The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 - Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

Enforcement Review
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

2 July 2014

Dear Sirs

HMT: Review of enforcement decision-making at the financial services regulators: call for evidence (May 2014)

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. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the **"Committee"**). The Regulatory Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Preliminary comments

We are focusing in this response on disciplinary enforcement action. While enforcement can be understood to encompass supervisory actions such as the issue of a Supervisory Notice or the exercise by the regulator of an Own Initiative Variation of Permission (and equivalent actions), and also market abuse, it seems to us that disciplinary action is the main thrust of the call for evidence.

There are many issues of fairness that are relevant to enforcement decision-making; in this response we restrict ourselves to the specific topics referred to in the Treasury paper, but would welcome an opportunity to raise wider issues that materially concern the regulated sector and its advisers. These include:

- The impact that the UK's stance on enforcement has on the perception of the UK as a place to do business where regulatory requirements are predictable, stable and well understood; and
- Whether firms and individuals are treated fairly during regulatory investigations and enforcement actions, or whether the focus is on achieving an expedited and well-publicised outcome that reflects favourably on the regulator.

Effectiveness

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

We consider that regulatory enforcement delivered through the current enforcement processes does deliver credible deterrence throughout the financial services sector. Firms are very alert to lessons learned from enforcement cases, for example reviewing wall-crossing after Greenhorn and structured product procedures after CSI/YBS.

There will always be firms in breach of regulatory requirements; some have not kept up-to-date with changing regulatory requirements, or have not adjusted quickly enough to new regulatory approaches. Others may simply be careless, while a few will be reckless or actually dishonest. However, there can be little doubt that the great majority of firms are fully aware of the imperative of ensuring compliance with regulatory requirements. Any review of enforcement decision-making will necessarily concentrate on the enforcement process and on cases that the regulators have brought for breaches. This should not, however, mask the fact that the majority of firms are never in enforcement. Most of the firms advised by members of this Committee go to extraordinary lengths to achieve compliance; they engage large staffs of legal, compliance and risk professionals and invest considerable sums in reviewing their businesses, identifying and managing risks. They take legal advice not only on new projects but also on business-as-usual operations. They have significant spends on external advice and benchmarking to ensure that they are up-to-date with what the regulators state is good market practice.

Similar considerations apply to individuals. Senior managers in both large and small firms are usually attuned to their obligations; they understand the tenets of the Principles for Approved Persons – honesty, competence and, for those in Significant Influence Functions, the need to manage risk and ensure the business is run compliantly. There will however always be exceptions.

Referral of cases

Question 2 – Are the criteria for referring a case from the FCA supervisory function to the enforcement function clear and used appropriately? Are all key criteria identified?

If not, what improvements could be made? Should the FCA give certain factors more weight than others?

The FCA states that its enforcement priorities are the same as its overall priorities (EG 2.6) and gives some criteria for enforcement action in DEPP 6, which include gravity – the nature, seriousness and impact of the suspected breach; reaction – how quickly, if at all, the firm brought the breach to the regulator's attention, whether it has implemented remedial action, and the likelihood of repetition; precedent – the firm's past conduct, and what action the FCA has previously taken in such cases; and guidance – whether the FCA has issued guidance on this area.

These criteria are clear, and as statements of principle have to cover a broad range of possible circumstances, although it is fair to say that their application can be inconsistent as a result of different approaches taken by different teams at the FCA. Practitioners generally understand the elements that take firms over the boundary of supervision to enforcement, which include objective elements such as customer detriment and severity of the breaches coupled with subjective elements such as the regulator's opinion of the firm and its management and whether the breaches fall within a theme upon which the regulator is currently focusing. It is probably not practicable for a regulator to expand on these criteria because it is difficult to identify any useful middle ground between the high level principles in EG and DEPP and a detailed exposition that derives from an analysis of countless regulatory cases, some public but many not.

One criterion, however, to which greater weight should be attached is that of self-reporting. While the FCA will sometimes state that failure to self-report, possibly from being unaware of the issue, is an aggravating factor, it does not state that this can be a factor that will tend to obviate a referral to enforcement. We consider that it should be such a factor as indicating both a proactive stance on compliance and on co-operation.

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

The PRA has said less about its enforcement process than the FCA and further clarification would be welcomed. However, in view of the fact that the PRA is yet publicly to announce the use any of its enforcement powers, a further "paper" explanation will be of limited assistance. It is the actual application of enforcement powers that sheds the most light on how enforcement works.

Coordinating investigations and enforcement action

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

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

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

There is at present insufficient experience of the operation of enforcement cases that jointly concern the FCA and the PRA to offer any response to these questions. However we have seen "joint" requests for information being made by the FCA and the PRA that do not identify in respect of which investigation the request is made. It is an important discipline for the regulators to do this as they are exercising a statutory power and failure to do this impedes the assessment of relevance.

Making representations

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

In the case of the FCA, the Notice of Appointment of Investigators coupled with the Scoping Meeting will usually enable the subject of the investigation to understand the initial scope of the investigation. However, the process thereafter lacks transparency, and the length and complexity of the investigation and enforcement process are wholly unpredictable. This is troubling for all firms, but especially for SMEs and even more so for individuals. We consider the following six actions are required to ensure the essential fairness of the decision-making that follows on from an investigation, namely that the regulator:

1 Adheres to a timetable for each investigation that it provides to the subject of the investigation; it could also publish indicative timetables for a straightforward, medium or complex case; there should be an absolute maximum start-to-finish time of six months for any case involving an individual;

2 Provides an individual or firm under investigation with a periodic statement of the progress of the investigation and the view that it is taking, in particular if it changes tack or wishes to rely on fresh assertions;

3 Provides the individual or firm under investigation with an opportunity to make representations in response to these statements;

4 Provides a substantive response to those representations;

5 Objectively assesses the facts as determined by the investigation rather than selecting those that suit the regulator's case; and

6 Proceeds in a timely fashion throughout the process – so that time limits apply to the regulator as well as to the subject of the process.

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

At present the FCA will not usually proactively offer updates and it is left to the firm or individual under investigation to enquire about progress with respect to further document requests, interviews or timetabling generally. The key areas on which the subject of the investigation wants information - how the investigation is proceeding, what views the regulator is forming and what action it is likely to take - are currently not, and will probably remain, topics that the regulator currently does not, but should be prepared to cover. To enable a firm or individual to make meaningful representations (see our response to

Question 9), the regulators should be prepared periodically to provide updates on progress, including the views they are taking, the next steps and the likely timetable.

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

There is no limit to the opportunities to make representations prior to and during the course of an investigation. The issue, however, is that a firm or an individual will usually want to make representations in order to address a set of facts, or an analysis based on them, made by the regulator. The efficacy of the process of making representations therefore depends on the regulator periodically articulating its views so that the subject of the investigation or, later, of the enforcement action can make a meaningful response. In practice this does not happen with any regularity.

a In many investigations there is no expression of the regulator's view that would enable the firm to offer a representation in response (unless the regulator is required to provide its interim views in a progress meeting – see our response to Question 8);

b Where a skilled person has been appointed, the firm or individual will normally have the opportunity to comment upon its draft findings and often contribute a management response within the final version, but this is likely to be on the facts alone;

c Where an FCA enforcement case proceeds to settlement, which the great majority do, there is in real terms only one opportunity to make representations, which will be in response to the draft warning notice that forms the agenda for the settlement negotiations;

d There is, separately, a real issue with third party rights, which arise when someone other than the subject of the action is identified in the warning notice The FCA takes a firm view that it never intentionally identifies any such person, so that someone who feels they are identified has on occasion needed to challenge the FCA before the Tribunal.

In summary, there are in practice insufficient opportunities for individuals and firms to make representations but this can only be remedied by requiring the regulators periodically to articulate their views during the course of an investigation.

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

Time is only allotted for representations at two points in the FCA enforcement process:

a During settlement negotiations, when a very strict 28 day deadline is usually imposed; and

b In response to the issue of a warning notice where there is no settlement, where there is a period of 14 days (recently reduced from 28 days) to respond.

Each of these periods is tight. The allocation of 28 days for settlement is usually manageable because the firm or individual has decided not to contest and there are unlikely to be major areas where it will seek to disagree on the facts or the interpretation of the regulations. Even if there were more time, or the firm wanted to challenge the warning notice, the outcome would probably be little different in most settled cases because of the FCA's

stance of refusing to negotiate the contents of the warning notice other than on relatively minor points.

The allocation of 14 days to respond to a warning notice is unreasonable; the regulators have as much time as they choose to take to investigate a case and prepare the warning notice and it is inequitable to require a firm or an individual to respond to what may be an unfamiliar analysis or presentation of material in so short a period. This, though, is a new statutory time limit which would require primary legislation to amend, and the only remedy would be for the regulators to state that their policy, other than in the most urgent cases, would be to grant an extension on request of at least a further 28 days. In our experience the regulator will usually do this, other than in formal Stage 1 settlement negotiations, but even then a few weeks extra is wholly disproportionate to the months that the regulator takes to assemble its case.

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

Yes this would be helpful, at least in relation to where there is no settlement – but only if accompanied by a general policy to allow an extension.

Settlement process

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

There are some assumptions embedded within these questions that call for examination before a response can be provided.

a A settlement is faster than a contested case for the simple reason that the firm or individual chooses not to contest and reaching settlement in the allowed 28 days is obviously faster than the months involved in taking a case before the RDC or making a reference to the Upper Tribunal. They are "more efficient" only insofar as the regulator is consequently required to expend fewer resources on pursuing the case.

b A settlement does not necessarily provide an earlier opportunity for redress because the settlement relates to the disciplinary proceedings, and any agreement by a firm to offer redress is wholly ancillary to the disciplinary proceedings. Sections 205, 206 and 206A do not make the payment of redress any part of the disciplinary process. Many enforcement cases are brought where there is no loss (for example most client money and system and controls cases) or where the firm has already provided for recompense while in other cases the firms and the regulator decide on redress wholly independently of any enforcement case. It is only recently – for example the Santander Final Notice (March 2014) – that the FCA has explicitly worked redress into a settlement decision and it should in any case be appreciated that there is no automatic connection between

them. This is therefore not a criterion by which to seek to evaluate the efficacy of the disciplinary settlement process.

c The discount for early settlement is not a discount in the true sense of a reduction in the usual price of something because there is no normal or published tariff for fines. The FCA uses, and the PRA states that it will adopt, a five-step methodology that gives it almost unlimited flexibility to determine what it considers to be appropriate (see, for instance, the fine in Clydesdale Bank (Final Notice September 2013) where the FCA created a new criterion and tariff just for the case). Many practitioners consider that the discount is priced into the fine so that, knowing that most cases settle at stage 1 (30% discount), the regulator sets the fine at such a level that levying it at 70% will still have adequate deterrent effect.

d A settlement is not a "settlement" in the way that this term would be used in relation to the resolution of a dispute. The regulator states that it is acting in the discharge of its statutory obligations and cannot agree, for example, to drop one allegation in return for the firm agreeing not to contest another. In real terms, "settlement" in this context typically means:

1 Accepting all or nearly all of the regulator's allegations contained in the warning notice;

2 Possibly persuading the regulator to amend some of the supporting wording; and

3 Making a usually modest (if any) change to the level of the fine.

e The majority of cases settle and for this reason it is important that the regulator acts in an investigatory rather than an adversarial manner and follows the six principles of fairness that we set out in response to Question 7.

To answer the questions:

a We consider that the available 10 – 30% reductions are reasonable, bearing in mind our earlier point that they are not discounts in the true sense. We do not believe that increasing or reducing them would have a material impact on the conduct of cases because they involve many other more important considerations such as (a) whether or not the firm or individual actually accepts the allegations; (b) the adverse impact of a fine at any level; the wording and timing of the final notice and press release; and (d) the scope of any redress, whether or not coupled with the settlement process.

b A discount does provide a measure of incentive for a firm to settle, although for most firms the attraction of a settlement is that it enables them to dispose of the case in short order where they will have some control over the process and its outcome. Settlement is significantly less attractive to an individual for whom the penalty will often entail prohibition or the payment of a fine from personal resources coupled with the unlikelihood of ever working again in financial services.

c The regulators determine that it is appropriate to offer a discount in order to achieve a "more efficient" outcome. We see no reason why this should be withheld in any type of case.

d The truest incentive for a firm to settle at any point is not a discount from the fine either at all or at any particular level but, rather, a feeling that the outcome is essentially fair.

This is a function of a number of factors, including some that fall outside the scope of this review such as:

i The transparency of the regulator's standards, which is not always fulfilled;

ii For relationship-managed firms, clarity on the part of the supervisors as to whether or not it is meeting the requisite standards;

iii The regulator acting consistently in determining whether to take enforcement action;

iv The regulator taking into account positive as well as negative points in framing a warning notice or the accompanying press release.

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

There is some inherent unfairness in expecting a firm to settle at the point where the regulator has not been required to take into account the firm's representations, and indeed often before the case against it is fully understood. This would be remedied by the regulator having periodic update meetings with the person being investigated, at which it discusses progress and indicates the view it is forming so that the person is then able to respond. This will help shape the investigation and ensure that, when the FCA Settlement Decision Makers (SDM) propose the draft warning notice, they have visibility of that person's position. Current experience is that the SDM adopt a rigid view and are most usually unwilling to countenance any material change to the draft warning notice, or the associated penalty, which is unfair as it has been drafted without the benefit of any input from the person under investigation.

Decision making process

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

There is insufficient experience of PRA practice to make any meaningful comparison on this point.

Most practitioners consider that the FCA's processes are broadly fair and efficient. There are occasional unacceptable periods of delay on the part of the FCA investigators, for example when the enforcement team is busy on another case, of sometimes three or six months or even longer. Firms are reluctant to complain for fear of focusing greater attention on them. Overall, more communication from the regulators regarding the progress and timing of, in particular, the investigation process, and of anticipated milestones in the decision-making

process, would alleviate some of the strains which the uncertainties inherent in the process can impose on firms and on individuals.

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

We consider that current composition strikes the right balance with a legal chairman and two or four market representatives.

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

The availability of a decision-maker which has not been directly involved in the establishment of the evidence and which is prepared to listen to arguments and reconsider its decision is an important protection that firms and individuals value and which should not be removed or diluted. For this reason we consider it is most important that the RDC be retained in its current form.

The RDC's role is qualitatively different from that of the Tribunal: it acts as the FCA's decision-maker, is bound to apply FCA policy and guidance and, perhaps most notably, does not test the evidence and cross-examine witnesses.

Going to the Upper Tribunal is major litigation, only to be undertaken by the well-resourced, the well-supported or the individual who may feel he or she has nothing to lose by taking the last step to protect their livelihood and career. Very few firms and individuals make a reference to the Upper Tribunal; indeed there are barely 100 cases for the 11 years of its existence. All the 40% statistic shows is that where a firm or individual feels strongly that they are right, then (a) they will not settle; and (b) if they do not persuade the RDC then they will wish the matter to be considered judicially. This does not indicate any duplication of roles.

International comparisons

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

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

We recognise that whistleblowers can play an important role in the detection of misconduct, and we fully support the principle that whistleblowers should be properly protected both by legislation, and through the regulators' own procedures. We would, however, strongly oppose the introduction of any form of whistleblower bounty programme; if this were to be proposed, we would wish to make more extensive submissions. At this stage we would merely note that such initiatives have produced some perverse results, and that the SEC, which introduced a new programme in 2010, has recently formally declared an individual ineligible for the programme following submission, over several years, of 196 claims, all but

one of which proved to be frivolous and unsupported.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Peter Richards Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, or Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours sincerely

Peter Richards-Carpenter
Co-chair, CLLS Regulatory Law Committee

Karen Anderson
Co-chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Karen Anderson (Herbert Smith Freehills LLP) (Co-chair)
Peter Richards-Carpenter (Berwin Leighton Paisner LLP) (Co-chair)
David Berman (Macfarlanes LLP)
Peter Bevan (Linklaters LLP)
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