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Dear Sirs,

FSA Consultation Paper (CP13/8) – Publishing information about enforcement warning notices

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees.

This response has been prepared by the CLLS Regulatory Committee (the "Committee"). Members of the Committee advise a wide range of firms in the financial markets and have significant experience of enforcement and disciplinary proceedings both in the U.K. and internationally.

The Committee welcomes the opportunity to respond to Consultation Paper 13/8 (the "CP"). We wish to make the following comments on the FCA's proposed approach to exercising its power to publish warning notices.

The legal power to publish

We consider that the following are core elements of the legal infrastructure which underpins the power to publish warning notices and they must be taken into account when framing the policy. These are:

- Section 391(1)(c) which provides that:

> "After consulting the persons to whom the notice is given or copied, the regulator giving the notice may publish such information about the matter to which the notice relates as it considers appropriate." (emphasis added)

This is to be contrasted with section 391(4) which refers to decision or final notices and which *requires* the regulator to publish such information as it considers appropriate. The Parliamentary intention is a presumption in favour of publishing material about decision and final notices, but not about warning notices. This distinction recognises the substantive difference between warning notices and

final/decision notices. Whilst a decision/final notice is issued after a process in which the subject will have had the opportunity to comment and formally challenge the findings contained in it, this is not the case with a warning notice. We consider this is an important distinction to be taken into account when the FCA determines whether to exercise the discretion to publish names at this stage.

- Section 391(6) provides that the FCA may not publish information if in its opinion publication would be unfair, prejudicial, detrimental, etc. Section 391(6) therefore expressly prohibits the publication of certain information, but it does not follow from this that, where the circumstances set out in section 391(6) are not met, then the names should be published. There is a very wide area between the fact of a warning notice and the prohibition on publishing any information, which is the area covered by the discretion to publish.

We are concerned that the policy appears to be that the FCA will "normally" publish a statement whenever it has issued a warning notice and that this will name firms/individuals unless one of the grounds in section 391(6) applies. This approach elides a number of different aspects. The discretion covers both when it is appropriate to disclose a warning notice and what it is appropriate to disclose. We consider that the policy should have three different elements. The first relates to a general policy on disclosing the conduct covered by warning notices, the second relates to the policy on whether or not in the normal course the name of a firm or an individual should be disclosed, the third relates to the circumstances in which the FCA will consider that the grounds in section 391(6) are met.

We have no particular concerns about a general policy that the nature of conduct covered by warning notices should be published but we do have serious concerns about a general policy to name individuals unless the grounds in section 391(6) are met, and we believe that such a policy cannot be justified as proportionate. We consider that it is only in particular circumstances that the FCA could justify at this stage identifying an individual by name. As far as firms are concerned we consider that the application of the section 391(6) tests may be the appropriate bar, but we have concerns as to how they are expressed in the draft.

Early transparency of enforcement proceedings

We see in policy terms a clear distinction between whether it is:

- appropriate to publish information about the nature of the warning notice and the conduct alleged; and

- appropriate to publish the name of the firm or the individual.

A policy generally to publish the nature of the conduct which is the subject of a warning notice seems appropriate and justifiable as opposed to publishing information about identity which we believe needs more justification.

The CP explains that the principal purpose of the new power is to promote early transparency of enforcement proceedings so that the industry and consumers will be able to understand the types of behaviour that the FCA considers unacceptable at an earlier stage. This is relevant to those cases where there is genuinely a new issue under consideration, for example whether a particular type of conduct constitutes market abuse. In such a case it could be potentially helpful for there to be early notice that the FCA had concerns about a particular practice, though it would not be necessary to identify a firm or an individual in order to convey the information and we do not consider that there is in the normal course a case for doing so.

In other cases (probably the majority) the allegations, if substantiated, would be about behaviour that it is well known is unacceptable. In those cases the issue may be more one

of fact, when again the question arises as to whether it is fair at that stage to name a firm or an individual. We would have thought the presumption should have been against naming them, save where it is thought reasonably necessary in the interests of consumers to do so.

In our view, the policy should be flexible enough to recognise that:

- there may be circumstances where there is a case for providing sufficient information to enable consumers, firms and market users to understand the nature of the FCA's concerns, but where the balancing of public interests does not require identification of the person subject to the enforcement action; and

- there may be circumstances in which identification of that person could help reduce the risk of on-going consumer detriment, where there may be a public interest in enabling prospective clients to make a properly informed choice as to whether to have dealings with the person concerned, or a need to quash rumours in the market.

The primary test for naming should be whether the FCA has reasonable grounds to be satisfied that to do so is necessary to avoid or limit further possible harms to consumers and that this outweighs the risk of harm to those persons who will be identified in the notice.

We comment further on these issues below with specific reference to the comments in the Consultation Paper.

What information is to be published

We recognise that the exercise of the power to publish information about enforcement warning notices can enable industry and consumers to understand the types of behaviour that the FCA considers unacceptable, and can demonstrate that the regulator is taking enforcement action, at an earlier stage than had previously been the practice under the previous regime. It is therefore entirely appropriate that the statement should provide sufficient information to enable consumers, firms and market users to understand the nature of the FCA's concerns.

We fully support and endorse the FCA's view that the publication of the level of fine would not give a complete picture of the sanctions sought in all cases, and would, without full contextualisation, not present a fair picture of the seriousness of the alleged failings.

Naming individuals

We do not believe that it will normally be appropriate to publish the name of an individual who is the subject of the warning notice. The Consultation Paper does not explain why the FCA believes it is necessary to name an individual in order to achieve its stated objective.

The following examples show how the communication of the FCA's concerns (as distinct from communicating the identity of the person to whom the concerns relate) does not require that an individual be named

- "the FCA has issued a warning notice against an asset manager for insider dealing involving [details a, b and c]"

- "the FCA has issued a warning notice against Peter Jones, an asset manager, for insider dealing involving [details a, b and c]"

The FCA will note that its *concerns* are communicated with equal force in both examples. All that naming an individual adds is an element of human interest and the personalisation of the allegations, neither of which are relevant to its expressed purpose. As explained above

we do not think this is an appropriate way to exercise the discretion in section 391(1)(c), since in effect the discretion is not exercised at all.

The FCA should also expressly address the question of proportionality under FSMA section 3B(1)(b) in relation to naming an individual who is the subject of a warning notice.

Publishing information about the identity of an individual will necessarily, in almost all cases, have a significantly detrimental effect on that individual and potentially on his employment. In this respect we disagree with the assumption underlying paragraph 2.23. An employer may well have decided to be supportive of the employee, but the employer's own stance could be affected by publicity, particularly if the employer then receives pressure from clients etc. The employer will not be able properly to explain its position for reasons of confidentiality etc. and will be put in an unviable position. We do not therefore think that the assumption in paragraph 2.23 will invariably (or even often) be the case.

We note that paragraph 2.12 says that the FCA will take into account the extent to which the person has been made aware of the case against him during the course of the investigation, "a warning notice is only issued after Enforcement has carried out an investigation which may have taken months or, in some cases, over a year". The length of time that Enforcement has been investigating a matter does not usually bear upon the extent to which the person is both aware of the case and has been able to respond, comment and challenge. We do not therefore think it is awareness of the case against him that is a relevant consideration.

We fully appreciate the FCA's aim to ensure that representations regarding publication decisions do not descend into arguments on the merits of the case made in the notice. However, it cannot be right to suggest that the weight of the evidence established in the course of the investigation is wholly immaterial to the publication decision, not least since the decision-maker who issued the warning notice will have been required to consider whether the material on which the recommendation is based is adequate to support the notice. That consideration may in certain circumstances recommend non-publication, or at least non-identification.

Irrespective of what the FCA determines should be the "normal" approach, it would be helpful if the policy set out the factors which will be taken into account in determining whether the "normal" position should be adopted or departed from.

We also note that no case had been made for the regulator to publish an individual's home address as part of the statement about the warning notice and we consider that publication of full address details would rarely be appropriate at the warning notice stage.

Naming firms

The naming of firms also has the potential to cause them serious harm at a very early stage, and also to their employees and clients. A firm which suffers a serious loss of business at this stage could be more likely to fail, which itself is not "normally" to be expected to be in consumers' interests. However, provided that the thresholds used in assessing the application of the tests in section 391(6) are appropriately calibrated, we believe that our concerns in this area could be addressed and we comment on this issue below.

Section 391(6) – determining whether publication is not permitted

Unfairness

The CP states at paragraph 2.12 that in considering whether publication would be unfair, the FCA will consider, amongst other matters:

- *whether the person to whom the action was proposed to be taken, is a firm or an individual:*

  It is not made clear how this difference will impact the determination

- *the extent to which the person has been made aware of the case against him during the course of the investigation:*

  Presumably the suggestion is that a person who is aware of the case against him has had an opportunity to make the FCA aware of anything which he may wish to rely on in his defence. The purpose of an investigation is to ascertain facts and not to communicate a case that will, in any event, turn on the facts discovered during the investigation: a person is unlikely to be aware at this stage of the evidence and until he sees the full extent of the allegations made against him should not be "threatened" or "punished" with publication. We do however agree that (whether or not they choose to take it) a firm or individual under investigation should be given an opportunity to answer the key allegations of misconduct which concern the investigators as part of a fair investigation process. This is not a substitute for a proper adjudication process, but if it is the case that no such opportunity has been afforded during the investigation (whether through interview or as part of a "preliminary findings" process) then the potential damage done by publicising a Warning Notice is much greater – because there can be even less assurance that the allegations in the Warning Notice have any foundation at all.

Taking account of uncertainty

We accept that a negative impact on a person's reputation is an inevitable consequence of publication. As Parliament has decided to confer an express power for publication of warning notice statements, the mere possibility of negative reputational impact alone should not normally be a sufficient ground for a decision not to publish a warning notice statement on the grounds of unfairness.

However, we consider that the considerations of, and the balancing exercise to be performed by, the regulator in considering whether publication would be unfair should nevertheless take some account of the fact that the outcome of the proceedings is inherently less certain at this stage of the proceedings, and of the impact on the person concerned over the significantly lengthier period of uncertainty between publication of a warning notice statement and the issue of any final notice (or notice of discontinuance). In behavioural terms, uncertainty tends to foster speculation.

In this regard, we note that academic research in the US[1] suggests that firms suffer the greatest impact from publication about the initiation of enforcement proceedings, where the market reacts to the uncertainty of the situation, and that publication of even an adverse outcome, irrespective of the nature or size of the sanction, results in positive market corrections because uncertainty is eliminated.

The positive impact of certainty of outcome does, however, depend on appropriate publicity being given to the publication of the outcome. The suggestion that "any harm caused in the

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[1] See e.g. Feroz, E., K. Park, and V. Pastena. 1991. "The financial and market effects of the SEC's accounting and auditing enforcement releases". Journal of Accounting Research 29 (Supplement): 107-142; Karpoff, J.M., D.S. Lee, and G.S. Martin. 2008. "The cost to firms of cooking the books", Journal of Financial and Quantitative Analysis 43(3): 581-611; Curtis Michael Nicholls "The impact of "Accounting and Auditing Enforcement Releases" on firms' cost of equity capital"; S M Khalid Nainar, AtulRai and SemihTartaroglu, International Journal of Disclosure and Governance; 10 January 2013; "Market reactions to Wells Notice: An empirical analysis"

interim is adequately remedied by publishing a notice of discontinuance" ignores the fact that notices of discontinuance are very unlikely to receive the same press coverage as the original warning notice, or a final notice. We also believe that if the original warning notice is to remain searchable online after a discontinuance notice, that original notice should be modified to make clear on its face that it was discontinued.

The threshold to be applied

Something more than a mere assertion of unfairness should be required, but the bar which the consultation paper proposes is being set too high. The warning notice is at the earliest stage of the enforcement proceedings, and thus at some considerable temporal distance from the decision-making which would fully engage the open justice principle. The threshold would appropriately reflect this on-going uncertainty if it were set at the level of "material risk" or "significant possibility", rather than "significant likelihood".

The scenarios

The consultation paper proposes that a person seeking to demonstrate potential unfairness from publication should be required to demonstrate that publication could materially affect their health, result in a disproportionate loss of income or livelihood, prejudice criminal proceedings to which they are a party or give rise to some other equal degree of harm.

The examples of unfairness put forward in the consultation paper include:

- *Where the person can demonstrate that his/her physical or mental health would be adversely affected by the publication of information*:

  The scenario appears to suggest that it would be necessary to demonstrate a significant or serious adverse effect. Paragraph 2.19 refers to "clear and convincing evidence that his illness would seriously deteriorate". Whilst a higher bar may be an appropriate test when considering publication of a decision notice, at this earlier stage of the enforcement process, a lower threshold both in relation to the materiality and likelihood of the adverse effect should be applied to reflect the longer timeframe over which the adverse effect will be suffered and the greater degree of uncertainty about the likely outcome of the process. We would suggest a "significant possibility of a materially adverse effect" would be a more appropriate test. In any event, we have a couple of observations on health aspects:

  - Where mental health is concerned, those most at risk of committing a successful suicide attempt are probably the least likely to draw attention to it. A number of us have seen serious mental health issues with individuals who are under investigation. We question how someone with mental health issues is meant to provide clear and convincing evidence that their illness will seriously deteriorate?

  - Even in the case of a physical illness, the medical profession may not be able to predict with any certainty what its course will be.

  In our view, the proposed policy bar in relation to physical and mental health issues is being set so high that in practice it will rarely if ever be met. The policy needs to have more flexibility in it, recognising the difficult issues that arise with both physical and mental health.

- *Where the physical or mental health of a close family member of the subject would be adversely affected:*

The scenario suggests the decision may be less straightforward, and that publication would be unlikely where the evidence demonstrated that the health of a direct family member would **also** be affected – we assume the intention is not that the effect on the health of a close family member would only be taken into account if there was also an impact on the health of the person concerned.

The scenario is perhaps less helpful in relation to the potential impact on the children since it posits that the impact has been suffered following press coverage prior to publication of the warning notice statement.

- *Where publication would cause loss of custom in turn leading to bankruptcy or insolvency or may cause loss of livelihood:*

  Again, likelihood and bankruptcy/insolvency seem to us disproportionately high thresholds to be applied, given the longer timeframe over which the adverse effect will be suffered and the degree of uncertainty about the ultimate outcome of the process at the warning notice stage. This will be particularly the case where the conduct in question is in fact relatively minor, though this may not be apparent from the statement published. We believe that it would be appropriate to consider whether publication would result in a "significant possibility of a disproportionately adverse impact on the financial position" of the firm or individual. We also believe that the FCA should give some consideration to the potentially higher impact of publication on a smaller rather than a larger business.

  We agree that the risk of staff redundancies caused by publication should be a factor to be taken into account.

How the information is to be published

It is important that the FCA's policy proposals should properly reflect the particular nature and characteristics of a warning notice and we welcome the FCA's intention to ensure that a statement published in respect of a warning notice should make clear its nature and status.

We have however some concerns that there is potential for the phrase "a warning notice is not the final decision of the FCA" to be misunderstood by those unfamiliar with the enforcement process, both because

- the use of the definite article may suggest that the decision that the FCA has taken in issuing the warning notice is something more than a decision to take disciplinary action, and because

- this fails adequately to differentiate the warning notice from the next stage in the decision-making process, the *decision notice* (again, not the final decision of the FCA, although it does represent a decision based on facts which have either been accepted or determined).

Judge Herrington made two important points in this respect when commenting on a *decision* notice in the recent Arch Cru case (*Arch Financial Products & others v FSA* 19 Nov 2012 (FS 2012/20) at para. 63), and these points have even greater force when applied to the FCA's proposal to publish a *warning* notice. They are

- to emphasise that the notice is provisional

  > "... it is important that adequate steps are taken when publicising the Decision Notices to ensure that it is clear that the decisions are provisional in the light of the fact that they are being challenged in the Upper Tribunal. I am concerned that some of the benefits expressed by the FSA to flow from the fact of

publication, such as the need to establish a deterrent effect could be said to be predicated on the basis that the findings are a fait accompli ... In my view ... any press release issued by the FSA should state prominently at its beginning that the Applicants have referred the matter to the Upper Tribunal where each will present their case and the Tribunal will then determine the appropriate action to take, which may be to uphold, vary or cancel the FSA's decision ... "

- to emphasise that findings of fact are provisional

> "Likewise in referring to the findings made, rather than give any suggestion of finality they should be prefaced with a statement to the effect that they reflect the FSA's belief as to what occurred and how the behaviour concerned is to be characterised ..."

We consider that each of these points should be clearly reflected in any publicity that the FCA gives to the issue of a warning notice.

A warning notice is simply a statutory notice which warns the party concerned of the action that the FCA is minded to take, and provides reasons for the proposal to take act[2]. The formal decision it enshrines is the decision to initiate enforcement proceedings – the regulatory equivalent of a decision to prosecute. It is essentially a statutory "minded to" procedure.

Whilst the decision to issue a warning notice is of course made after the FCA's enforcement team has carried out an investigation (which may have taken months or years), nevertheless, the statements made in a warning notice are viewed as allegations which, if not challenged through representations, may be regarded as undisputed by the decision maker at the decision notice stage (see e.g. DEPP 2.3.2G).

In the criminal context, the nature of the step of laying charges against a person is well known, and there is a general understanding that whilst the authorities believe that the person charged has a case to answer, no independent determination has yet been made. It is important that the status of a warning notice should be equally clearly understood by the public.

We therefore suggest that the introductory paragraph should read:

> "The Financial Conduct Authority (the FCA) gave *a notice warning* [name of firm] of [address], (Firm Reference Number: [----------]) on 1 September 2013 that *it/the FCA proposes* to take action in respect of the behaviour summarised in this statement. This statement reflects the FCA's belief as to what occurred and how the behaviour concerned is to be characterised, which will be subject to further consideration in the light of any representations which [name of firm] may make."

and that the explanatory text should adopt the indefinite article:

> **"IMPORTANT: a warning notice is not a final decision of the FCA ..."**

We also suggest that the use of language such as "the FCA considers that" may be inappropriate in a published summary of a notice on which the FCA has yet to hear representations and make a considered decision. While such language is often used in Warning Notices, they are not currently drafted for public consumption and the proposed reasons or "findings" in any Warning Notice are, in reality, just allegations that have yet to be tested through the full decision making process. In the context of reporting, for example,

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[2] It also confers right of access to material, and to make representations to the RDC (as the FCA's decision-maker in disciplinary cases)

pending criminal proceedings the press are well used to employing terms such as "alleged" in order to make clear that accusations have not been accepted or determined. We believe there is otherwise is a real risk that despite the boilerplate "warning" included by the FCA, journalists will nevertheless feel free to follow the summary text used by the FCA and as a result will report as concluded findings allegations that the FCA may well amend or withdraw in the course of its own decision making process. This will not only present an unfair picture of the status of the findings at the Warning Notice stage but may well prompt uncomfortable questions from the press, public and politicians if findings are then withdrawn having previously been presented so starkly.

So, in the example given, the last three bullets would read as follows:

"• The Warning Notice alleges that during the period from 1 January 2007 to 31 December 2009 (the Relevant Period) [*name of firm*] breached Principle 3 of the FCA's Principles for Businesses by failing to take reasonable care to establish and maintain effective systems and controls in respect of the suitability of its advice regarding the sale of [*name of product*] to its customers.

- In particular, the Warning Notice alleges that, during the Relevant Period, [*name of firm*]:
    - failed to have in place adequate systems and controls in respect of the determination of its customers' attitudes to risk;
    - failed to take reasonable care to adequately record that the [*name of product*] it recommended to its customers were suitable;
    - did not effectively monitor its staff to ensure that they took reasonable care to ensure the suitability of their advice.
- The Notice alleges that, as a result of the above failings, [*name of firm*]'s customers were exposed to an unacceptable risk of being sold [*name of product*] which was unsuitable for them."

The statement might then end such a summary with words along the lines of "The FCA will consider any representations made by [*Firm*] before making a determination in relation to these allegations and deciding what if any action is appropriate"

Prominence

The prominence which the FCA proposes to give to the clarificatory wording regarding the nature of the warning notice (as reflected in the illustrations set out in the CP) is helpful. However, we would urge the FCA to give careful consideration to the way in which statements are published on its website.

The importance of prominence can be demonstrated by a number of press reports of - and particularly press headlines relating to – the publication of the decision notice in the Angela Burns case which suggested that the fine and the ban were operative.

The FCA's press release in that case did set out information about the referral of the matter in the second paragraph of smaller print. However, as this information was effectively sandwiched after:

- the large bold heading "FCA publishes a Decision Notice against Angela Burns deciding to ban and fine the former non-executive director £154,800 for failing to disclose her conflicts of interest"

- a repetition of the text in the heading immediately below the heading, in large font and within a highlighted text box

- a further statement "The Financial Conduct Authority (FCA) has today published a Decision Notice against Angela Burns"

and before

- "The Decision Notice, which reflects the FCA's view of what occurred and how the behaviour is to be characterised, states that the FCA has decided to fine Angela Burns £154,800 and ban her from performing any role in regulated financial services for failing to act with integrity as a non-executive director (NED) at two mutual societies by failing to disclose her conflicts of interest"

it is perhaps unsurprising that some readers failed to focus sufficiently on the provisional status of the decision.

Prejudice to the interests of consumers or detriment to the stability of the UK financial system

The FCA's duty to publicise such information from a decision notice or final notice as it considers appropriate is subject to a prohibition on publication if it would be unfair to the person against whom action has been taken, where it would be prejudicial to the interests of consumers or detrimental to the stability of the UK financial system. These latter grounds are not fully addressed in the proposed changes to the Enforcement Guide, and the existing guidance at EG 6.9 simply seems to elide the two tests.

Finally, we also consider that there will be instances in which the FCA may wish to choose not to publish a warning notice statement, for example where this could jeopardise a wider on-going investigation, and that such instances (which may fall within the scope of potential prejudice to the interests of consumers) should also be addressed in the policy.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours faithfully

Margaret Chamberlain

Margaret Chamberlain
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

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