

CLIENT UPDATE

FCA ENFORCEMENT PROCESS UNDER REVIEW

LONDON

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REVIEW OF ENFORCEMENT PROCESSES AND REGULATORY DECISION-MAKING LAUNCHED

The United Kingdom's Financial Conduct Authority ("FCA"), responsible for regulating the financial services industry, has in recent years asserted its enforcement powers ever more regularly, levying large fines against an increasing number of firms and individuals for various wrongdoing and breaches of its principles.

But these enforcement procedures are now undergoing review by the UK's Treasury (the "Review"), which has opened a consultation into the fairness, transparency, speed and efficiency of enforcement processes and decision-making at both the FCA and its sister organisation, the Prudential Regulation Authority ("PRA").¹ One possible outcome of the scrutiny is that the FCA might lose a significant amount of its decision-making powers.

The Review is said to reflect the Government's desire to improve accountability within the financial services sector and is part of the multi-year, multi-faceted reaction to the financial crisis and various financial scandals. In particular, it follows the June 2013 report of the

¹ Chancellor launches review of enforcement decision-making at the financial services regulators, HM Treasury, 6 May 2014. Accessible at: <https://www.gov.uk/government/news/chancellor-launches-review-of-enforcement-decision-making-at-the-financial-services-regulators>.

Parliamentary Commission on Banking Standards (the “**Commission**”), which proposed replacing the FCA’s current enforcement mechanism with an autonomous, judge-led decision-making body within the FCA.²

The Treasury has called upon industry participants, stakeholders and professional advisors to submit evidence. Roundtable discussions are scheduled to take place in June and interested parties must submit their evidence to the Treasury by 4 July 2014. The Treasury will deliver its final report to the Chancellor of the Exchequer in the autumn.

THE CURRENT ENFORCEMENT REGIME

Financial services in the UK are regulated by the so called “twin peaks”³ of the FCA and PRA, formed in April 2013 from the Financial Services Authority.

The FCA is a standalone statutory body whose overriding strategic objective is to ensure that “*markets function well*”.⁴ Its operational objectives are to:

- Secure an appropriate degree of protection for consumers;
- Protect and enhance the integrity of the UK financial system; and
- Promote effective competition in the interests of consumers.⁵

The PRA is part of the Bank of England and supervises and regulates financial institutions with the aim of protecting and improving the stability of financial services in the UK.

Both bodies exercise enforcement powers, but unlike the PRA, which has so far been quiet, the FCA has adopted a robust approach to enforcement. The FCA has issued 47 fines totalling over £465 million since its creation just over a year ago, the largest of which was the £137 million fine handed to JP Morgan Chase in September 2013 for serious failings relating to its “London Whale” trades.⁶

² Final Report – Changing banking for good, Parliamentary Commission on Banking Standards, 19 June 2013. Accessible at: <http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/publications/>.

³ See <http://www.bankofengland.co.uk/pr/pages/default.aspx>.

⁴ See s.1B(2), Financial Services Markets Act 2000.

⁵ See s.1B(3), Financial Services Markets Act 2000.

⁶ Final Notice, JP Morgan Chase Bank NA, 18 September 2013. Accessible at: <http://www.fca.org.uk/your-fca/documents/final-notice/2013/jpmorgan-chase-bank-na>.

This year alone, the FCA has issued £131 million of fines⁷, including a £30 million fine to HomeServe Membership Limited, a home and maintenance consumer insurance provider, for mis-selling insurance policies and other shortcomings.⁸ These numbers are significantly higher than comparable figures for the FCA's predecessor. Nonetheless, questions have been raised regarding its enforcement architecture, particularly by the Commission.

THE PARLIAMENTARY COMMISSION ON BANKING STANDARDS

The Commission, appointed by both Houses of Parliament in response to a perceived lack of professionalism and ethics within the banking sector, considered the professional standards and culture of the UK banking industry in detail, focusing, inter alia, on the way the FCA operates. It expressed particular concern that there *"is an inherent tension between the role of real-time regulators and the enforcement function, which can involve reaching judgements about matters in which supervisors were involved at the time"*.⁹

The Commission saw a number of risks in the FCA's structure, with perhaps the greatest being that *"ex post enforcement... become[s] a replacement for effective supervisory intervention as problems emerge"*.¹⁰ In short, therefore, the Commission worried that the more focus the FCA put on enforcement after the fact, the less it would place on effective regulation and prevention before the fact, potentially paving the way for more financial crises.

The solution the Commission proposed was a greater separation between the FCA's supervisory, investigatory and enforcement functions, as has been done in both the legal and medical professions.¹¹ It called for the creation of an autonomous, statutory decision-making body within the FCA to replace the Regulatory Decisions Committee ("**RDC**"), which currently decides on enforcement action. The new body would be chaired by an individual with senior judicial experience and would make enforcement decisions for both the FCA and the PRA.¹²

⁷ See <http://www.fca.org.uk/firms/being-regulated/enforcement/fines>.

⁸ Final Notice, HomeServe Membership Limited, 12 February 2014. Accessible at: <http://www.fca.org.uk/your-fca/documents/final-notice/2014/homeserve-membership-limited>.

⁹ Final Report – Changing banking for good, Parliamentary Commission on Banking Standards, 19 June 2013. Accessible at: <http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/publications/>.

¹⁰ See Final Report – Changing banking for good, Parliamentary Commission on Banking Standards, Volume II, page 517.

¹¹ See Final Report – Changing banking for good, Parliamentary Commission on Banking Standards, Volume II, pages 521-521.

¹² See Final Report – Changing banking for good, Parliamentary Commission on Banking Standards, Volume II, page 522.

THE FCA'S RESPONSE

The FCA responded to the Commission's proposals in October 2013. It argued that its supervisory, investigative and enforcement functions were already separate as the RDC had its own legal advisors and support staff and, with the exception of the RDC's Chairman, no members of the RDC were FCA employees.

The FCA further argued that a judge-led decision-making body would duplicate the work of the Upper Tribunal, which has the power to review RDC decisions, and cause delays to enforcement, thus undermining the FCA's aim of credible deterrence.¹³ The government at the time agreed, stating that the *"benefit of adding an extra layer of quasi-judiciary process is not clear and would likely lead to increased costs"*.¹⁴

THE TREASURY REVIEW

These divergent opinions regarding the optimal FCA enforcement process are the background for the Review – which then goes far beyond them.

According to the government, the Review will constitute a further step towards its goal of strengthening accountability in the financial services industry. The government hopes that it will do so by examining the fairness, transparency, speed and efficiency of enforcement processes and decision-making at the FCA and PRA.¹⁵

The Terms of Reference set by the Chancellor calls upon the Treasury to examine:

- The process for referring cases for enforcement investigation and the relationship between the regulators' supervisory and enforcement functions;
- Coordination of investigations between, and enforcement action taken by, the FCA and PRA;
- The settlement process and, in particular, discounts offered for early settlement; and

¹³ See The FCA's response to the Parliamentary Commission on Banking Standards, October 2013, at page 37. Accessible at: <http://www.fca.org.uk/news/pcbs-response>.

¹⁴ The Government's response to the Parliamentary Commission on Banking Standards, July 2013, para. 5.40. Accessible at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211047/gov_response_to_the_parliamentary_commission_on_banking_standards.pdf.

¹⁵ See Review of enforcement decision-making at the financial services regulators: call for evidence, 6 May 2014, para. 1.

- How post-investigative disciplinary decisions are made, including the ability of those subject to investigation to make representations to the regulators and how cases are referred to the Upper Tribunal.¹⁶

The Review will also consider enforcement practices in other jurisdictions and ultimately seek to identify the optimum structure and process for punishing breaches of financial regulations.

ISSUES FOR DISCUSSION

To progress its review, the Treasury has focused its consultation on 18 questions, including both broad and narrow issues, focussing on all stages of investigation and enforcement, from the initial referral, through settlement to sanctions.¹⁷

At the broadest level, participants are asked to provide their opinions on whether “*current enforcement processes and supporting institutional arrangements provide credible deterrence*” to misconduct and, if not, what impediments they see to this objective.¹⁸

Narrower issues are tackled with a number of more specific queries including the following:

- Are the criteria for referring a case from the FCA supervisory function to the enforcement function clear and used appropriately?
- Is the scope of investigations made sufficiently clear to those subject to them?
- Should the regulators offer the opportunity for regular progress meetings during the investigation?
- Are there sufficient opportunities for individuals and firms to make representations?
- Is it appropriate to give a discount for early settlement?
- Could the settlement process be changed to offer clearer incentives to settle after the time limit for receiving a 30% discount has expired?

¹⁶ See Review of enforcement decision-making at the financial services regulators: call for evidence, 6 May 2014, Annex A. Accessible at: <https://www.gov.uk/government/consultations/review-of-enforcement-decision-making-at-the-financial-services-regulators-call-for-evidence>.

¹⁷ See Review of enforcement decision-making at the financial services regulators: call for evidence, 6 May 2014, paras 3.1-3.8.

¹⁸ See Review of enforcement decision-making at the financial services regulators: call for evidence, 6 May 2014, para. 3.2.

Given the breadth and depth of review, and the importance to financial services (and indeed the economy) of financial regulatory enforcement, the consultation is likely to attract significant attention and possibly controversy within the financial services sector.

The Treasury's report and the Chancellor's response thereto this autumn is, therefore, eagerly awaited. Depending on its outcome, it could pave the way for wholesale change of UK financial enforcement, notwithstanding the government's previous opposition to the Commission's proposals. Any parties with interests in the outcome of any potential reform should, therefore, take the opportunity to voice their opinions to the Treasury.

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Please do not hesitate to contact us with any questions.

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