THE FCA MARKETS PRACTITIONER PANEL

Response to HM Treasury's Enforcement Decision Making at the Financial Regulators – Call for Evidence

4 July 2014

1. Introduction

The FCA Markets Practitioner Panel (the Panel) was established by the Financial Services and Markets Act (as amended) to provide external and independent input to the Financial Conduct Authority (FCA), specifically from the point of view of financial market participants. The Panel provides advice to the FCA on its policies and strategic development of financial services regulation.

We provide below some comments and observations with regard to HM Treasury's review of enforcement decision making processes at the financial regulators.

2. Executive Summary:

- The Panel is supportive of the FCA's strategy of credible deterrence. However, to be effective, there should be an appropriate balance between the use of enforcement vs. regulatory tools (i.e. not solely focused on punishment) and it should be proportionate to the conduct it is seeking to address (i.e. intentional misconduct vs. unintentional conduct that may or may not have caused harm).
- The Panel believes that improvements could be made to the transparency of the FCA's enforcement criteria, and in considering upfront the potential range of enforcement outcomes.
- The scope of an investigation is usually defined clearly at the outset. There are also sufficient opportunities to meet with the FCA to discuss progress. However, in the event that the scope of an investigation changes as the case progresses, firms could be afforded more opportunities to revisit previous decisions made, such as with regard to early settlement.
- The FCA process provides sufficient opportunity for firms to make representations, but there is a case for allowing these to be made earlier in the process, so that issues can be resolved sooner than is seen currently.
- The Panel is supportive overall of the settlement process. Nonetheless, there may be scope to improve the flexibility in both the process and size of settlement discounts to better meet the circumstances of each case. Care is also required to avoid a "parking fine" mentality where firms see settlements as a way of moving on from a case without properly addressing the concerns identified. The regulators may also wish to consider using Behavioural Economics to determine the incentives which could distort fairness in either bringing or settling investigations.
- The value to firms of the Regulatory Decisions Committee (RDC) process could be questioned, given that RDC decisions rarely diverge from the FCA's own decisions. This could be improved through increased independence and transparency of the process.
- With regard to international regulators, the UK regulators may wish to look at the US Securities and Exchange Commission's (SEC) approach to early engagement with firms during investigations. The UK regulators might also like to revisit their "no admissions as to liability" approach to settlement, as it currently has civil liability consequences internationally.

Panel response:

Question 1: Do current enforcement processes and supporting institutional arrangements provide credible deterrence across the spectrum of firms and individuals potentially subject to the exercise of enforcement powers by the regulators? If not, what is the impediment to credible deterrence and where does it arise?

The FCA's strategy has, for many years, been "credible deterrence." For deterrence to be credible, it must be both fair and designed to achieve a variety of aims for the betterment of firms and markets, and not unduly (or solely) focused on punishment.

To the extent that certain non-UK enforcement bodies are focused on increasing fines and corporate-only actions, caution is warranted. Some fines do not appear linked to the seriousness of the conduct or broader market goals. Indeed, on occasion, they can be quite the contrary linked to extraneous criteria.

In our view, there are differing types of conduct, ranging from: (1) intentional misconduct (which should result in enforcement action, regardless of harm caused); (2) unintentional conduct (reckless, negligent, strict liability) that causes harm; and (3) unintentional conduct that has not, but could, cause harm.

While enforcement should make sure that any harm is addressed, enforcement as a tool to address unintentional conduct can be less effective as a form of deterrence. Unintentional conduct, depending on the case, should be dealt with through regulation and prudential oversight if these can be shown to be more effective at remediating and preventing problematic conduct in future. For example, if early detection of certain market behaviours is the goal, then is it effective to punish unintentional conduct or incentivise firms to develop “best practices” market surveillance in remediation? We believe there is scope for rebalancing the enforcement agenda to focus on positive outcomes for the market, at least in certain cases.

We also question the increasingly common approach by enforcement that misconduct necessarily indicates a failure of systems and controls. We do not feel it is correct to say that inappropriate conduct must imply an actionable failure of systems and controls. Nonetheless, this seems to be increasingly the attitude adopted by regulators. We believe enforcement should show more discretion in this area. Again, we believe there are cases that might be best disposed of by recognising that systems and controls were entirely reasonable, but nonetheless enhancements are merited.

We believe that a measure of rebalancing should also be considered in matters involving misconduct. Misconduct is rarely attributable to an institutional desire to misbehave. It typically reflects the actions of an individual (or a small group of individuals). This may justify meaningful penalties for employees, but it does not mean that penalties directed at the firms that employ them are necessarily appropriate. Concomitantly, it should be a core enforcement principal that a regulator cannot charge a company with misconduct unless there is a finding that an individual or set of individuals engaged in misconduct.

Question 2: Are the criteria for referring a case from the FCA supervisory function to the enforcement function clear and used appropriately? Are all key criteria identified? If not, what improvements could be made? Should the FCA give certain factors more weight than others?

In many cases, this is the most critical phase of any regulatory problem because there is general belief that once the matter is referred, a disciplinary outcome is inevitable.

We consider that, to be credible over time, the referral process either needs to be independent or it needs to be transparent. Currently we are concerned that it is perceived to be neither.

We believe there should be greater transparency regarding the criteria for referral. We also believe that firms should have the opportunity at the referral stage to make the case to the regulators where they believe there is no prima facie case against them (just as occurs in the UK courts).

Question 3: Should the PRA say more publically about its enforcement processes? In particular, should the PRA publish enforcement referral criteria?

Whilst the PRA has no track record of enforcement action at this time, the Panel is supportive of transparency around the PRA's enforcement processes and referral criteria.

Question 4: Are the enforcement sections of the FCA/PRA MoU being applied in practice? If not, please give specific examples of implementation deficiencies.

and

Question 5: Is the MoU the most effective way to deliver effective co-ordination? If not, what alternative mechanism should be developed for enforcement cases?

and

Question 6: Do any suggestions for improvement or reform relate to the referral stage, the investigation stage, the decision making stage or all three stages?

The Panel provides no comments to these questions.

Question 7: Is the scope of investigations made sufficiently clear to those subject to them?

Generally, the Panel considered that the scope of investigations are made sufficiently clear initially. However, it is not unusual for investigations to increase in scope as they progress (e.g. the relevant period is expanded or additional issues are added to the memorandum of appointment). We believe it would be beneficial to have a more formal approach to allowing firms to reconsider prior decisions if an investigation materially changes (such as the ability to return to a stage 1 settlement process).

Question 8: Should the regulators offer the opportunity for regular progress meetings during the investigation?

The Panel is supportive of regular progress meetings being held during an investigation. The Panel believes that in most instances, this does already happen on a "without prejudice" basis. These meetings are a key way to help focus issues and dispel misunderstandings on either side.

Question 9: Are there sufficient opportunities for individuals and firms to make representations?

While the formal FCA process gives ample room for representations, the timing of those representations can be problematic.

Currently, the opportunity to make representations arises after receipt of the FCA's Preliminary Investigation Report. If firms had earlier access to the allegations being made, and the FCA had earlier access to the firms' representations, issues might be addressed and resolved, or focused on sooner in the process.

While the FCA is stated to be open to early discussions with firms, the sense is that the FCA is, in fact, reluctant to engage to discuss the possibility of early settlement or resolution.

Question 10: Does the time allotted for making representations strike the right balance between fairness and speed?

The Panel believes that that there may not always be sufficient time to prepare for representations. In fact, it appears that making requests for extensions to the timetable have become common practice.

However, where cases move too slowly, corporate and individual memories fade, which can put a just and fair conclusion to a case at risk.

Question 11: Should the regulators publish factors they will take into account when considering whether to grant extra time?

We believe that each case is genuinely unique and therefore this does not lend itself to external publication of the factors that regulators would take into account when considering whether to grant extra time. However, if not done so already, there is clearly value in the FCA ensuring that equivalence of treatment between regulated entities is achieved where possible.

Question 12: Settlements are faster and more efficient than exhausting the decision making process. They often deliver fairness to consumers by providing earlier opportunity for redress. Is it appropriate to give a discount for early settlement? Should there be any types of case where such discounts are not available? Could the settlement process be changed to offer clearer incentives to settle after the time limit for receiving a 30% discount has expired? Do you agree with the incentives given?

The early settlement procedure allows firms to receive a 30% discount, but it is at a very early stage, when the firm does not have access to key materials (e.g.

FCA interview transcripts) and the FCA does not have the benefit of seeing the firm's response to a preliminary investigatory report.

To address this, a larger measure of flexibility could be allowed. For example, the FCA may want to consider higher discounts - or longer periods for discussion - depending on the facts of a case. Such flexibility acknowledges the complexity of matters faced by the FCA, and that not every case merits the same approach.

From a Market Integrity perspective, care should be taken such that the process does not simply drive a 'parking fine' mentality in the market, which entails management being more driven by a desire to move on rather than closely examine and challenge (internally and externally) the conclusions reached following an investigation.

The regulators might want to consider applying the insights of Behavioural Economics, which has helped define the regulatory agenda, to the enforcement process and agenda as well. In doing so, they should look carefully at incentives – rational and irrational – which distort fairness – either in the bringing or settling actions. Some biases that could be explored include:

- Fear of criticism for wasting resources could discourage the investigation of an important issue which is difficult or resource intensive to investigate. That same fear might unfairly bias regulators in bringing charges after an investigation to avoid the criticism of having wasted resources;
- Fear of political and press criticism might inappropriately influence agendas;
- Desire by an employee of the regulators to work in the private sector could unduly encourage more gentle treatment of a regulated firm than is warranted;
- Perceived willingness of firms vs. individuals to settle could impact on the types of cases the regulators are prepared to take on, and hence the overall deterrent effect in the market (including whether the propensity to settle is counterproductive for the purposes of deterrence);
- Untested assumptions around the effectiveness of particular types of enforcement action (such as in relation to firms compliance and control programmes could lead the regulators to continue to pursue cases in these areas, without exploring others.

The regulators might also wish to consider exploring seconding staff from firms to contribute to assist it in bringing expertise to bear in its enforcement process.

Question 13: Do the current approaches to settlement also deliver fairness to firms and individuals subject to enforcement action, bearing in mind that settlement is a voluntary process? If not, what improvements could be made better to balance the interests of all parties?

We consider that the size of the discount could have a greater impact on cases against individuals as opposed to firms. As such, individuals may be more likely than firms to be prepared to settle whilst still disagreeing with the decision, because they consider they cannot afford further delays

We believe that if settlement discussions are being engaged in positively by both sides then the 'clock should be stopped' for the purposes of determining the level of discount available.

Question 14: Since the changes made by the FSA in 2005, FCA executives make early settlement decisions and the RDC takes the decisions on the issue of statutory notices in contested cases. How does this compare with the PRA's executive-based approach? Could further changes be applied to either regulator's processes to improve the balance between fairness, transparency, speed and efficiency?

and

Question 15: Should the composition of the RDC/DMC be changed? If so, why and how?

and

Question 16: Almost 40% of cases considered by the RDC are subsequently referred to the Upper Tribunal. Does the RDC process duplicate too much the Tribunal process for firms and individuals who are likely to refer a Decision Notice to the Tribunal? What changes could be made to make the process more proportionate and/or efficient, consistent with the delivery of the regulatory objectives?

The Panel believes that the establishment of both an administrative review (Regulatory Decisions Committee) and an independent review (Upper Tribunal) is laudable. Providing due process - a mechanism for checks/balances on the FCA - is key to credible deterrence, and is a process that is missing in certain other jurisdictions.

That said, the statistics suggest that the RDC rarely diverges from the FCA. As a result, there is some question as to what the RDC process offers firms, particularly given the recent decision to make this process semi-public, with the ability to publish warning notices under certain circumstances. Refining this process to ensure that the FCA consults with its own industry experts about results that will optimise the objectives (remediation, prevention, agency and credibility) would be valuable.

The issue from a market integrity perspective is again that the current process is perceived as neither independent nor transparent and more should be done to achieve these objectives.

Question 17: What more could the UK learn from international practice?

As the call for evidence notes, the FCA/PRA has not adopted a path for a "no admissions as to liability" settlement. This has significant civil liability consequences not just here but internationally, particularly in the US, and is something that should be revisited. For example, such a settlement may be useful where the rules or conduct were less than clear, but the market would benefit from understanding the FCA/PRA view on "best practices."

To the extent possible, we encourage this process to be used to ensure greater coordination in multi-country investigations. In our view, the multi-country approach to "headline" investigations wastes precious enforcement resources.

Question 18: Are there specific features of other jurisdictions' enforcement processes which might be introduced in the UK?

Although no process is flawless, the U.S. Securities and Exchange Commission (SEC) may be seen to work well in areas of engagement with firms. For example, in advance of the staff of the SEC recommending any charges, ordinarily there is ample opportunity for pre-Wells submissions and informal white papers to focus the legal and factual issues. And, before charges are recommended to the Commission, there is a formal Wells submission process.