
How the Financial Conduct Authority will investigate and report on regulatory failure

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Introduction

This document sets out our thinking on how the Financial Conduct Authority (FCA) will meet the new statutory requirement to investigate possible instances of regulatory failure and provide reports to the Treasury for publication. We want to be clear when we think this level of scrutiny would and would not be justified.

The Financial Services Act 2012 (the 2012 Act) requires the FCA to publish a statement of policy setting out the matters it will take into account in deciding whether an investigation into possible regulatory failure is required, and give a report of its findings and recommendations to the Treasury to publish.

The statement of policy, which has been approved by the FCA Transitional Board and which the Treasury has given its consent for us to publish, is included as Annex 1 to this document.

The triggers and thresholds which would ensure that the statutory duty was focused on the significant events and serious failures mentioned in the legislation have been the subject of considerable discussion internally and with external stakeholders.

Any quantitative threshold would have to vary in accordance with the type of activity, and qualitative considerations will also be relevant. In Chapter 6, we use hypothetical examples to illustrate whether we think the statutory test would or would not have been met.

We are keen to know and understand stakeholders' views on the issues raised in this document. Chapter 8 sets out how we will gather feedback.

1. Context

- 1.1** Journey to the FCA set out the FCA's approach and how it will differ from the way the Financial Services Authority (FSA) operated. It also reflects on the organisational and cultural changes that are under way.
- 1.2** Two of the topics mentioned in that document are particularly relevant in relation to the duty to investigate and report on regulatory failure:
- Our commitment to accountability and operating with an appropriate level of transparency (Chapter 7).
 - Our risk-based approach (p42).

Accountability and Transparency

- 1.3** In March 2013 we published a discussion paper on Transparency, which – as well as discussing our accountability – set out ideas for how we could be more transparent about the work we do.
- 1.4** The requirement to carry out investigations and publish reports in the event of regulatory failure is one of the accountability measures imposed by the 2012 Act. The instances which meet the conditions in the statutory test will by definition be significant events and serious failures – the requirement comes into force only when things have gone badly wrong.
- 1.5** The FCA is constantly looking to find ways of doing things better, and we are considering the extent to which it will be possible and useful to publish – in summary form – the things we have changed as a result of our 'business as usual' lessons learned reports.

Risk-based approach

- 1.6** The FCA will not be able to prevent or control everything that causes harm to consumers and financial markets – the costs of any attempt to do so would be prohibitive and such an approach would stifle innovation and competition, which would not be in the interests of consumers.
- 1.7** And not every instance of market failure resulting in consumer detriment will constitute a 'regulatory failure' within the terms of the statutory test.
- 1.8** Subsequent chapters set out how our risk-based approach will be relevant in determining whether the conditions in the statutory test are met.

2. What is a regulatory failure?

- 2.1** The FSA has, in recent years, published three reports in which it evaluated its effectiveness in the period up to and including the financial crisis:
- a. The Internal Audit Report into the failure of Northern Rock (March 2008)
 - b. The Board Report into the failure of RBS (December 2011)
 - c. The Internal Audit Report on LIBOR (March 2013)
- 2.2** The management response to the LIBOR report set out that reports into Northern Rock and RBS identified clear examples of major regulatory failure – both in the international capital framework and in the FSA’s own approach to supervision – and made recommendations that helped transform the performance of the FSA. The Internal Audit report on LIBOR identifies important areas where the FSA should have performed better, and makes valuable recommendations for the future, but does not suggest major regulatory failure on the scale identified in the Northern Rock or RBS reports.
- 2.3** There was no framework setting out what should be regarded as a regulatory failure at the time the FSA carried out these lessons learned exercises and published the reports.
- 2.4** The 2012 Act sets out what should be regarded as regulatory failure for the FCA, in line with its objectives which came into force on 1 April 2013. The 2012 Act requires the FCA to assess when there has been a regulatory failure in accordance with the conditions set out in the 2012 Act, and if so, to carry out investigations and deliver reports to the Treasury for publication.

Statutory requirements

- 2.5** The 2012 Act¹ sets out a two-part test for determining when we must carry out an investigation into potential regulatory failure and produce a report. The first part of the test is linked to our operational objectives, and the second part is about the regulatory system, including the FCA’s actions and decision-making within that system. Both parts of the test must be met.
- 2.6** We are required to carry out an investigation and produce a report when:

Part One

events have occurred in relation to a regulated person or others which indicated a **significant failure** to secure appropriate consumer protection, or had or could have had a **significant adverse effect** on our integrity or competition objectives;

¹ Financial Services Act 2012 Part 5, sections 73,77-83

and

Part Two

the events might not have occurred or the adverse effect might have been reduced but for a **serious failure** in the system established by the Financial Services and Markets Act 2000 (as amended) (FSMA) or the operation of that system.

- 2.7** The Treasury can require the FCA to carry out an investigation where it appears to the Treasury that the above test is met. Alternatively, the Treasury may require the FCA to investigate where it considers that it is in the public interest that the FCA should carry out an investigation into relevant events and it does not appear to the Treasury that the FCA has undertaken or is undertaking an investigation (whether under Part 5 or otherwise) into those events.
- 2.8** The Treasury can also give directions regarding the scope of any investigation, the period during which the investigation is carried out, the conduct of the investigation and the making of reports.
- 2.9** The 2012 Act allows the FCA to postpone the start of, or suspend, an investigation if necessary to avoid a material adverse effect on the exercise of any of its other functions.
- 2.10** The reports produced in accordance with these requirements must be provided to the Treasury, which must publish them in full, subject to prescribed exceptions set out in the Act.
- 2.11** Reports must set out:
- the result of the investigation;
 - the lessons (if any) that the FCA considers that it should learn; and
 - such recommendations (if any) as the FCA considers appropriate.

3. Event with an adverse effect on the objectives

The first part of the statutory test

... where it appears to the FCA that events have occurred in relation to a regulated person or collective investment scheme which:

- indicated a significant failure to secure an appropriate degree of protection for consumers;
- had or could have had a significant adverse effect on the integrity of the UK financial system (the integrity objective); or
- had or could have had a significant adverse effect on effective competition in the interests of consumers (the competition objective) ...

- 3.1** We have a single strategic objective – to ensure that the relevant markets function well – and three operational objectives, to:
- a. secure an appropriate degree of protection for consumers;
 - b. protect and enhance the integrity of the UK financial system; and
 - c. promote effective competition in the interests of consumers.
- 3.2** The first part of the statutory test is about significant failures and significant adverse effects in relation to each of the operational objectives.

Significant adverse effects on our objectives – detriment and how to measure it

- 3.3** Overall, outcomes that are significantly different from those we might observe in well-functioning markets will suggest adverse effects on one or more of our operational objectives.
- 3.4** These adverse effects can be defined in terms of choices, prices, availability and other direct and indirect proxies, which we can use to measure detriment in the market. This measure of detriment can then be used to establish the ‘significance’ of the adverse effect.

- 3.5** An economic approach suggests that detriment is the loss in consumer welfare – that is, the difference between the intrinsic value and the price of products in a market – arising from a market or regulatory failure.
- 3.6** Using this approach, we would ideally focus on all consumers and potential consumers within a particular market, rather than measure detriment at the level of the individual consumer. This is because we are attempting to measure overall consumer welfare, not just the potential detriment suffered by individuals who have purchased a product.
- 3.7** For example, the complete disappearance of a market due to regulatory intervention imposes ‘costs’ on those for whom the product would have been suitable (since they will not be able to purchase the product and may opt for a less suitable alternative), as well as providing benefits to those for whom the product would have been unsuitable (in that they are prevented from buying an unsuitable product).
- 3.8** And in the case of an uncompetitive market, where prices are higher than they would be in a competitive market, some consumers who value the product will not purchase it at the higher rate, and therefore are worse off.
- 3.9** The overall measure of detriment would encompass those who benefited as well as those who suffered costs.
- 3.10** This measure of detriment can be applied to all three operational objectives:
- a. For consumer protection, it is clear that if a retail consumer is advised to buy an unsuitable product the market outcome is not optimal. The purchase of an unsuitable good would be considered a detriment to the consumer and would be included in the above definition.
 - b. For market integrity, if a failure in the formation of prices results in prices that are ‘wrong’ then we can say that the market is not functioning well. For example, the misuse of information to influence market prices would be a deviation from the optimal market outcome and would be considered detriment.
 - c. For competition, if consumers face higher prices or lower quality than would be expected in a well-functioning market, then the difference between expected and realised prices/quality would be detriment.
- 3.11** In practice, in some cases it will not be possible to estimate detriment directly so we have to use our judgement to develop reasonable proxies:
- a. Under the consumer protection objective, realised monetary losses, such as from the purchase of an unsuitable product, may be the best proxy we have of detriment.
 - b. An example for the integrity objective may arise where there is disruption to the functioning of a trading venue. In such cases we could rely on measures of the length or frequency of such disruptions.
 - c. For the competition objective, we may have to rely on indicators of concentration or entry and exit, at least as a starting point. We can then supplement these measures with an assessment of price and quality across time and across products to understand the nature of the detriment.

- 3.12** And in some cases, we may also consider well-being measures, i.e. subjective measures of satisfaction, for instance in cases where emotional distress is particularly important.
- 3.13** We now look at each of the objectives in turn and briefly discuss some measures of detriment.

The consumer protection objective

- 3.14** As set out above, in determining whether events have occurred that indicate a significant failure to secure appropriate consumer protection, it may be appropriate to use direct measures of monetary loss. The factors which would indicate a significant failure to protect consumers are:
- a. the amount of detriment suffered by consumers in total, or per consumer;
 - b. the number of consumers who have suffered detriment; and
 - c. the characteristics of those consumers, if particularly important.
- 3.15** We have considered whether the measures of consumer loss should be before or after remedies (redress or compensation), whether provided by regulated persons or by the Financial Ombudsman Service or the Financial Services Compensation Scheme. Since any 'net' figure of loss/detriment can take some time to establish after the relevant event, we have decided that the best measure for the first part of the statutory test is the 'gross' detriment figure.
- 3.16** The availability of redress or compensation will be relevant for the second part of the test (see Chapter 5, paras 5.16 to 5.18).
- 3.17** In some cases, we may also consider wider impacts, for example the distress associated with experiencing arrears, which are not directly captured by financial losses but are still important for consumers' wellbeing. And, not all negative outcomes are the result of financial loss – for example, a temporary inability to access funds could cause huge amounts of distress if that was the only source of funds.

The integrity objective

- 3.18** In determining whether an event had or could have had a significant adverse effect on our integrity objective, we will consider the extent to which the event led to outcomes which differ from what would be expected if markets were functioning well.
- 3.19** The factors to be taken into account here are:
- a. the pervasiveness of any misconduct, e.g. number of institutions involved and the length of time it persisted;
 - b. the severity and incidence of the (potential) impact, for example the value and number of contracts affected by the issues or the extent to which criminal offences may have been committed; and

- c. the duration and impact of market disruption if transactions have to stop due to technical failures. The importance of the venue for the trading of the financial instruments affected and the availability of alternative trading venues will be relevant in determining the impact of any disruption.

The competition objective

- 3.20** Overall, if prices are high, quality low or choice for consumers limited in terms of product availability or selection, this suggests that competitive forces are not working properly.
- 3.21** A direct measure of such outcomes is difficult and we would have to monitor markets on an ongoing basis to assess the level of competition. As part of our competition strategy we aim to monitor a number of indicators that can signal the evolution of competition in markets such as concentration ratios, measures of entry and exit, switching behaviour etc.
- 3.22** Initially, in determining whether an 'event' has occurred suggesting that the first part of the statutory test has been met, we will consider whether the circumstances in place when our competition objective commenced have changed for the worse as a result of an act or omission over which we had control. The fact that competition may not be effective in relevant markets now does not in itself mean that the first part of the test has been met.
- 3.23** It follows that the receipt of a supercomplaint² will not in itself be considered an event having a significant adverse effect on our competition objective. If the FCA takes action as a result of the supercomplaint but the same circumstances which gave rise to it are still in place after some years, we would need to consider whether the statutory test for a regulatory failure report has been met, if it appears our action did not resolve the issue.
- 3.24** The same applies in respect of competition scrutiny advice from the Office of Fair Trading (or its successor body)³ that can ultimately lead to a direction by the Treasury – the fact that this mechanism has been used does not automatically indicate a regulatory failure, but if the FCA's action does not result in improved competition in the relevant market we would consider whether the statutory test for a regulatory failure investigation and report had been met.
- 3.25** In the future, development of competition in the markets we regulate will have to be taken into account to establish whether or not the first part of the test for a report has been met.

² Section 234C of FSMA enables bodies which represent the interests of consumers and which have been designated by the Treasury to make a complaint to the FCA that a feature of the market in the UK for financial services or combination of features is or appears to be significantly damaging to the interests of consumers.

³ Sections 140B and 140G provide for the OFT to give advice to the PRA or FCA stating that the OFT considers that the regulating provisions or practices of either regulator (or a combination of both) may cause or contribute to the prevention, restriction or distortion of competition in the supply or acquisition of goods and services in the UK, or that a feature of the market that could be dealt with by regulating provisions or practices of either regulator (or both) has that effect, the regulator is required to respond to the advice within 90 days. If the OFT is not satisfied with the response, it may refer the matter to the Treasury, who may ultimately give a direction to the regulator requiring the regulator to take specified action.

4.

Thresholds – what is significant?

- 4.1** In Chapter 3 we set out a number of indicators which we will use to measure whether an event caused an adverse effect on the FCA objectives. This chapter sets out our thinking on how to judge whether the adverse effect is significant or not.

Why set a threshold?

- 4.2** As part of our ongoing accountability, the FCA is committed to being a transparent organisation and carrying out reviews into significant events so that we can learn lessons for the future.
- 4.3** We have a duty to use resources economically and efficiently⁴ and we want to ensure that the fees paid by firms (and, indirectly, consumers of financial services) are focused on the right areas, with an appropriate balance between learning the lessons from past events and working to achieve our objectives.
- 4.4** Where the statutory test is not met, the FCA will still seek to learn lessons from events, without the expense in cash and human resource terms of a formal investigation and report. And, we will aim to publish the lessons we have learned through our annual report.
- 4.5** The FCA expects to carry out a formal statutory investigation and write a report for the Treasury to publish only in exceptional cases. To determine which these are, we want to put in place a workable threshold against which we can measure how significant any adverse effect on our objectives may be.
- 4.6** The FCA operates a risk-based approach, which means that not all individual instances of an adverse effect in relation to our objectives (for example a firm failure or a consumer loss) will constitute a regulatory failure. The interaction of our risk-based approach with the second part of the statutory test is set out in Chapter 5. The rest of this chapter focuses on how we will use a quantitative threshold and qualitative factors, in line with our risk framework, to determine whether the first part of the statutory test has been met.

Indicative threshold to retain flexibility, supplemented by qualitative factors

- 4.7** In considering whether any adverse effect on our objectives is significant, for these purposes, we want to apply a quantitative threshold. The spectrum of consumers (including all users of markets) covered by the FCA's remit, across the range of markets it regulates, means that setting a threshold is not straightforward.

⁴ Section 3B(1)(a) FSMA.

- 4.8** Our view is that the FCA should put a threshold in place and adjust its application for different types of consumers. For both individuals and firms, the trigger should be relative to the financial resources of those suffering the detriment:
- If consumers are firms (for example in wholesale markets) the threshold should be higher than if consumers are individuals.
 - Within firms, the threshold should be set higher for large financial firms than for small non-financial businesses.
 - For individuals, the threshold should be set higher for those with more wealth and/or financial sophistication.
- 4.9** Having reviewed instances of past adverse events (such as major mis-selling cases) in relation to the FSA's objectives, and taken into account the different remit and approach of the FCA, we think that a suitable quantitative threshold for relevant events in relation to the FCA objectives is a range from £150 million to £30 million of total consumer detriment, particularly in reference to our consumer protection objective.
- 4.10** We think a range is most appropriate because it means we can differentiate between different types of customers and markets. For example:
- a. We are likely to regard £150 million or more of total consumer detriment as significant for many types of consumers, unless the only detriment suffered is to large or sophisticated financial firms.
 - b. Between £150 million and £30 million we will consider other factors, such as the characteristics of the consumers concerned, the loss per consumer or the size of the market, when deciding whether the adverse effect is significant.
 - c. We are unlikely to consider that total consumer detriment below £30 million would justify a public report, unless other qualitative factors apply, such as whether the characteristics of the consumers active in the relevant market mean that they are particularly vulnerable.
- 4.11** For the integrity and competition objectives the threshold will need to be adjusted for the market, and the other factors set out in Chapter 3 are more likely to be relevant.
- 4.12** Another factor we might take into account is how damaging the behaviour leading to the relevant event was (for example the disregard for market integrity shown in the LIBOR case), particularly when considering the significance of the adverse impact on the integrity objective.
- 4.13** For these reasons, and to retain some flexibility, qualitative as well as quantitative factors will be relevant.
- 4.14** The FCA is currently developing a segmentation model of individual retail consumers which will set out the characteristics of consumers relevant to the financial markets in which they are active. We will use this to help inform and prioritise regulatory activity in order to prevent detriment to those with lower levels of financial resources and capability or greater vulnerability, or where the level of potential detriment is highest in relation to their financial resources.⁵

⁵ This does **not** mean that we do not act to prevent detriment to 'wealthier' consumers through our ongoing work to set standards and monitor compliance, but that, where we need to prioritise, customer characteristics are one of the factors we will take into account.

- 4.15** We also expect that this model will help us decide how to apply the threshold range when determining the significance of any adverse effect in relation to the first part of the statutory test.
- 4.16** It is important to note that setting the threshold range at this level is not suggesting that there is an 'acceptable' level of detriment, or that we would not seek to prevent this level of detriment arising. As stated above, these reports are expected to be infrequent occurrences and the range is set accordingly.
- 4.17** It should also be noted that, when determining whether there has been a significant adverse effect on our competition objective, we will consider the significance of the financial services market in relation to our objectives, rather than the significance *within* each market.
- 4.18** So, if a market consisted of two firms and our regulatory activity caused one of them to withdraw from that market, there would have been a significant impact on competition in that market, but we would decide how significant the adverse effect was on our competition objective with reference to the importance of that market to the UK financial system. One of the factors we would take into account is the numbers of consumers affected, and the extent of the impact on them.
- 4.19** How the threshold range would work in practice, and how the two parts of the statutory test interact, are explored through hypothetical examples in Chapter 6.

5. Serious failure of the regulatory system or its operation

... where it appears to the FCA that events have occurred in relation to a regulated person or collective investment scheme which:

- indicated a significant failure to secure an appropriate degree of protection for consumers;
- had or could have had a significant adverse effect on the integrity of the UK financial system (the integrity objective); or
- had or could have had a significant adverse effect on effective competition in the interests of consumers (the competition objective) ...

... and

The second part of the statutory test

... those events might not have occurred, or the failure or adverse effect might have been reduced, but for a **serious** failure in:

- the system established by FSMA for the regulation of authorised persons and their activities, for the listing of securities or for the regulation of collective investment schemes, so far as it relates to the functions of the FCA; or
- the operation of that system, so far as it relates to those functions.

- 5.1** The FCA has substantially revised the FSA's approach to regulation and learned from failings in the past. We have designed a forward-looking judgement-based approach to make sure that regulatory outcomes improve.
- 5.2** A judgement-based approach may mean we get some things wrong, but this does not have to mean a regulatory failure, if the proper approach was followed, and without the benefit of hindsight.
- 5.3** The second part of the statutory test has two further parts, either of which must be met to trigger an investigation and report. Each instance would need to be considered on its own merits, but we would distinguish them as follows:

Failure of the regulatory system would include failure of the regulatory framework, that is, the standards and boundaries set by the regulatory framework that are relevant to the functions of the FCA are not adequate. For example:

- a. an event happened but it was outside the regulatory perimeter;
- b. an event happened where responsibility for acting to prevent it was unclear due to overlap/underlap with other regulators; or
- c. an event happened but the FCA did not have sufficient powers to prevent it.

Failure of the operation of the system would be where the FCA did not act to prevent an event or acted to bring it about. This would include a failure in the regulatory processes or approach and/or the execution of those processes or approach. In other words, we acted or failed to act such that it could be said that we were not meeting our objectives. For example:

- a. an event happened because we failed to conduct our operations in accordance with our risk-based approach/framework;
- b. our risk-based approach was seriously flawed; or
- c. the event was the result of the adverse impact of our policymaking and rules.

- 5.4** We have mentioned above that the FCA will operate a risk-based approach in order to target its resources to best meet its objectives.
- 5.5** Operating a risk-based approach involves us making choices and prioritisation decisions about which activities to carry out, how often, and to what level of intensity.
- 5.6** If we have acted in line with our risk-based approach, as approved by the Board, with any exceptions having been sanctioned through appropriate governance, our starting point is that events arising from decisions made in line with that approach will not *prima facie* be the result of a failure of the system or its operation.
- 5.7** The exception to that is where our risk-based approach is seriously flawed. An example of this would include where we had not allocated sufficient resource to carry out activities necessary to meet our legal obligations.
- 5.8** Similarly, where our risk-based approach is seriously out of line with reasonable expectations; for example, if we moved from making supervisory contact with regulated firms at least every four years to every 10 years without putting in place alternative mechanisms to supervise those firms.
- 5.9** To avoid doubt, where our risk-based approach would have prioritised an action, but we failed to take any action and a 'relevant event' took place as a result, we think that would be a potential failure of the operation of the system, and would merit consideration of how serious a failure it was.
- 5.10** And, if events arose where we did not act because our risk-based approach did not prioritise action, we would not consider this a failure of the operation of the system in relation to that event. However, we may need to consider whether we should adjust our framework for future events, depending on the extent of the adverse effect on our objectives. This would not require a report.

Competition

- 5.11** As stated above, in determining whether an ‘event’ has occurred suggesting that the first part of the statutory test has been met, we will consider whether the circumstances in place when our competition objective commenced have changed for the worse as a result of an act or omission over which we had control. The fact that competition may not be effective in relevant markets now does not in itself mean that the first part of the test has been met, or that there has been a failure in regulation.
- 5.12** For events resulting in a significant adverse effect on competition, occurring after 1 April 2013, which we could have affected by acting or not acting, we will need to consider whether a serious regulatory failure was involved.
- 5.13** Possible examples include unintended consequences of a policy initiative (where the market disappears), or too-restrictive barriers to entry at authorisation possibly imposed to protect consumers.
- 5.14** Another example would be where our supervisory function did not spot behaviour that would be anticompetitive by a firm that is sufficiently large to act independently of its competitors.
- 5.15** We expect to carry out post-implementation reviews of significant discretionary policy initiatives to see if they are achieving the changes we desired and at what cost. These will not be the same as the regulatory failure reports. However, the results – if not what we expected – may prompt consideration of whether to carry out an investigation into possible regulatory failure.

The Financial Ombudsman Service and the Financial Services Compensation Scheme

- 5.16** As previously stated, the threshold for the first part of the test relates to ‘gross consumer detriment’, before redress or compensation. The Financial Ombudsman Service (FOS) and Financial Services Compensation Scheme (FSCS) are part of the regulatory system, operating as ‘safety nets’ for specific categories of customer who would otherwise suffer loss where firms fail, or fail to comply with regulatory requirements.
- 5.17** The operation of these safety nets is a function of the system operating as it is designed to operate, and the need to have recourse to them not in itself a failure of the system or its operation.
- 5.18** However, there may be instances relating to the interaction of the FCA with the FOS and FSCS which result in the conclusion that there has been a failure of the system or its operation, for example if the rules (which are made by the FCA for the FOS and jointly by the FCA and Prudential Regulation Authority (PRA) for the FSCS) do not operate as intended.

What is a ‘serious’ failure?

- 5.19** The statutory test is met if there is a ‘serious’ failure of the regulatory system or its operation.
- 5.20** There is a spectrum of activity which could result in the instances of regulatory failure set out above being considered ‘serious’. At one end, an individual member of staff may have failed to

act in line with the professional standards the FCA expects. At the other, the organisation may not be operating as it ought to or has said it will.

- 5.21** We will assess whether a failure is serious on a case-by-case basis, but consider that at the smaller, more isolated end of the spectrum, the complaints scheme⁶ is likely to be a more appropriate method of remedying a failure.
- 5.22** Organisational deficiencies would be more likely to constitute a serious failure.
- 5.23** And we acknowledge that the consequences of the failure, if any, are likely to influence the determination of how serious it is.
- 5.24** The interaction of the two parts of the statutory test and how the threshold range would work in practice are explored through hypothetical examples in the following chapter.

⁶ The complaints scheme provides a procedure for enquiring into and, if necessary, addressing allegations of misconduct by the FCA arising from the way in which it has carried out or failed to carry out its functions. The complaints scheme covers complaints about the way in which the FCA has acted or omitted to act, including complaints alleging:

- (a) mistakes and lack of care;
- (b) unreasonable delay;
- (c) unprofessional behaviour;
- (d) bias; and
- (e) lack of integrity.

It excludes complaints in relation to the performance of the FCA's legislative functions.

6. Examples – what does this mean in practice?

- 6.1** The interaction of the two parts of the statutory test and how the threshold range would work in practice are explored through hypothetical⁷ examples in this chapter.

Example 1

The FCA receives intelligence about poor sales practices in respect of a product which has recently been brought within its regulatory scope. The product is mainly sold to retail consumers, many of whom are vulnerable; it is suitable for some consumers. The FCA writes rules designed to reinforce the requirement that sales are made only when suitable.

The FCA carries out reviews of compliance with the rules, and finds continued poor sales practices, whereupon it issues further guidance and takes enforcement action resulting in fines against some firms. It goes through this cycle a further two times, reviewing more firms, increasing the intensity of its messages and taking more enforcement action.

The FCA does not carry out the analysis which would identify that the profit incentive for firms outweighs the deterrent effect of potential enforcement action.

After some time, when it has become apparent that the action it has taken to date has not been effective and that the poor sales practices have resulted in significant consumer losses, the FCA effectively bans the product and requires the industry to carry out proactive reviews of past sales to identify and compensate those who have been mis-sold the product. The potential consumer loss – before any redress has been paid – has reached a total of £10 billion, averaging £3000 per customer.

Does this meet the statutory test? Yes

We would regard this as a significant failure to protect consumers – the total loss is well over the indicative threshold, and the customers are retail individuals, many of whom are vulnerable.

The FCA had the powers to take more effective action sooner but did not do so. The incentive for firms to mis-sell was discoverable at the time, as was the amount of detriment being suffered by consumers. We would regard this as a serious failure of the operation of the system.

If the FCA had identified the issue but did not have the power to ban the product, we may decide this was a serious failure of the regulatory system.

⁷ We have used some of the facts from cases relevant to the FCA objectives which arose during the FSA's regulation, but we have changed and exaggerated specific details.

Example 2

A significant wholesale market firm fails, and it is discovered that it failed to segregate its client money. FCA practice at the time is to rely on auditors to monitor adherence to the client assets rules and its risk-based approach identifies this as a high priority area for supervisory review. In the period leading up to the firm failure, there is little evidence of effective supervisory review and the auditor's report identifies some concerns which are not followed up.

The legislative framework surrounding insolvency means it takes many years before all client money (over £2 billion) is paid out, although customers receive a small interim payment and ultimately most of the money is recovered and returned to customers. In the interim, customers suffer economic loss of use of their money and there is considerable market disruption to trading activity.

Does this meet the statutory test? Yes

Assuming that a significant proportion of the customers – although sophisticated – are not market counterparties, we decide this represents a significant failure to protect consumers.

As events caused significant disruption to the functioning of the market after the firm fails (outstanding trades not completed, other firms affected, etc), the event would have had a significant adverse effect on the integrity objective.

Failure to effectively supervise the firm or follow up on the auditor's report is a serious failure of the operation of the system.

The delay in payment of client money is as a result of the insolvency regime which is not the result of a failure in the regulatory system as defined in the second part of the statutory test.

Example 3

An individual has been carrying out unauthorised investment business resulting in £25 million of consumer detriment once discovered and stopped. Customers are retail individuals. No recoveries are made from the perpetrator; the losses are not eligible for compensation from the FSCS as this is unauthorised business.

The FCA has had some information about the case for some years but did not have the evidence necessary to take action to close down the scheme. Under its risk-based approach other cases took priority so the FCA did not devote more resources to a proactive search for evidence.

Does this meet the statutory test? No

£25 million of total consumer detriment is lower than the indicative threshold set but these retail individuals did not receive any redress/compensation. Unauthorised business (UB) cases rarely reach the level of £30 million of detriment, but it cannot be right that UB cases could never result in an investigation into possible regulatory failure. Rather than lower the threshold, we would consider whether the amount of detriment is significant in respect of this type of activity, and the characteristics of the consumers affected. In this instance, we might decide that the first part of the statutory test has been met.

This would not be a failure of the operation of the system if the FCA operated in line with its risk-based approach, since the FCA has to prioritise the many thousands of UB cases it becomes aware of each year.

Example 4

Firms carrying out a new type of business seek authorisation from the FCA. Due to concerns that consumers may not understand the risk involved in the product, the barrier to entry is set very high in order to protect consumers, and few firms actually meet the authorisation requirements. After a couple of years, there is little evidence that the consumers who have entered into this business have suffered as a result. In pursuit of its duty to promote competition, the FCA decides to relax the barriers for entry.

Does this meet the statutory test? No

It could be argued that there has been a significant adverse effect on competition in this market, in that the market has been severely restricted: those who bought the product may have done so at a price much higher than would have otherwise been the case if entry barriers were lower, since the few firms in the market would have been able to charge a higher price. In addition, many consumers who may have bought the product at competitive market rates did not do so at the higher, uncompetitive market price. We would be able to compare prices before and after we lowered our entry barriers and be able to identify the reduction in price that would result, and assess it against the threshold. We should also seek to ascertain the size of the potential market to understand the extent to which this affected consumers and potential consumers of this product.

If, having considered the competition aspects at the time, the FCA made the decision to apply the high barrier in pursuit of its consumer protection objective, and had no evidence to suggest that the high barrier would be unnecessary, we would be likely to decide that this is not a failure of the operation of the system. Although we have a duty to promote competition, so far as is compatible with advancing our other objectives, if we genuinely consider that an action is necessary for consumer protection we are likely to take it notwithstanding that it does not promote effective competition.

Example 5

Significant control failures in a firm which is prudentially regulated by the PRA have resulted in millions of pounds of detriment to past consumers, and a strong probability of increasing detriment to new consumers. The FCA considers that radical action is necessary and wants to take formal action to prevent the firm undertaking the business at issue until it has rectified the problem. This will cost the firm a huge amount of money, and present reputational risk to the firm, and the PRA considers this a threat to the firm's safety and soundness and to financial stability. The FCA and the PRA are unable to reach agreement on this issue, so the PRA vetoes⁸ the FCA action. The FCA takes alternative action which is less likely to be effective.

⁸ Section 31 FSMA.

Does this meet the statutory test? No

If the firm is critical to financial stability this could represent a significant failure to protect consumers, since the FCA cannot take the most effective means of preventing further consumer detriment, which could be expected to meet the quantitative and/or qualitative criteria.

Although it is expected that the PRA and FCA will be able to come to agreement so that the veto will not need to be used, the veto is designed as a backstop for use in exceptional circumstances. Should those circumstances arise it is unlikely that the FCA's inability to take stronger action could be considered a failure of the regulatory system or of its operation by the FCA.

Example 6

A wholesale firm loses £2 billion as a result of trading by a rogue trader over three months.

The firm does not fail and the rogue trader is prosecuted for fraud. The firm is subject to enforcement action for failings in its systems and controls.

Does this meet the statutory test? No

Even though it is well over the indicative £150 million threshold, no consumers suffered, and the integrity of the market did not suffer, so there would not have been a significant adverse effect on our objectives.

The FCA could not be expected to detect a rogue trader operating over a short period, even if there had been previous evidence of systems and controls failings at the firm, so there would have been no serious failure of the operation of the system.

Example 7

The FCA becomes aware that many customers have been sold a product without being told that costs are dependent on changes in a particular reference value, and without being given clear indications of the costs to exit the product, which fluctuate.

Initial review work identifies that potential total customer detriment, before redress, could be as much as £5 billion, and that individual detriment often runs into many thousands of pounds. The FCA takes action to ensure firms review the sales to more vulnerable customers and provide redress where customers have not been treated fairly.

The issue had been raised individually in respect of certain firms over the previous couple of years, but the focus at the time on firms in this sector had been on prudential issues.⁹ Also, the customers involved – although meeting the Handbook definition of retail customer – were not generally regarded as vulnerable. The FCA had taken action at the time but not intrusively, contrary to its published approach.

⁹ The FCA retains responsibility for the prudential supervision of those firms not supervised by the PRA.

Does this meet the statutory test? Possibly

£5 billion of total gross detriment is well over the upper limit of the indicative threshold, so this would constitute a significant failure to protect consumers, unless all the 'consumers' were extremely large or financially sophisticated companies.

If these customers would not have been prioritised within the FCA's risk-based approach, and if other issues were higher priority within the individual firms, there would have been no failure of the operation of the system in failing to investigate the issue more thoroughly, earlier.

If the customers should have been prioritised, or there was a failure to 'join the dots' which would have brought the potential size of the problem to light, it could be argued that there was a failure of the operation of the system – the question would then be how serious was that failure.

The over-riding focus on prudential issues, at the expense of being more proactive in following up conduct issues, might be considered a failure of the operation of the system.

Example 8

For five years, a firm has been selling an insurance product which has little or no value to consumers. The premium would have been approximately £100 per policy per year, and ultimately the total cost to consumers – who bought this product alongside another product unlikely to be bought by the most vulnerable consumers – could have been as high as £1 billion.

The FCA has been taking action to prevent this over the period, through supervisory actions with which the firm appeared to be complying. Eventually, since the firm continued to sell the product, enforcement action is taken resulting in the firm being fined and required to give compensation to customers.

Does this meet the statutory test? Possibly

Even though the total gross consumer detriment was over the indicative threshold of £150 million, the loss per consumer is unlikely to have exceeded £500 in total/£100 per year – the extent to which this represents a significant failure to protect consumers depends on the characteristics of the consumer. Although the consumers are retail individuals in this example, the indications are that they are not so vulnerable that this loss would have severely impacted their financial position, so we may decide there has not been a significant failure to protect consumers.

When viewed as an isolated case, it may appear the FCA should have taken enforcement action earlier. However, in many cases the appropriate and proportionate regulatory response is to give firms the chance to fix things, and they do fix things. Enforcement is an expensive and time-consuming tool and we use it where it has become necessary to secure consumer outcomes and provide credible deterrence.

It is likely that the customers will receive redress since the firm has been required to carry out a proactive exercise to identify and compensate those who purchased the product.

Accordingly, it is likely that we would decide this was not a failure of the operation of the system.

Example 9

An FCA review of anti-money laundering controls in a high risk firm finds serious failings, and indications that some money laundering may have taken place. The failings dated from before the previous periodic supervisory visit, which was focused on other conduct priorities and did not include a review of anti-money laundering controls.

Enforcement action is taken against the firm.

Does this meet the statutory test? Possibly

The extent to which there has been a significant adverse effect on our integrity objective is difficult to measure in this instance, so our decision would be based on the extent to which the UK market (in the wider sense) might have been brought into disrepute as well as on the effect on the specific elements included in the definition of 'integrity'.¹⁰

Whether the event occurred as a result of a failure in the operation of the system depends on whether the FCA was carrying out sufficient supervision, in line with its risk-based approach, to meet its obligations in respect of financial crime.¹¹ If this firm was high risk for money laundering, we may decide that failure to review the controls on a periodic visit was a failure of the operation of the system.

¹⁰ See section 1D(2) FSMA.

¹¹ For example, section 1D(2)(b) FSMA provides that protecting and enhancing the integrity of the UK financial system includes it not being used for a purpose connected with financial crime.

7. How the investigations and reports will be carried out

- 7.1** The following arrangements (from para 7.8) will apply for statutory investigations leading to the publication of a report, whether the investigation is undertaken at the FCA's initiative or is undertaken at the direction of the Treasury.¹²
- 7.2** We expect events which may meet the first part of the statutory test to be identified through internal risk-based reporting, as well as suggested by external parties other than the Treasury (although the FCA will decide whether the statutory test has been met in these instances).
- 7.3** We will consider first whether there has been a significant adverse effect on our objectives, and then whether there may have been a failure of the system or the operation of the system, and how serious any such failure might be.
- 7.4** Potential cases will be escalated through our risk reporting mechanisms to the Board for decision as to whether to proceed with an investigation with a view to producing a report. There will be safeguards in place to minimise the possibility that potential cases are not escalated.
- 7.5** The Board will be provided with details of the issue, and why it apparently meets the criteria for both parts of the test, as well as any information about the possible impact of an investigation on the exercise of the FCA's other functions (e.g. enforcement).
- 7.6** The Board will review whether the case has met the criteria, make the decision as to whether an investigation is required, and consider whether there are any reasons why an investigation should be delayed. Reasons for this would include:
- Where enforcement action is ongoing or pending.
 - To ensure clarity about the event, so that the investigation is not reviewing events which are still evolving (which would probably increase the expense).
- 7.7** The Board will propose to the Treasury whether the timing should be adjusted for specific reasons, and oversee liaison with the Treasury in respect of any directions as to timing, conduct and scope which the Treasury may give, or any changes to the timing once underway.
- 7.8** The Board will oversee the investigation process. The precise nature of this oversight (for example whether it is necessary to set up a sub-committee of the Board for the purpose) will depend on the circumstances of each case.

¹² S73(2) or s77 Financial Services Act 2012.

Process

- 7.9** The process will be tailored to the particular circumstances of each case, but in general, the elements below will be in place.
- 7.10** Independence will be built into the process of conducting an investigation and producing a report. If necessary, parts of the investigation may be outsourced. Where investigations are not outsourced, they will be undertaken by (unconflicted) staff not part of the original events, and managed by areas not part of the frontline. Independent reviewers may be part of the process if necessary.
- 7.11** Appropriate expertise, whether from internal or external resources, will be applied to the investigation.
- 7.12** We expect firms and others to engage with us in an open and co-operative way when we are conducting investigations. Where necessary or appropriate, we may also use the formal powers available to us to gather information.
- 7.13** Should it be necessary, those subject to potential criticism will be given an opportunity to make representations in response before the report is finalised and sent to the Treasury.

Coordination with other bodies

- 7.14** Where necessary, we will co-ordinate with and involve other bodies when carrying out an investigation.
- 7.15** In particular, firms subject to the PRA's prudential supervision will also be subject to our conduct regulation ('dual-regulated firms'). In situations where a dual-regulated firm, or firms, are the subject of a statutory investigation, we will co-ordinate with the PRA as appropriate when carrying out an investigation and producing a report.
- 7.16** We will ensure that the PRA is informed of aspects of the investigation relevant to them and we will seek their input where necessary, while at the same time avoiding unnecessary duplication or overlap if the PRA is also carrying out a separate investigation.
- 7.17** Other bodies that we may need to involve in an investigation include the Office of Fair Trading (or its successor body, the Competition and Markets Authority), the Financial Ombudsman Service, the Financial Services Compensation Scheme and other regulators.
- 7.18** We will also liaise with the Complaints Commissioner to see whether it is necessary to delay adjudication on any complaints against the regulator covering the same subject matter, pending the outcome of the investigation (but we note the difference in scope of the complaints scheme).

Publication

- 7.19** The Board will approve the report before sending it to the Treasury for publication.

- 7.20** We anticipate that in some instances we may want to publish a report where the first part of the statutory test has been met, but our internal investigation concludes that the second part has not. Any such report would not be a statutory report in relation to regulatory failure for the purposes of Part 5 of the 2012 Act. This means that we will be bound by our statutory confidentiality requirements, so such a report is likely to be less detailed than a statutory report.

8. Next steps

- 8.1** The statement of policy set out at Annex 1 applies from 1 April 2013 for events arising on or after that date.
- 8.2** We expect to learn whether we have set the threshold for events with a significant adverse effect on our objectives at the right level, and whether we have placed the right emphasis on the related qualitative factors, through the experience of applying the policy.
- 8.3** Given the changing regulatory landscape, including the change in the scope of the FCA to regulate Consumer Credit from April 2014, and the continuing development of our strategy to meet our competition objective and duty, we expect to review the policy after a year of the FCA's operation.
- 8.4** If you have comments on the contents of this document, we would be interested to receive them, and we will feed comments into our review. Please send comments to FCAApproach@fca.org.uk.
- 8.5** After the initial review, we expect to review the statement of policy periodically, and in particular when we make changes to our risk framework. We expect that the rationale for any changes – if necessary – would be published in our Annual Report.
- 8.6** It should be noted that the Treasury must consent to any changes to the statement of policy.

Annex 1

Financial Conduct Authority

Statement of policy regarding conducting statutory investigations into regulatory failure and producing reports

Introduction

1. The Financial Conduct Authority (“the FCA”) is required under the Financial Services Act 2012 (“the Act”) to investigate and report to the Treasury on possible regulatory failures where certain conditions are met. It must also investigate and report in relation to relevant events where the Treasury consider it to be in the public interest.
2. The requirements to investigate and report are set out in Part 5 of the Act.¹³
3. The Act also requires us to prepare and issue a statement of policy with respect to the exercise of our functions in Part 5, and in particular:
 - i. the matters we will take into account in determining whether the conditions that give rise to our duty to carry out an investigation into regulatory failure are met; and
 - ii. how we will carry out investigations.
4. This statement of policy fulfils this requirement. The FCA Transitional Board¹⁴ has approved the policy and the Treasury has consented to its publication.

The statutory provisions

The FCA Objectives

5. The Financial Services and Markets Act 2000 (as amended) sets out our statutory objectives.¹⁵ We have a single strategic objective – to ensure that the relevant markets function well. This objective is complemented by three operational objectives, to:
 - i. secure an appropriate degree of protection for consumers;
 - ii. protect and enhance the integrity of the UK financial system; and
 - iii. promote effective competition in the interest of consumers.

¹³ Sections 73, 77-83.

¹⁴ In accordance with Article 5 of the Financial Services Act 2012 (Transitional Provisions) (Rules and Miscellaneous Provisions) Order 2013 the FSA has appointed certain persons to discharge functions of the FCA before 1 April 2013 as if they were its governing body.

¹⁵ See sections 1B(2) and (3) of the Act.

6. In discharging our general functions we must, so far as is reasonably possible, act in a way which:
- i. is compatible with our strategic objective, and
 - ii. advances one or more of our operational objectives.¹⁶

Duty to investigate and report on possible regulatory failure

7. The statutory requirements set out a test that is in two parts for determining when we must carry out an investigation into regulatory failure and produce a report. The first part of the test is linked to our operational objectives, and the second part is about the regulatory system, including the FCA's actions and decision-making within that system. Both parts of the test must be met.
8. We are required to carry out an investigation and produce a report when:
- i. events have occurred in relation to a regulated person or others¹⁷ which indicated a significant failure to secure appropriate consumer protection, or had or could have had a significant adverse effect on our integrity or competition objectives; **and**
 - ii. the events might not have occurred or the adverse effect might have been reduced but for a serious failure in the system established by FSMA or the operation of that system.¹⁸
9. For this purpose, events are events occurring on or after 1 April 2013.
10. The Treasury can require the FCA to carry out an investigation where it appears to the Treasury that the above test is met.¹⁹ Alternatively, the Treasury may require the FCA to investigate where it considers that it is in the public interest that the FCA should carry out an investigation into relevant events and it does not appear to the Treasury that the FCA has undertaken or is undertaking an investigation (whether under Part 5 or otherwise) into those events.²⁰ The Treasury can also give directions in respect of the scope of any investigation, the period during which the investigation is carried out, the conduct of the investigation and the making of reports.²¹
11. The Act allows the FCA to postpone the start of, or suspend, an investigation if necessary to avoid a material adverse effect on the exercise of any of its other functions.²²
12. Reports must be provided to the Treasury who must publish them in full, subject to prescribed exceptions set out in the Act.²³
13. Reports must set out:
- i. the result of the investigation;

¹⁶ See section 1B(1).

¹⁷ Also covered are a collective investment scheme, a recognised investment exchange, a person lawfully carrying on a regulated activity, a person carrying on business in breach of the general prohibition in section 19 of FSMA and an issuer of listed securities.

¹⁸ Section 73(1).

¹⁹ Section 73(2).

²⁰ Section 77(1). "Relevant events" are events that occurred on or after 1 December 2001 in relation to a collective investment scheme, a person carrying on a regulated activity (whether authorised or not) or listed securities or an issuer of listed securities.

²¹ Section 78 (5)–(7).

²² Section 78(3).

²³ Section 82.

- ii. the lessons (if any) that the FCA considers that it should learn; and
- iii. such recommendations (if any) as the FCA considers appropriate.²⁴

Investigating and reporting on regulatory failures

- 14.** The document “Journey to the FCA” sets out how we will approach our regulatory objectives, and how we may use some of our new powers. This statement of policy should be read in conjunction with “How the Financial Conduct Authority will investigate and report on regulatory failure”, which expands on how the FCA’s approach to achieving its objectives is relevant to identifying whether an investigation into possible regulatory failure is required.

The matters the FCA will take into account

- 15.** As previously stated, the Act sets out a two part test determining when the FCA must carry out an investigation and produce a report. We set out below the criteria we will take into consideration in relation to each operational objective for the first part of the test, and set out thresholds based on consumer detriment (financial loss) which – supplemented by qualitative factors and adjusted for the relevant market – would indicate whether the effect of the event on the objective has been ‘significant’.
- 16.** Factors which may indicate that the second part of the test is met, including how we distinguish failures of the regulatory system from failures of its operation, and what will constitute a ‘serious’ failure, are also set out below (paras 30-33).

The consumer protection objective

- 17.** The factors which would indicate a significant failure to protect consumers are:
- a. the amount of detriment suffered by consumers in total, or per consumer;
 - b. the number of consumers who have suffered detriment; and
 - c. the characteristics of those consumers.
- 18.** We may also consider wider impacts, such as the distress associated with experiencing arrears or a temporary inability to access funds, which are not directly captured by financial losses but are still important for consumers’ wellbeing.

The integrity objective

- 19.** In determining whether an event had or could have had a significant adverse effect on our integrity objective, the factors we will take into account are:
- a. the pervasiveness of any misconduct, e.g. number of institutions involved and the length of time it persisted;
 - b. the severity and incidence of the (potential) impact, for example the value and number of contracts affected by the issues or the extent to which criminal offences may have been committed; and

²⁴ Section 79.

- c. the duration and impact of market disruption if transactions have to stop due to technical failures. The importance of the venue for the trading of the financial instruments affected and the availability of alternative trading venues will be relevant in determining the impact of any disruption.

The competition objective

- 20. In determining whether an 'event' has occurred suggesting that the first part of the statutory test has been met, we will consider whether the circumstances in place when our competition objective commenced have changed for the worse as a result of an act or omission over which we had control. The fact that competition may not be effective in relevant markets now does not in itself mean that the first part of the test has been met.
- 21. As part of our competition strategy we aim to monitor a number of indicators that can signal the evolution of competition in markets such as concentration ratios, measures of entry and exit, switching behaviour etc.
- 22. In the future, development of competition in the markets we regulate will be taken into account to establish whether or not the first part of the test for a report has been met.

How we will judge 'significance'

- 23. The spectrum of consumers (including all users of markets) covered by the FCA's remit, across the range of markets it regulates, means that setting thresholds, to help determine whether an adverse effect on the operational objectives is significant, is not straightforward. In addition, we consider that it is desirable to retain some flexibility, so qualitative as well as quantitative factors will be relevant.
- 24. We have established a range from £150m to £30m of total 'gross' consumer detriment (that is, financial losses before any recoveries are made through redress or compensation mechanisms) as a quantitative threshold for the significance of the effects of relevant events in relation to the FCA objectives.
- 25. Where total consumer detriment is £150m or more, in respect of the consumer protection objective, we are more likely to consider the adverse effect significant and so decide that the first part of the statutory test has been met, unless the consumers are large or sophisticated financial firms.
- 26. Between £150 and £30m we will consider other factors, such as the characteristics of the consumers concerned, the loss per consumer or the size of the market, when deciding whether the adverse effect is significant.
- 27. We are unlikely to consider total consumer detriment below £30m indicative of a significant adverse effect for the purposes of the statutory test, unless other qualitative factors apply, such as whether the characteristics of the consumers active in the relevant market mean that they are particularly vulnerable.
- 28. This range is indicative. If the only detriment suffered is to large/sophisticated financial firms, even losses exceeding £150m may not be considered as indicating a significant failure to protect consumers.
- 29. Similarly, for the integrity and competition objectives the threshold will be adjusted for the market, and other factors as set out in paragraphs 19-22 are more likely to be relevant.

Serious failure of the system or its operation

30. The second part of the statutory test has two further parts, either of which must be met in order to trigger an investigation and report. Each instance would need to be considered on its own merits, but we would distinguish them as follows:
- a. Failure of the regulatory system would include failure of the regulatory framework, that is, the standards and boundaries set by the regulatory framework, which are relevant to the functions of the FCA, are not adequate. For example:
 - i. an event happened but it was outside the regulatory perimeter;
 - ii. an event happened where responsibility for acting to prevent it was unclear due to overlap/underlap with other regulators; or
 - iii. an event happened but the FCA did not have sufficient powers to prevent it.
 - b. Failure of the operation of the system would be where the FCA acted to bring about the event or did not act to prevent it. This would include a failure in the regulatory processes or approach and/or the execution of those processes or approach such that it could be said that we were not meeting our objectives. For example:
 - i. an event happened because we failed to conduct our operations in accordance with our risk based approach/framework;
 - ii. our risk-based approach was seriously flawed; or
 - iii. the event was the result of the adverse impact of our policymaking and rules.
31. This does **not** mean that every instance where it appears that our objectives have not been met is a regulatory failure; we are not operating a zero failure regime.
32. If we have acted in line with our risk-based approach, as approved by the Board, with any exceptions having been sanctioned through appropriate governance, our starting point is that events arising from decisions made in line with that approach will not *prima facie* be the result of a failure of the system or its operation.
33. Where we think there has been a failure of the system or its operation, we will make the decision as to how serious it is, with reference to:
- a. The extent to which it is an organisational failure rather than an isolated instance of one or a small number of people not meeting our professional standards.
 - b. The consequences – in effect, if there has been a failure, and it has resulted in a significant adverse effect on our objectives, it is hard to argue that the failure is not serious.
34. Both parts of the test have to be met in each case for the statutory requirement to investigate and make a report to be triggered.
35. However, we anticipate that in some instances it may be necessary to make a public report where the first part of the statutory test has been met, but investigation concludes that the second part has not. Any such report would not be a statutory report in relation to regulatory failure for the purposes of Part 5 of the Act.

How the FCA will carry out investigations

36. The following arrangements will apply for statutory investigations leading to the publication of a report, whether the investigation is undertaken at the FCA's initiative or is undertaken at the direction of the Treasury.

Governance

37. The Board will make the decision as to whether an investigation is required (unless the Treasury directs the FCA to undertake an investigation) and will oversee the investigation process. The precise nature of this oversight will depend on the circumstances of each case.
38. The Board will also propose whether the timing should be adjusted to minimise any adverse effect on the exercise of our functions, for example because there is enforcement action pending or ongoing, and oversee liaison with the Treasury in respect of any directions as to timing, conduct and scope which the Treasury may give.
39. The Board will aim to ensure that investigations are undertaken when there is some stability of knowledge about what has happened.
40. The Board will be conscious of the need to balance costs and the time taken to produce the report, with the need for independence and appropriate expertise.
41. The Board will approve the report in advance of sending it to the Treasury.

Process

42. The process will be tailored to the particular circumstances of each case, but in general, the elements below will be in place.
43. Independence will be built into the process of conducting an investigation and producing a report. If necessary, parts of the investigation may be outsourced. Where investigations are not outsourced, they will be undertaken by (unconflicted) staff not part of the original events, and managed by areas not part of the front line. Independent reviewers may be part of the process if necessary.
44. We expect firms and others to engage with us in an open and co-operative way when we are conducting investigations. Where necessary or appropriate, we will use the formal powers available to us to gather information.
45. Should it be necessary, those subject to potential criticism will be given an opportunity to make representations in response before the report is finalised and sent to the Treasury.

Timing

46. The statutory requirements provide that we can postpone the start of, or suspend an investigation to avoid a material adverse effect on the exercise of our functions.²⁵ In instances where there is likely to be enforcement action or where enforcement action is already underway, we would generally expect to begin an investigation only after enforcement investigations and actions are complete.
47. We must notify the Treasury if we postpone the start of, or suspend, an investigation and specify when it will begin or resume.²⁶

²⁵ See section 78(3).

²⁶ See section 78(4).

Co-ordination with the other bodies

- 48.** Where necessary, we will co-ordinate with and involve other bodies when carrying out an investigation.
- 49.** In particular, firms subject to the Prudential Regulation Authority's (PRA) prudential supervision will also be subject to our conduct regulation ("dual-regulated firms"). In situations where events have occurred in relation to a dual-regulated firm, or firms, which are the subject of a statutory investigation, we will co-ordinate with the PRA as appropriate when carrying out an investigation and producing a report.
- 50.** We will ensure that the PRA is kept fully informed of aspects of the investigation relevant to it and we will seek its input where necessary.
- 51.** If the PRA is carrying out its own investigation²⁷ we will seek to avoid unnecessary duplication.

²⁷ The PRA has its own statutory test linked to its own objectives.

Financial Conduct Authority



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