seen that the projected '*Operating profit*' of £1,083,195 did not include the total projected expenses of £488,925 such that the projected '*Operating profit*' was overstated by £192,500<sup>22</sup> and should therefore read as £890,695.<sup>23</sup>

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<sup>19</sup> See page 7 of the February 2016 Regulatory Business Plan.

<sup>20</sup> See page 2 of the February 2015 Regulatory Business Plan.

<sup>21</sup> See paragraph 3.17 above.

<sup>22</sup> Being £488,925 less £296,425.

<sup>23</sup> Being £1,083,195 less £192,500.

3.23 Further, given the February 2016 Regulatory Business Plan was submitted to the FCA in February 2016 it would also cause concern that the projections included are out of date, do not reflect actual figures in the intervening period and that without further enquiries being made, limited, if any, reliance could be placed upon the document as constituting a reasonable projection of the profits of LCF for the year ended 31 March 2016.

#### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 14 OCTOBER 2016

3.24 The LCF financial information provided to the FCA on 14 October 2016 consisted of a further 'Regulatory Business Plan' dated 04 October 2016, ("**the October 2016 Regulatory Business Plan**") which includes, under the heading '*Financials*', an updated limited summary of the actual profits for the years ended 31 March 2015 and 2016 together with a limited summary of the projected profits for the years ended 31 March 2017, 2018 and 2019.<sup>24</sup>

3.25 There are significant variances between:

- i The actual '*Profit before Tax*' of £148,550 for the year ended 31 March 2016 shown in the October 2016 Regulatory Business Plan and the projected '*Profit before Tax*' of £660,695 set out in the February 2015 Regulatory Plan;<sup>25</sup> and
- ii The actual '*Operating profit*' of £148,871 for the year ended 31 March 2016 shown in the October 2016 Regulatory Business Plan and the projected '*Operating profit*' of £1,083,185 set out in the February 2016 Regulatory Business Plan.<sup>26</sup>

3.26 These significant variances are such that the actual '*Profit before Tax*' and '*Operating profit*' are only 22%<sup>27</sup> and 13%<sup>28</sup> respectively of the projected figures for the year ended 31 March 2016 previously reported to the FCA.

3.27 In addition, there is a significant difference between the actual '*Profit before Tax*' of £2,236 for the year ended 31 March 2015, shown in the October 2016 Regulatory Business Plan<sup>29</sup>, and the profit for the year that can be calculated from the balance on the '*Profit and Loss account*'

<sup>24</sup> See page 8 of the October 2016 Regulatory Business Plan.

<sup>25</sup> See page 2 of the February 2015 Regulatory Business Plan.

<sup>26</sup> See page 7 of the February 2016 Regulatory Business Plan.

<sup>27</sup> Being £148,550/£660,695 x 100%.

<sup>28</sup> Being £148,871/£1,083,185 x 100%.

<sup>29</sup> See page 8 of the October 2016 Regulatory Business Plan.

shown in the Abbreviated Accounts for the year ended 31 March 2015 with comparatives for the period ended 31 March 2014.

- 3.28 By reference to the balances on the '*Profit and Loss account*' as at 31 March 2014 and 2015 shown in the Abbreviated Accounts, the profit for the year can be calculated as amounting to £80,782.<sup>30</sup> Notwithstanding this would be a profit after tax, there is a significant difference between the calculated profit for the year ended 31 March 2015 of £80,782 and the actual profit before tax for the same period of £2,236 shown in the October 2016 Regulatory Business Plan.
- 3.29 Therefore, if the financial information in the October 2016 Regulatory Business Plan had been compared to Financial Documents previously submitted to the FCA on 21 October 2015 and 17 February 2016 the reader would have identified a number of significant differences that would have caused concern that without further enquiries being made, limited, if any, reliance could be placed upon the document as constituting a reasonable projection of the profits of LCF for the years ended 31 March 2017, 2018 and 2019.
- 3.30 In addition, there is an absence of any underlying financial documentation in support of the projected profits, including cashflow and balance sheet projections, that sets out the values of the loans advanced, and to be advanced, together with how LCF is and would be funded such that the reader would be able to fully understand the financial projections put forward in the October 2016 Regulatory Business Plan.
- 3.31 Further, the absence of monthly cashflow and balance sheet projections was also identified and queried by the relevant FCA staff member in the Third Set of Queries.<sup>31</sup> However, whilst a narrative response was received from LCF no projections were submitted.<sup>32</sup> These responses received from LCF are also commented upon further in this report in the context of the reasonableness and credibility of the LCF business model.<sup>33</sup>

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<sup>30</sup> See page 1 of the Abbreviated Accounts for the year ended 31 March 2015. Being £100,348 less £19,566.

<sup>31</sup> See pages 10 & 11, points 19 and 20, columns 1 and 3.

<sup>32</sup> See pages 10 & 11, points 19 and 20, columns 2 and 4. Whilst in column 4 there is a reference to a projected balance sheet being attached this is understood to be in respect of the "*forecast trial balance for the year ended 30 November 2017*" submitted by LCF to the FCA on 8 May 2017. See paragraph 3.49 below.

<sup>33</sup> See Section 6 to this report.

**LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 26 JANUARY 2017**

- 3.32 The LCF financial information provided to the FCA on 26 January 2017 consisted of a projected profit and loss account for LCF for the year ended 31 December 2017 (“**the 2017 Profit and Loss Account Projections**”). This is in the form of an excel workbook that contains the detailed profit and loss account on one spreadsheet (“**the detailed projected profit and loss account**”) with the supporting calculations in respect of ‘*Turnover*’ and ‘*Interest (payable)*’ on the second spreadsheet (“**the supporting calculations**”).
- 3.33 The detailed projected profit and loss account is forecasting an ‘*Operating profit*’ for the year ended 31 December 2017 of £7,138,996.
- 3.34 Notwithstanding that previously submitted Financial Documents consisted of financial information prepared to a year end of March or April, a comparison of the projected ‘*Operating profit*’ for the year ended 31 December 2017 to the projected ‘*Operating profits*’ for the years ended 31 March 2017 and 2018 set out in the October 2016 Regulatory Business Plan indicates a significant variance.
- 3.35 The projected ‘*Operating profit*’ for the year ended 31 December 2017 of £7,138,996 compares to that of £1,363,500 and £1,940,500 for the years ended 30 April 2017 and 2018 respectively.<sup>34</sup>
- 3.36 Irrespective of how the projected profits in the October 2016 Regulatory Business Plan are projected to accrue on a monthly basis in the years ended 30 April 2017 and 2018, it can be seen that the projected ‘*Operating profit*’ for the year ended 31 December 2017 is nearly four times the value projected in a document prepared only some 3 or 4 months earlier.
- 3.37 Further, not only is the projected ‘*Operating profit*’ of £7,138,996 for the year ended 31 December 2017 significantly higher than that projected in the October 2016 Regulatory Business Plan it is also 48 times the actual ‘*Operating profit*’ of £148,550 of LCF for the year ended 30 April 2016.<sup>35</sup>

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<sup>34</sup> It would now appear that the year ends to which the financial information is prepared in the October 2016 Regulatory Business Plan is April and not March. The reason being that upon receipt of the Annual Report and Financial Statements of LCF for the year ended 30 April 2016 (“**the 2016 Financial Statements**”) it can now be seen that the ‘*Operating profit*’ for the year ended 30 April 2016 of £148,550 (see page 8) agrees to the 2016 actual ‘*Operating profit*’ in the October 2016 Regulatory Business Plan (see page 8).

<sup>35</sup> See page 8 of the 2016 Financial Statements.

- 3.38 In addition, it can be seen from the assumptions noted at the foot of the detailed projected profit and loss account that “*cost of funds is calculated on sheet 2 (the supporting calculations) at 25.5% for online fundraising and 10% for network fundraising. This is charged on to borrowers on a see through basis added on to their loans. As such it has been eliminated from this forecast.*”
- 3.39 These accounting transactions are not reflected in the detailed projected profit and loss account and, whilst referred to in the assumptions note and calculated in (but do not form part of) the supporting calculations, in the absence of underlying cash flow and balance sheet projections it does not enable the reader of the 2017 Profit and Loss Account Projections to see the full financial position of LCF and fully comprehend the extent of the cost of funds upon the balance sheet.
- 3.40 The absence of the accounting transactions in respect of the cost of funds was identified and queried by the relevant FCA staff member in the Third Set of Queries where the question was asked “*please explain why the interest and raising costs will not create a cost for [LCF] in the profit and loss account which is not offset by the debtor having to pay an equal amount?*”<sup>36</sup> However, it does not appear that any satisfactory response was received from LCF who replied “*[a]ll costs are passed through to the borrower (client), including raising costs.*”<sup>37</sup>
- 3.41 Further, the absence of monthly cashflow and balance sheet projections was also identified and queried by the relevant FCA staff member in the Third Set of Queries.<sup>38</sup> However, whilst a narrative response was received from LCF no projections were submitted.<sup>39</sup>
- 3.42 A review of the supporting calculations indicates that there are no capital repayments of either loans advanced, or bonds issued by LCF.
- 3.43 In the case of bonds payable this can be ascertained by comparing the balance at the beginning of the projected period with the balance at the end of the projected period.<sup>40</sup>

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<sup>36</sup> See page 9, point 14, column 1.

<sup>37</sup> See page 9, point 14, column 4.

<sup>38</sup> See pages 10 and 11, points 19 and 20, columns 1 and 3.

<sup>39</sup> See pages 10 and 11, points 19 and 20, columns 2 and 4. Whilst in column 4 there is a reference to a projected balance sheet being attached this is understood to be in respect of the “*forecast trial balance for the year ended 30 November 2017*” submitted by LCF to the FCA on 8 May 2017. See paragraph 3.49 below.

<sup>40</sup> See cells B29 (£33,850,000) + O29 (£177,175,000) = P29 (*yr end gross total of £211,025,000*).

- 3.44 In the case of loans advanced by LCF there is no similar opening balance figure in the supporting calculations. However, by reference to the interest receivable on existing loans it would appear that the consistency of the monthly amounts of the interest receivable is such that there are no projected repayments of loans made in the period.<sup>41</sup>
- 3.45 The absence of any capital repayments of either loans advanced or bonds issued by LCF in the calculations underlying the 2017 Profit and Loss Account Projections together with the above comments regarding the comparability of the projections to the historic and previously submitted projections would have caused concern that without further enquiries being made, limited, if any, reliance could be placed upon the document as constituting a reasonable projection of the profits of LCF for the year ended 31 December 2017.
- 3.46 This issue was also identified and queried by the relevant FCA staff member in the Third Set of Queries where it states “[t]he second page of the projections appears to make no allowance for repayment of the existing finance. Please provide this showing when the existing finance is due to be repaid”.<sup>42</sup> However, it does not appear that any satisfactory response was received from LCF who replied, “[p]lease note that repayment of bonds is also passed through to borrowers.”<sup>43</sup>

#### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 14 MARCH 2017

- 3.47 The LCF financial information provided to the FCA on 14 March 2017 consisted of Management Information for the 7 months ended 30 November 2016, (“**the November 2016 Management Accounts**”). The format of the November 2016 Management Accounts follows that of the 2016 Financial Statements save that it does not include detailed accounting policies.<sup>44</sup>
- 3.48 The November 2016 Management Accounts record a nominal actual ‘Profit before tax’ generated by LCF of £10,694.<sup>45</sup> Whilst this is in respect of only a seven month period, if it is compared to the 2017 Profit and Loss Account Projections received less than 2 months earlier, which were projecting an ‘Operating profit’ for the year ended 31 December 2017 of £7,138,996, it would have added to the concerns that without further enquiries being made,

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<sup>41</sup> See row 63 - L TOTAL (EXISTING). It is not possible to check the calculations as the figures in the row are ‘hard coded’.

<sup>42</sup> See page 9, point 15, column 1.

<sup>43</sup> See page 9, point 15, column 4.

<sup>44</sup> In addition, whilst internally paginated it would appear that the first part of the ‘Directors’ Report’ is missing. See page 5.

<sup>45</sup> See page 8 of the November 2016 Management Accounts.



limited, if any, reliance could be placed upon the 2017 Profit and Loss Account Projections as constituting a reasonable projection of the profits of LCF for the year ended 31 December 2017.

### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 8 MAY 2017

- 3.49 The LCF financial information provided to the FCA on 8 May 2017 consisted of the following Financial Documents:
- i An Income statement forecast for the year ended 30 November 2017; and
  - ii A forecast trial balance for the year ended 30 November 2017.
- 3.50 The figures in the Income statement forecast for the year ended 30 November 2017 (“**the 2017 Income forecast**”) are derived from the forecast trial balance for the year ended 30 November 2017 that was also submitted to the FCA on 8 May 2017.
- 3.51 The forecast trial balance for the year ended 30 November 2017 (“**the 2017 forecast trial balance**”) shows the opening balances for each of the individual profit and loss account and balance sheet items of LCF as at 30 November 2016.<sup>46</sup> The subsequent columns show the forecast monthly movements in those individual balances culminating in the forecast profit and loss account and balance sheet as at 30 November 2017.<sup>47</sup>
- 3.52 The 2017 Income forecast shows an ‘*Operating profit*’ (and ‘*Profit before Tax*’) of £4,973,635. However, the November 2016 Management Accounts, whilst in respect of only a 7 month period, showed an actual ‘*Operating profit*’ generated by LCF of £10,683.<sup>48</sup> Notwithstanding the reduced time period covered by the November 2016 Management Accounts, this significant variance between the historic actual 2016 and forecast 2017 ‘*Operating profit*’ would have raised concerns that without further enquiries being made, limited, if any, reliance could be placed upon the 2017 Income forecast as constituting a reasonable projection of the profits of LCF for the year ended 30 November 2017.
- 3.53 In addition, in the narrative response from LCF to questions raised by the relevant FCA staff member in the Third Set of Queries regarding the absence of monthly cashflow and balance sheet projections accompanying the financial information submitted by LCF to the FCA on 26

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<sup>46</sup> Which agree to the November 2016 Management Accounts.

<sup>47</sup> The balances as at 30 November 2016 within the heading ‘*Income Statement*’ (shown on page 2) do not (correctly) appear to form part of the forecast profit and loss account for the year ended 30 November 2017.

<sup>48</sup> See page 8 of the November 2016 Management Accounts.



January 2017, LCF state in relation to the 2017 Income forecast and the 2017 forecast trial balance “[p]lease note that the 12-month financial projections given were supposed to be 12 months from approval. The heading ‘Forecast for the 12 months ending 30 November 2017’ is not correct – it is supposed to be 12 months from approval... The date stipulation just indicates the accountants used the November 16 accounts as a base for projections. It was an oversight and should have been removed for both documents”.<sup>49</sup>

- 3.54 However, the cited response provided by LCF to the FCA is not fully understood as it is clear from the workings and summation of the figures in the 2017 forecast trial balance that it commences with the individual balances as at 30 November 2016 then shows the monthly movements over the following twelve months which by default would culminate in the total movement for the twelve months and the balance as at 30 November 2017.

#### **LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 22 MAY 2017**

- 3.55 The LCF financial information provided to the FCA on 22 May 2017 consisted of Management Information for the 11 months ended 31 March 2017 (“**the March 2017 Management Accounts**”). The format of the March 2017 Management Accounts follows that of the November 2016 Management Accounts and 2016 Financial Statements save that it does not include detailed accounting policies.
- 3.56 Again, a further area of concern to the reader of the March 2017 Management Accounts would be the level of actual ‘*Profit before tax*’ generated by LCF of £152,096.<sup>50</sup>
- 3.57 Whilst this is in respect of only an eleven month period, if it is compared to both the 2017 Profit and Loss Account Projections received less than four months earlier, which were projecting an ‘*Operating profit*’ for the year ended 31 December 2017 of £7,138,996, and the 2017 Income forecast received 2 weeks earlier, which was projecting an ‘*Operating profit*’ for the year ended 30 November 2017 of £4,973,635 it would have added to the concerns that without further enquiries being made, limited, if any, reliance could be placed upon those Financial Documents as constituting reasonable and reliable projections of the profits of LCF for the year ended 31 December/30 November 2017.

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<sup>49</sup> See page 11, point 20, column 4.

<sup>50</sup> See page 8 of the March 2017 Management Accounts.

**THE FINANCIAL REGULATORY RETURNS SUBMITTED BY LCF**

3.58 The Financial Regulatory Returns submitted by LCF to the FCA covered the six quarters ending 31 July 2017 to 31 October 2018 and comprised:

- i FSA029 - all periods being balance sheet information;
- ii FSA030 – all periods being profit and loss account information; and
- iii FSA031 – all periods being capital adequacy information.

3.59 The financial information in share capital and reserves reported in FSA031 is consistent with that reported in FSA029. However, there are significant differences (in all but one quarter)<sup>51</sup> between the quarterly movements in the ‘*Retained earnings*’ that can be calculated from the quarterly ‘*Retained profit or (loss) for the period*’ that is reported on FAS029 and the corresponding quarterly reported values in FS030.

3.60 The calculations and differences are set out in the following table:

**Table 3.1 LCF reported retained profits for the quarters 31/07/17 to 31/10/18 (all figures in £000)**

Description/Quarterly Return	31 July 2017	31 Oct 2017	31 Jan 2018	30 April 2018	31 July 2018	31 Oct 2018
Retained earnings – as per FSA029	353	646	632	784	587	5,251
Retained profit or (loss) for the period – as calculated from FSA029 <sup>52</sup>	n/a	293	(14)	152	(197)	4,614
Retained profit for the period – as per FSA030	n/a	508	383	152	284	143
Difference in reported profit for the period	n/a	215	397	0	481	(4,471)

Source: *FSA029 and FSA030*

<sup>51</sup> Being Q4, 30/04/2018.

<sup>52</sup> The retained profit for the period is calculated by deducting the balance on one quarter from the immediately preceding quarter. Eg £646k as at 31 October 2017 less £353k as at 31 July 2017 equates to £293k.

- 3.61 It is not known how such significant differences could arise between the quarterly movements in the '*Retained earnings*' that can be calculated from the quarterly '*Retained profit or (loss) for the period*' that is reported on FAS029 and the corresponding quarterly reported values in FS030.
- 3.62 However, these differences would have raised concerns that without further enquiries being made, limited, if any, reliance could be placed upon the quarterly figures reported by LCF to the FCA for the quarters in question.

## 4 THE ABILITY OF LCF TO MEET ITS FINANCIAL OBLIGATIONS AS THEY FALL DUE

- 4.1 A review of the relevant financial documentation submitted, and responses provided, to the FCA by LCF during its regulatory lifecycle indicates a significant number of 'red flags' and concerns over the ability of LCF to meet its financial obligations as they fall due.
- 4.2 The net current liabilities position of LCF at the various points in time during which the Financial Documents and Financial Regulatory Returns were submitted to the FCA indicates that LCF did not have sufficient current assets and liquidity to meet its liabilities in the following twelve month period. Consequently, it would appear that LCF would have been in the position of having to continually raise significant funds from either issuing further bonds or other external sources of funding.
- 4.3 In addition, in the absence of further enquiries and information being made available, the responses received by the FCA from LCF would not appear to alleviate concerns over the liquidity of LCF and its ability to discharge its current liabilities over the following twelve month period and as they fall due.
- 4.4 For ease of reference we set out our comments on the relevant documentation as grouped by the dates on which the relevant documents were submitted.

### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 20 DECEMBER 2016

- 4.5 The LCF financial information provided to the FCA on 20 December 2016 consisted of the Annual Report and Financial Statements of LCF for the year ended 30 April 2016, ("**the 2016 Financial Statements**"). The 2016 Financial Statements are without an audit qualification and in particular in respect of any going concern issues.<sup>53</sup>
- 4.6 Notwithstanding the absence of any audit qualification, a review of the 2016 Financial Statements does indicate areas of concern over the liquidity of LCF and its ability to discharge its current liabilities over the following twelve month period.
- 4.7 The extent of the detailed accounting knowledge of the individuals at the FCA who would have reviewed the Financial Documents is not known, but the applicable accounting policies of a

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<sup>53</sup> See page 5 of the 2016 Financial Statements for a brief summary of the going concern concept.

business such as LCF are complicated and do require some brief explanation in undertaking a review of the Financial Documents.<sup>54</sup>

- 4.8 Essentially there is a difference between the value of *'Loans and receivables'* in the balance sheet at the year end ("the carrying value") and the value of the *'Loans and receivables'* outstanding at the same date ("the notional value").<sup>55</sup> This difference arises because the carrying value of *'Loans and receivables'* (and, in subsequently submitted Management Accounts *'Bonds payable'*), are shown in the balance sheet net of deferred revenue/prepaid costs incurred on bonds issued (and passed on to the borrowers). These *'Financial prepayments/Deferred costs of funds income'* are charged/credited to the profit and loss account of LCF over the term of the Loans and Bonds (ie amortised) such that as the Loans and Bonds approach maturity the carrying values effectively increase to equate to that of the notional values.<sup>56</sup>
- 4.9 Whilst the balance sheet as at 30 April 2016 shows *'Net current assets'* of £545,384 it can be seen that the calculation of this figure includes *'Trade and other receivables'* amounting to £3,038,457.<sup>57</sup> Reference to the notes to the 2016 Financial Statements shows that this figure in turn includes *'Prepayments'* of £1,869,593, which would appear to arise from the application of the accounting policies discussed above.<sup>58</sup>
- 4.10 In simple terms, these *'Prepayments'* of £1,869,593 will be amortised to the profit and loss account of LCF over the term of the related Loans and Bonds and whilst from a presentational point it is correct to include them within *'Current trade and other receivables'* it is not strictly an asset that will be fully receivable within 12 months.<sup>59</sup>

<sup>54</sup> Unfortunately, the matter is further complicated by a change in presentation of the financial information in relation to Bonds payable (which follows the treatment of *'Loans and receivables'*) that is applied by LCF in the Management Accounts subsequently submitted to the FCA. See pages 12 to the November 2016 and March 2017 Management Accounts.

<sup>55</sup> See pages 1 and 21 of the 2016 Financial Statements.

<sup>56</sup> See pages 14, 15 and 21 of the 2016 Financial Statements *'Loans and receivables'* and *'Other financial liabilities'* and Note 10 *'Financial instruments'*.

<sup>57</sup> See page 9 of the 2016 Financial Statements.

<sup>58</sup> See page 20 of the 2016 Financial Statements.

<sup>59</sup> The issue of *Prepayments* was identified and queried by the relevant FCA staff member in the Second and Third Set of Queries without a response. However, the language used may indicate that the relevant FCA staff member understood the prepayment to be a payment made by LCF for future services as opposed to the unwinding of the amortised interest and passing on of costs associated with the bonds payable. See Second Set of Queries point 6iii, column 1 and Third Set of Queries page 13, point 21iii, column 1 and page 12, column 3.

- 4.11 Therefore, in evaluating the net current assets and liquidity of LCF based on the 2016 Financial Statements and its ability to discharge its current liabilities over the following twelve month period, it is not necessarily simply a question of comparing one number in the balance sheet with another.
- 4.12 It can be seen from the 2016 Financial Statements that there are current '*Loans receivable*' of £585,568 as compared to non-current '*Loans and receivables carried at amortised cost*' of £6,848,446.<sup>60</sup> Notwithstanding the inclusion of the words '*at amortised cost*' in the non-current '*Loans and receivables*', all things being equal it is reasonable to assume, absent any detailed underlying calculations, that the '*Prepayments*' of £1,869,593 will relate primarily to non-current '*Loans and receivables*'.<sup>61</sup>
- 4.13 Therefore, in evaluating the net current assets and liquidity of LCF based on the 2016 Financial Statements and its ability to discharge its current liabilities over the following twelve month period it would be appropriate to calculate the position as constituting the difference between the '*Net current assets*' of £545,384 less the '*Prepayments*' of £1,869,593 (to the extent they relate to non-current '*Loans and receivables*'). This results in net current liabilities of £1,324,209 which indicates that LCF does not have sufficient current assets and liquidity to meet its liabilities in the following twelve month period and as they fall due.
- 4.14 It can be seen from the 2016 Financial Statements that there are '*Current Liabilities - Trade and other payables*' of £2,774,735, the substantial majority of which constitute bonds payable of £2,556,357.<sup>62</sup>
- 4.15 Consequently, without further enquiries and information being made available, it would appear that LCF, in order to meet its liabilities over the twelve months from 1 May 2016, would have been in the position of having to raise funds after 30 April 2016 from either issuing further bonds or other external sources of funding.

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<sup>60</sup> See page 20 of the 2016 Financial Statements.

<sup>61</sup> Without access to the detailed underlying calculations it is not possible to comment in detail on the constituent parts of the figure of £1,869,593 and what proportion, if any, would be applicable and added to the carrying value of the current '*Loans receivable*' of £585,568 to identify the notional value receivable within twelve months.

<sup>62</sup> See pages 9 and 23 of the 2016 Financial Statements. By way of further explanation whilst the Bonds are shown in the 2016 Financial Statements at notional value, in the Management Accounts subsequently submitted to the FCA they are shown at carrying value. See pages 12 of the November 2016 and March 2017 Management Accounts.

- 4.16 The timing difference between the current 'Loans receivable' of £585,568 and the 'Current Liabilities – bonds payable' of £2,556,357 was identified and queried by the relevant FCA staff member in the Second Set of Queries where the question was asked “[t]here appears to be a difference in the periods over which the bonds will run and the period over which the loans these funded will be repaid... Please confirm how [LCF] intends to fund (or has funded since 30 April) the repayment of the bonds as they fall due”.<sup>63</sup>
- 4.17 In the absence of any satisfactory response from LCF, the relevant FCA staff member repeated the request twice in the Third Set of Queries<sup>64</sup> where LCF replied firstly that “[t]he loan agreement with clients has an agreement that, if bond holders do not wish to roll over (reinvest), LC&F can request repayment of the loan amounts”<sup>65</sup> and subsequently “[t]he loan agreements with each borrower stipulates that the Borrower shall repay when [LCF] so requests – within 14 days... [LCF] may also request amounts from other Borrowers (even those not in default) based on that specific clause in the loan agreements, in order to meet a Bond repayment.”<sup>66</sup>
- 4.18 The responses received from LCF are commented upon further in this report in the context of the reasonableness and credibility of the LCF business model.<sup>67</sup> However, in the absence of further enquiries and information being made available the responses from LCF would not appear to alleviate concerns over the liquidity of LCF and its ability to discharge its current liabilities over the following twelve month period and as they fall due.

#### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 14 MARCH 2017

- 4.19 The LCF financial information provided to the FCA on 14 March 2017 consisted of Management Information for the 7 months ended 30 November 2016, (“**the November 2016 Management Accounts**”). The format of the November 2016 Management Accounts follows that of the 2016 Financial Statements save that it does not include detailed accounting policies.<sup>68</sup>

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<sup>63</sup> See point 6v, column 1.

<sup>64</sup> See page 14, point 21v, column 1 and pages 12 & 13, final paragraph, column 3.

<sup>65</sup> See page 12, point v, column 2.

<sup>66</sup> See page 12, point 21v, column 4.

<sup>67</sup> See Section 6 to this report.

<sup>68</sup> In addition, whilst internally paginated it would appear that the first part of the ‘Directors’ Report’ is missing. See page 5.

- 4.20 A review of the document indicates areas of concern over the liquidity of LCF and its ability to discharge its current liabilities over the following twelve month period.
- 4.21 A number of explanatory points relevant to understanding the November 2016 Management Accounts are set out in paragraphs 4.7 to 4.13 above and are not repeated here. However, in the presentation of the financial information in relation to 'Bonds' this now follows the treatment of 'Loans and receivables' that was applied by LCF in the 2016 Financial Statements.<sup>69</sup>
- 4.22 Notwithstanding this change in presentation, it can be seen from the 'Statement of Financial Position' that there are net current liabilities of £7,189,551.<sup>70</sup> If this deficiency is reduced to take account of the inclusion of the values in respect of 'Financial prepayments/Deferred costs of funds income'<sup>71</sup> then it results in revised net current liabilities of £6,876,333.<sup>72</sup>
- 4.23 It can be seen from the November 2016 Management Accounts that this deficiency is effectively attributable to 'Current portion of bonds' amounting to £8,206,399, (as compared to the 'Current portion of loans' receivable amounting to only £421,458).<sup>73</sup>
- 4.24 This significant deficiency indicates that LCF does not have sufficient current assets and liquidity to meet its liabilities in the following twelve month period and as they fall due.
- 4.25 Consequently, without further enquiries and information being made available, it would appear that LCF, in order to meet its liabilities over the twelve months from 1 December 2016, would have been in the position of having to raise significant funds after 30 November 2016 from either issuing further bonds or other external sources of funding.

#### **LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 8 MAY 2017**

- 4.26 The LCF financial information provided to the FCA on 8 May 2017 consisted of the following Financial Documents:
- i An Income statement forecast for the year ended 30 November 2017; and

<sup>69</sup> In other words, the 'Bonds' are shown in the balance sheet at the carrying value net of deferred revenue/prepaid costs incurred on bonds issued. See pages 11 and 12 to the November 2016 Management Accounts.

<sup>70</sup> See page 9 of the November 2016 Management Accounts.

<sup>71</sup> For the reasons discussed in paragraphs 4.12 and 4.13 above.

<sup>72</sup> Being £7,189,551 – (£6,995,765 less £6,682,547). See pages 10 and 11 to the November 2016 Management Accounts.

<sup>73</sup> See pages 10 and 11 of the November 2016 Management Accounts.



ii A forecast trial balance for the year ended 30 November 2017 (“**the 2017 forecast trial balance**”).<sup>74</sup>

4.27 A review of the 2017 forecast trial balance indicates significant areas of concern over the liquidity of LCF and, on the face of the document, its inability with effect from May (the month the document was submitted to the FCA) to discharge its current liabilities whereby the net positive cash balance of LCF moves from £215,570 to a net negative position of £1,940,670.<sup>75</sup>

4.28 The overall net current liabilities and cash position worsens significantly over the forecast months such that as at 30 November 2017 the projected net current liabilities of LCF have increased to £148,048,137.<sup>76</sup>

4.29 The projected net current liabilities as at 30 November 2017 of £148,048,137 are calculated as follows:

- i Current portion of loans receivable of £5,512,742;<sup>77</sup> less
- ii Current portion of bonds payable of £125,379,603;<sup>78</sup> less
- iii Negative cash and cash equivalents of £28,461,777;<sup>79</sup> plus
- iv Sundry other net current assets of £280,501.<sup>80</sup>

<sup>74</sup> See paragraph 3.51 above for a description of the 2017 forecast trial balance.

<sup>75</sup> See page 2 of the 2017 forecast trial balance column headed ‘Month 6’ and row titled ‘Current assets: cash and cash equivalents’.

<sup>76</sup> Being Total current assets (£21,157,234) less Prepaid commissions on bonds (£6,682,547 + £37,128,063) less Current Liabilities: Trade and other payables (£125,394,761). This compares to the net current liabilities per the November 2016 Management Accounts (as adjusted) of £6,876,333. See paragraph 4.22 above. The calculation also does not reflect the inclusion of the values in respect of ‘Prepaid commission on bonds/Deferred income – LTD Loan Cost of Funds’. See paragraphs 4.7 to 4.13 above.

<sup>77</sup> See nominal ledger code 7100 Loans: £421,458 (opening balance as at 30 November 2016) + £5,091,284 (the total projected monthly movements for the year ended 30 November 2017). See page 1 of the 2017 forecast trial balance.

<sup>78</sup> See nominal ledger code 8010 Long term bonds current portion: £8,206,399 (opening balance as at 30 November 2016) + £117,173,204 (the total projected monthly movements for the year ended 30 November 2017). See page 1 of the 2017 forecast trial balance.

<sup>79</sup> See summary line on page 2 of the 2017 forecast trial balance, Current assets: cash and cash equivalents.

<sup>80</sup> Being nominal ledger codes 7120, 7280, 7300, 724z, 7432, 7890, 8097 and 8170.

**LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 22 MAY 2017**

- 4.30 The LCF financial information provided to the FCA on 22 May 2017 consisted of Management Information for the 11 months ended 31 March 2017 (“**the March 2017 Management Accounts**”). The format of the March 2017 Management Accounts follows that of the November 2016 Management Accounts and 2016 Financial Statements save that it does not include detailed accounting policies.
- 4.31 Again, a number of explanatory points relevant to understanding the March 2017 Management Accounts are set out in paragraphs 4.7 to 4.13 above and are not repeated here. However, in the presentation of the financial information in relation to ‘*Bonds*’ this now follows the treatment of ‘*Loans and receivables*’ that was applied by LCF in the 2016 Financial Statements.<sup>81</sup>
- 4.32 It can be seen from the ‘*Statement of Financial Position*’ that the net current liabilities have now increased to £11,219,418.<sup>82</sup> If this deficiency is reduced to take account of the inclusion of the values in respect of ‘*Financial prepayments/Deferred costs of funds income*’<sup>83</sup> then it results in revised net current liabilities of £9,817,886.<sup>84</sup>
- 4.33 This deficiency is effectively attributable to ‘*Current portion of bonds*’ amounting to £10,086,009, (as compared to the ‘*Current portion of loans*’ receivable amounting to only £122,276).<sup>85</sup>
- 4.34 This significant net current liabilities deficiency indicates that LCF does not have sufficient current assets and liquidity to meet its liabilities in the following twelve month period.
- 4.35 Consequently, without further enquiries being made and information being made available, it would appear that LCF, in order to meet its liabilities over the twelve months from 1 April 2017, would have been in the position of having to raise significant funds after 31 March 2017 from either issuing further bonds or other external sources of funding.

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<sup>81</sup> In other words, the ‘*Bonds*’ are shown in the balance sheet at the carrying value net of deferred revenue/prepaid costs incurred on bonds issued. See pages 11 and 12 of the March 2017 Management Accounts.

<sup>82</sup> See page 9 of the March 2017 Management Accounts as compared to the figure of £7,189,551 in the November 2016 Management Accounts.

<sup>83</sup> For the reasons discussed in paragraphs 4.12 and 4.13 above.

<sup>84</sup> Being £11,219,418 – (£11,436,446 less £10,034,914). See pages 10 and 11 to the March 2017 Management Accounts.

<sup>85</sup> See pages 10 and 11 of the March 2017 Management Accounts.

**THE FINANCIAL REGULATORY RETURNS SUBMITTED BY LCF**

4.36 The Financial Regulatory Returns submitted by LCF to the FCA covered the six quarters ending 31 July 2017 to 31 October 2018 and comprised:

- i FSA029 - all periods being balance sheet information;
- ii FSA030 – all periods being profit and loss account information; and
- iii FSA031 – all periods being capital adequacy information.

4.37 A review of the Financial Regulatory Returns indicates, in a number of quarters, areas of concern over the liquidity of LCF and its ability to discharge its current liabilities over the following twelve month period and as they fall due.

4.38 The net current assets/(liabilities) position of LCF as reported to the FCA are set out in the following table:

**Table 4.1 LCF reported net current assets/(liabilities) for the quarters 31/07/17 to 31/10/18 (all figures in £000)**

Description/Quarterly Return	31 July 2017	31 Oct 2017	31 Jan 2018	30 April 2018	31 July 2018	31 Oct 2018
Net Current Assets (Liabilities)	1,998	(14,000)	(18,544)	(16,694)	5,224	4,299

Source: *FSA029*

4.39 As discussed in section 3 of this report, there are significant differences (in all but one quarter)<sup>86</sup> between the quarterly movements in the 'Retained earnings' that can be calculated from the quarterly 'Retained profit or (loss) for the period' that is reported on FAS029 and the corresponding quarterly reported values in FS030.<sup>87</sup>

4.40 Notwithstanding these differences, which would have raised concerns that without further enquiries being made, limited, if any, reliance could be placed upon the quarterly figures reported by LCF to the FCA, the significant net current liabilities as reported in respect of the quarters ended 31 October 2017 to 30 April 2018 indicate that at those dates LCF does not have sufficient current assets and liquidity to meet its liabilities in the following twelve month period and as they fall due.

<sup>86</sup> Being Q4, 30/04/2018.

<sup>87</sup> See paragraphs 3.59 to 3.61 and Table 3.1 above.

## 5 THE ACTUAL AND FORECAST GROWTH OF LCF

- 5.1 The actual and projected financial information provided by LCF to the FCA during its regulatory lifecycle shows a picture of rapid growth of the business and in particular in respect of the loans advanced and bonds payable by LCF.
- 5.2 Whilst, in isolation, the concept of rapid growth is not in itself a 'red flag' and concern, taken together with the other 'red flags' and concerns addressed in this report it could be seen as further evidence of enhanced risk prevailing within LCF.
- 5.3 By reference to the loans advanced and bonds payable by LCF shown in the actual and projected financial information submitted and reported to the FCA, we set out in the tables below a summary of the values in:
- i The Financial Documents that were submitted by LCF to the FCA at varying intervals between 21 October 2015 and 22 May 2017 (table 5.1); and
  - ii FAS029 being the regulatory return submitted by LCF to the FCA for the quarters ending 31 July 2017 to 31 October 2018 (table 5.2).

**Table 5.1 Summary of loans advanced and bonds payable per Financial Documents submitted by LCF to the FCA between 21 October 2015 and 22 May 2017 (all figures in £000)**

Description/Balance Sheet date	30 April 2016 Actual <sup>88</sup>	30 Nov 2016 Actual <sup>89</sup>	31 Mar 2017 Actual <sup>90</sup>	30 Nov 2017 Forecast <sup>91</sup>
<b>Loans receivable</b>				
Current	586	421	122	5,512
Non- current	6,848	26,040	45,214	161,460
<b>Carrying Value</b>	<b>7,434</b>	<b>26,461</b>	<b>45,336</b>	<b>166,972</b>
Financial Prepayments	1,869	6,683	10,035	43,811
<b>Nominal Value</b>	<b>9,303<sup>92</sup></b>	<b>33,144</b>	<b>55,371</b>	<b>210,783</b>
<b>Bonds payable</b>				
Current	2,556	8,206	10,086	125,380
Non- current	7,395	18,848	33,903	9,593
<b>Carrying Value</b>	<b>9,952</b>	<b>27,054</b>	<b>43,989</b>	<b>134,973</b>
Deferred cost of funds income	-. <sup>93</sup>	6,996	11,436	42,649
<b>Nominal Value</b>	<b>9,952</b>	<b>34,050</b>	<b>55,425</b>	<b>177,622</b>

Source: *Financial Documents*

- 5.4 It can be seen from the table above that LCF experienced significant actual growth between 30 April 2016 and 31 March 2017, and in respect of the actual reported results, the total values of loans advanced and bonds payable correspond accordingly.<sup>94</sup>
- 5.5 Further, this significant growth was projected by LCF to increase five/six fold in the twelve months from 30 November 2016 to 30 November 2017.
- 5.6 The actual growth in the loans advanced and bonds payable by LCF is even more stark when the position from 31 March 2017 shown above is compared to the financial information

<sup>88</sup> See pages 20 and 23 of the 2016 Financial Statements.

<sup>89</sup> See pages 10 and 11 of the November 2016 Management Accounts.

<sup>90</sup> See pages 10 and 11 of the March 2017 Management Accounts.

<sup>91</sup> See the 2017 forecast trial balance (being the summation of the balances as at 30 November 2016 and the total forecast monthly movements thereafter in the individual balances as described in paragraph 3.51 above.

<sup>92</sup> There is an immaterial unexplained difference to the figure of £9,397k on page 1 of the 2016 Financial Statements.

<sup>93</sup> Different accounting treatment applied in the 2016 Financial Statements. See footnote 54.

<sup>94</sup> In relation to the forecast for the year ended 30 November 2017 the imbalance between the totality of loans advanced and bonds payable is essentially the projected overdrawn cash position of £28,462k as at 30 November 2017 and the projected profit for the year of £5,000k. See paragraph 4.29 above.

reported by LCF to the FCA in regulatory return FSA029 for the quarters ending 31 July 2017 to 31 October 2018.

- 5.7 The nomenclature set out in FSA029 is by its nature a broad classification of assets and liabilities and to that extent it will differ from the classifications specific to those applied by LCF in the Financial Documents submitted to the FCA.
- 5.8 We have therefore assumed in table 5.2 below that any amounts in respect of assets and liabilities other than loans advanced or bonds payable (and included within for example fixed assets or sundry creditors) are not material to the values reported to the FCA.

**Table 5.2 Summary of loans advanced and bonds payable per Financial Regulatory Return FSA029 reported by LCF to the FCA between 31 July 2017 and 31 October 2018 (all figures in £000)**

Description/Quarter ended	31 July 2017	31 Oct 2017	31 Jan 2018	30 April 2018	31 July 2018	31 Oct 2018
<b>Loans receivable</b>						
Current	25,837	17,784	3,125	875	1,133	810
Non- current	48,144	98,860	101,491	129,674	162,163	193,660
<b>Total</b>	<b>73,981</b>	<b>116,644</b>	<b>104,616</b>	<b>130,549</b>	<b>163,296</b>	<b>194,470</b>
<b>Bonds payable</b>						
Current	24,616	32,951	22,014	21,645	93	186
Non- current	49,738	84,164	82,265	112,147	166,750	192,708
<b>Total</b>	<b>74,354</b>	<b>117,115</b>	<b>104,279</b>	<b>133,792</b>	<b>166,843</b>	<b>192,894</b>

Source: *FSA029*

- 5.9 It can be seen from tables 5.1 and 5.2 above that in the 18 months between 31 March 2017 and 31 October 2018 LCF experienced significant actual growth such that the total values of loans advanced and bonds payable increased approximately 3 ½ times from £55m to £193m.
- 5.10 The projected rapid growth in the business of LCF was also identified and queried by the relevant FCA staff member in the Third Set of Queries where the question was asked “*You state that you are assuming ‘interest income on the existing loan book will double over the next 12 months’... Please explain the basis for this assumption...*”<sup>95</sup>

<sup>95</sup> See page 8, point 12, column 1.

- 5.11 In response, LCF state *“We’re expecting our loan book to double. Our demand for funds exceeds supply, so we’re working to expand our bond book considerably. At present, our funds are loaned out as soon as it is raised. We are currently working on 2 bonds to be listed of £100m each... which we expect to be filled by institutional investors.... Also, most investors (last month c.75% of bondholders) reinvest upon maturity.”*<sup>96</sup>
- 5.12 Further, the relevant FCA staff member went on to ask *“I note you are assuming £60 million new lending. The second page of the projections shows sourcing of £177 million of new finance. Please explain this. Particularly if [LCF] will be sourcing bond finance in excess of the amount being lent please explain why the interest and raising costs will not create a cost for [LCF] in the profit and loss forecast which is not offset by the debtor having to pay an equal amount.”*<sup>97</sup>
- 5.13 In response, LCF state *“Please note that our financial projections keep moving forward and the projections provided to you earlier are already out of date. At present our financial projections indicate for Nov 2017: A bond book of c. £142m and a loan schedule of c. £166m... All costs are passed through to the borrower (client), including raising costs.”*<sup>98</sup>

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<sup>96</sup> See page 8, point 12, column 4.

<sup>97</sup> See page 9, point 14, column 1.

<sup>98</sup> See page 9, point 14, column 4.

## 6 THE REASONABLENESS AND CREDIBILITY OF THE LCF BUSINESS MODEL

- 6.1 A review of the relevant financial documentation submitted, and responses provided, to the FCA by LCF during its regulatory lifecycle indicates a significant number of ‘red flags’ and concerns over the reasonableness and credibility of the LCF business model.
- 6.2 Whilst a number of these issues to some extent overlap with those previously addressed, in this section of the report we comment on those ‘red flags’ and concerns which can be specifically identified by reference to the level of detail that appears in the financial information submitted by LCF to the FCA on 26 January 2017<sup>99</sup> and the responses provided by LCF to the FCA in the Third Set of Queries.

### LCF FINANCIAL INFORMATION PROVIDED TO THE FCA ON 26 JANUARY 2017

- 6.3 The LCF financial information provided to the FCA on 26 January 2017 consisted of a projected profit and loss account for LCF for the year ended 31 December 2017 (“**the 2017 Profit and Loss Account Projections**”). This is in the form of an excel workbook that contains the detailed profit and loss account on one spreadsheet (“**the detailed projected profit and loss account**”) with the supporting calculations in respect of ‘*Turnover*’ and ‘*Interest (payable)*’ on the second spreadsheet (“**the supporting calculations**”).
- 6.4 It can be seen from the assumptions noted at the foot of the detailed projected profit and loss account that “*cost of funds is calculated on sheet 2 (the supporting calculations) at 25.5% for online fundraising and 10% for network fundraising. This is charged on to borrowers on a see through basis added on to their loans. As such it has been eliminated from this forecast.*”
- 6.5 In simple terms the process would therefore appear to be as follows:
- i LCF issue a bond for (say) £10,000 but only receive £7,450 in cash;<sup>100</sup>
  - ii LCF make a loan of (say) £10,000 but because of the passing on of the cost of funds the borrower only receives £7,450; and

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<sup>99</sup> Being the 2017 Profit and Loss Account Projections. This is in fact the only Financial Document that provides such level of detail.

<sup>100</sup> Being £10,000 less (£10,000 x 25.5%).



iii In both instances of the bonds issued and loans advanced the prevailing interest rate applied is levied on the full value of the bond or loan being £10,000.

6.6 A review of the supporting calculations indicates that there are no capital repayments of either loans advanced, or bonds issued by LCF.

6.7 In the case of bonds payable this can be ascertained by comparing the balance at the beginning of the projected period with the balance at the end of the projected period.<sup>101</sup>

6.8 In the case of loans advanced by LCF there is no similar opening balance figure in the supporting calculations. However, by reference to the interest receivable on existing loans it would appear that the consistency of the monthly amounts of the interest receivable is such that there are no projected repayments of loans made in the period.<sup>102</sup>

#### **Turnover – interest receivable and loan arrangement fees**

6.9 The supporting calculations show that interest is charged on new loans advanced by LCF at 1.75% per month.<sup>103</sup> This equates to 21% on a simple annual basis.

6.10 However, a review of the supporting calculations shows that the total projected interest receivable to LCF on the loans advanced is the summation of four separate components<sup>104</sup>:

- i The interest payable by LCF to new bond holders;<sup>105</sup> plus
- ii The interest payable by LCF to existing bond holders;<sup>106</sup> plus
- iii The interest receivable by LCF on existing loans advanced;<sup>107</sup> plus

<sup>101</sup> See cells B29 (£33,850,000) + O29 (£177,175,000) = P29 (*yr end gross total* of £211,025,000).

<sup>102</sup> See row 63 - *L TOTAL (EXISTING)*. It is not possible to check the calculations as the figures in the row are 'hard coded'.

<sup>103</sup> See cell C14 and its application in row 66 against the projected new monthly loans advanced in row 44.

<sup>104</sup> See row 67 being the summation of rows 59, 64 (which in turn is the summation of rows 62 and 63) and 66.

<sup>105</sup> Row 59. This is at varying rates between 6.5% and 8%: see cells C3, C4 and C7. The remaining cells C2, C5, C6, C8 and C9 are not linked to the calculation of interest on bonds.

<sup>106</sup> Row 62. The figures for monthly interest are 'hard coded' and in the absence of additional information cannot be checked.

<sup>107</sup> Row 63. The figures for monthly interest are 'hard coded' and in the absence of additional information cannot be checked.

iv The interest receivable by LCF on new loans advanced (ie the 21% referred to above).<sup>108</sup>

- 6.11 Therefore, absent further information, the interest rate charged by LCF to its borrowers could amount to potentially in excess of 29%. In addition to the above totals for interest receivable, borrowers of LCF are also charged a 2% loan arrangement fee and importantly between 10% and 25.5% of the amounts advanced are deducted such that for every £10,000 borrowed the borrower only receives between £9,000 and £7,450, but is charged interest on the full £10,000.
- 6.12 A reader of the 2017 Profit and Loss Account Projections may therefore have been concerned that these exceptionally high costs and terms of borrowing from LCF may not align with the proposed and existing lending profile of LCF as set out in the 2016 Financial Statements which state that LCF lend “to medium sized businesses on a fully secured basis....The Company holds fixed and floating charges over the assets of its customers to secure the loans. At the year end the loan to notional value (of secured assets) is 15%”.<sup>109</sup>
- 6.13 In particular, without further enquiries and information being made available, it is unclear why, with such low loan to secured asset ratios, borrowers of LCF would be prepared to accept such high costs and terms of borrowing. This would give cause for concern as to the quality of the lending being made by LCF, the true loan to secured assets ratios and LCF’s ability to fully recover the interest and capital on the loans advanced in a timely fashion such that it can service the contractual interest costs and repayment demands of its bondholders without the need to raise further funds from new bondholders to repay the liabilities due to existing bondholders.

### RESPONSES PROVIDED BY LCF TO THE FCA IN THE THIRD SET OF QUERIES

- 6.14 In response to a request from the relevant FCA staff member to “...explain what assumptions are in place in relation to non payment of debts...”<sup>110</sup> LCF respond “Non-payment of debts: Currently we are maintaining a beneficial loan-to-value ratio, holding assets of c. £222 [million] against loans of c. £65m. In the unlikely event of non-performance of a borrower, we would be able to liquidate said assets. We have intimate knowledge of the assets, our borrowers and their ability to repay.”<sup>111</sup>

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<sup>108</sup> Row 66.

<sup>109</sup> See page 1 of the 2016 Financial Statements.

<sup>110</sup> See page 8, point 12, column 1.

<sup>111</sup> See pages 8 and 9, point 12, column 4.

- 6.15 However, notwithstanding the high costs and terms of borrowing on the loans advanced, LCF respond to a request from the FCA in connection with the 2017 Profit and Loss Account Projections not making any “allowance for repayment of the existing finance”<sup>112</sup> by stating “[p]lease note that repayment of bonds is also passed through to borrowers. We inform them 3 months in advance of repayment. They then repay such bond amounts as we require. This is part of the loan agreement.”<sup>113</sup>
- 6.16 In response to a further request from the relevant FCA staff member to “...confirm how [LCF] intends to fund (or has funded since 30 April [2016]) the repayment of bonds as they fall due”<sup>114</sup> LCF respond “[t]he loan agreement with clients has an agreement that, if bond holders do not wish to roll over (reinvest), [LCF] can request repayment of the loan amounts.”<sup>115</sup>
- 6.17 In the light of that unsatisfactory answer the FCA repeat the request and LCF respond “[t]he loan agreements with each borrower stipulates that the Borrower shall repay when the Firm so requests – within 14 days. In the event of a default, we may turn to the guarantor, or directly effect the security (in terms of the Deed, full title to all assets are already assigned) immediately. Bondholders will be repaid out of other funds available. The Firm may also request amounts from other Borrowers (even those not in default) based on that specific clause in the loan agreements, in order to meet a Bond repayment.”<sup>116</sup>
- 6.18 Notwithstanding what appears to be inconsistencies between one response stating “if bond holders do not wish to roll over (reinvest), [LCF] can request repayment of the loan amounts”, another stating “[w]e inform them 3 months in advance of repayment. They then repay such bond amounts as we require” and yet another response stating “[t]he loan agreements with each borrower stipulates that the Borrower shall repay when the Firm so requests – within 14 days... Bondholders will be repaid out of other funds available. The Firm may also request amounts from other Borrowers (even those not in default)” one interpretation of the various responses provided by LCF to the FCA could mean that all the loans advanced by LCF are effectively repayable on demand.

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<sup>112</sup> See page 9, point 15, column 1.

<sup>113</sup> See page 9, point 15, column 4. A similar response is also provided by LCF in respect of point 19 (see pages 10 & 11, column 4).

<sup>114</sup> See page 14, point 21v, column 1.

<sup>115</sup> See page 12, point 21v, column 2.

<sup>116</sup> See page 12, point 21v, column 4.

- 6.19 Again, it is unclear why, with such apparent low loan to secured asset ratios, borrowers of LCF would be prepared to accept such high costs and terms of borrowing as set out by LCF in its responses to requests submitted by the FCA.
- 6.20 As in the case of the LCF financial information provided to the FCA on 26 January 2017, the responses provided by LCF to requests for information made by the FCA add to the concerns addressed above as to the reasonableness and credibility of the LCF business model.
- 6.21 In particular, these concerns extend to the quality of the lending being made by LCF, the true loan to secured assets ratios and LCF's ability to fully recover the interest and capital on the loans advanced in a timely fashion such that it can service the contractual interest costs and repayment demands of its bondholders without the need to raise further funds from new bondholders to repay the liabilities due to existing bondholders.

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