



Financial Services Authority

Enforcement process review

Issues Paper

March 2005

Enforcement process review

1. On 23 February we set out a number of opportunities for interested parties to contribute ideas to the Enforcement Process Review. We said then that we would be publishing a short issues paper in March seeking views on a number of specific points. These are set out below.
2. We would welcome responses to the questions raised by Wednesday, 13 April. Although this is not a formal consultation process, we will be making all responses available for public inspection unless the respondent specifically requests otherwise. Responses should be sent to suggestions.enf-review@fsa.gov.uk.

Background

3. The FSA consulted extensively on its enforcement and related decision-making processes in the run-up to the coming into force of the Financial Services and Markets Act (FSMA). In addition, these processes were also subject to scrutiny by the Joint Committee of the Lords and Commons which considered the draft Bill before its introduction into Parliament and as the Bill made its way through the Parliamentary process.
4. This short paper will not attempt to cover all the background again. Its focus is on the terms of reference of the review, in particular on the options for making regulatory decisions based on a fair procedure by persons not directly involved in establishing the evidence on which those decisions are based, as required by FSMA.
5. In order to provide some context for the specific questions set out below, it is important to bear in mind the volume and variety of “regulatory decisions” that the FSA is obliged to take. These range from authorisation and approval decisions, to decisions on change of control of authorised firms through to disciplinary action.
6. The FSA’s new responsibilities for mortgage and general insurance regulation have increased the number of authorised firms by around 15,000 to over 25,000 in total. It is therefore likely that the number of decisions required will rise significantly. This, in turn, underscores the need for the FSA’s decision-making processes to combine fairness with cost-effectiveness in a way that creates confidence in them on the part of both industry and consumers.

It is also essential that the FSA designs decision-making processes that work effectively for small firms (which now comprise over 97% of total regulated firms) as well as for large firms, and for individuals, only some of whom will be represented by legal and other advisers.

Section 1: Regulatory decisions

The Legislative Framework

7. The FSA is not contemplating any changes to primary legislation as a result of the Review. It is therefore important to explain what is required by FSMA. This includes the warning notice, decision notice and tribunal framework.
8. According to section 387 of FSMA, a warning notice must set out the action the FSA is proposing to take (for example, the size of a proposed financial penalty) and the reasons for it. In most cases, together with the notice, the FSA is also required to disclose to the firm or individual concerned the material on which it relies and any material that might undermine the decision. Following the warning notice, the FSA is required to allow the person concerned at least 28 days in which to make representations. Following this the FSA can either issue a notice of discontinuance if it decides that no further action is to be taken or issue a decision notice under section 388, setting out the action the FSA has decided upon and the reasons for it. The disclosure provisions also apply here so if there is additional material relied on or that might undermine the decision, this must be disclosed.
9. Following the decision notice, the person concerned may refer the matter to the Financial Services and Markets Tribunal, a tribunal independent of the FSA run by the Department of Constitutional Affairs in accordance with rules made by Parliament. This is not an appeal; rather the Tribunal considers the whole matter afresh and decides what the appropriate action is for the FSA to take. There is a full trial of the merits before the Tribunal, with witnesses called and cross-examined by each side and further disclosure of documents. Proceedings before the Tribunal can be lengthy and it is an expensive process for both sides, although settlement and mediation is still possible at the Tribunal stage (see paragraph 23).
10. The only requirement in FSMA on the decision to issue warning and decision notices is that the decision which gives rise to the obligation to give any such notice is taken by a person not directly involved in establishing the evidence on which that decision is based (section 395(2)).

11. Any FSA regulatory enforcement process must therefore comply with this statutory framework. In particular, the FSA must:
 - issue a statutory warning notice; and
 - take a decision following representations and issue a statutory decision notice.

The FSA cannot simply decide there is a case to answer in disputed cases and allow the Tribunal to resolve the issue. Against this background the FSA has therefore sought to develop a decision-making procedure that is effective, fair and does not duplicate the function of the Tribunal. It is not intended to provide a judicial hearing of the case, but rather to enable the principal issues to be identified and, if possible, resolved, without a Tribunal hearing being necessary.

12. Within these constraints there is considerable scope for flexibility in the process and the current model is not the only possible one.

The Current Decision Making Body

13. The FSA's decision-making procedures are set out in detail in the decision making manual (DEC), part of the FSA Handbook. This covers a number of regulatory decisions that the FSA can make under FSMA, not just Enforcement action. Some decisions can be taken by means of "Executive Procedures", taken by FSA staff, not directly involved in establishing the evidence on which the decision is based, at a sufficiently senior level. Those decisions which have the greatest potential impact on the person involved, such as imposing a financial penalty, are taken by the Regulatory Decisions Committee (RDC). Formally, the RDC is a Committee of the FSA Board and is accountable to the Board for its decisions. These decisions are decisions of the FSA for which the FSA is responsible. The RDC comprises a mixture of current and recently retired practitioners and non-practitioners all of whom are appointed by the Board and represent the public interest, with the Chairman and non-practitioners representing the majority. With the exception of the Chairman, none of the members of the RDC is an employee of the FSA.
14. At present, there are 24 members of the RDC who sit in groups of, usually, eight when considering warning notices and in a smaller panel, usually three, when considering representations and taking the decision whether to issue a decision notice. Each group sits for one day per month.
15. The FSA has chosen to structure its decision-making in this way. The RDC is not mandated by FSMA and the requirements of FSMA could be met by other models, as explained below.

Other Possible Models

16. We believe that the objectives for the decision-making process remain those set out in Consultation Paper 17 in December 1998 (the first major consultation paper on enforcement procedures, but issued before the legislation was finalised). These are reproduced below:

(a) **fair and seen to be fair**

This involves:

- providing those subject to FSA action with sufficient information as to the reasons for that action, and the evidence on which the action is based, so as to enable them to understand the FSA's grounds and, if they wish, to challenge them
- providing those subject to FSA action with a reasonable opportunity effectively to challenge the grounds for the proposed action and present any evidence and arguments that are relevant to the decision in question
- ensuring that decisions to exercise the FSA's enforcement powers are subject to consideration by a person or persons who are able to take a dispassionate and impartial view of the case for FSA action.

(b) **efficient and effective**

This involves:

- ensuring that decisions are informed by the views of persons with adequate experience and expertise in the subject matter
- avoiding unnecessary expense (whether to the FSA, the persons subject to FSA action or the public purse)
- avoiding unnecessary delay to the FSA's ability to take effective action or to bring disputes over FSA action to a conclusion
- providing a mechanism for determining at an early stage what issues are in dispute and ensuring that the process remains focused on those issues
- providing an opportunity for the FSA and the person concerned to reach agreement as to the matters of concern to the FSA and the action to be taken
- avoiding unnecessary duplication of work (whether by the FSA or the Tribunal) in the consideration of issues which are in dispute
- providing sufficient flexibility to enable procedures to be tailored to the requirements of each case.

17. The limits of who can take the decision to issue warning and decision notices is constrained by the requirement that those directly involved in establishing the evidence cannot take it and that the decision must be the FSA's. At one extreme this means that it is not therefore possible for the investigators to take the decision. Nor could the FSA lawfully delegate the decision to a wholly independent body.
18. Within these limits, there is a range of options as to how the decision-making process could be structured:
 - a wider range of decisions could be made by Executive Procedures, ie by FSA staff, provided of course that section 395(2) continued to be met. This could help strengthen the efficiency and effectiveness of the process, but might be thought to undermine the (perceived) fairness of the process;
 - decisions could be taken by individuals employed full-time by the FSA specifically for the purpose of making regulatory decisions;
 - practitioners could be involved in different ways – as decision makers (as now) or as advisers to the individual or committee making the decision;
 - there could be a different balance between practitioner and non-practitioner involvement in decision making.

Questions on which we seek views

- Do you agree that the objectives for the decision-making process as set out in CP17 remain valid? Have any been superseded? Do developments since December 2001, when the FSA took on its FSMA powers, suggest that additional considerations are now relevant?
- Do you see scope for efficiency gains from a wider range of decisions being taken by Executive Procedures? If so, which types of decisions might be taken by this means? The table at DEC 2 Annex 1 (<http://fsahandbook.info/FSA/handbook/DEC/2/Annex1.pdf>) sets out who the decision maker is at present.
- Does a Committee like the RDC remain the right model for making the most contentious decisions? Are there ways in which the operation of the current model could be improved?
- What are the best ways to involve practitioners in the decision-making process? Current practitioners will have competing demands on their time while past practitioners will inevitably find it more difficult to keep abreast of the latest market developments. What is the right balance between practitioners and non-practitioners (assuming that both categories continue to be expected to operate in the public interest)?

Representations

19. FSMA requires the FSA to give recipients of a warning notice an opportunity to make representations. The FSA has chosen to give recipients of warning notices the option of making both written and oral representations direct to the RDC within the context of an administrative decision-making process. Experience indicates that the representations process is effective in enabling a better decision to be made. Representations in many cases will result in refinements to the reasons for the proposed action set out in the decision notices and, in some cases, the level of financial penalty originally proposed being changed. In others, the action will be discontinued.
20. Witness evidence is not heard by the decision-making body and, in any event, there is no power to compel the attendance of witnesses who are unwilling to appear (unlike the position in the Tribunal where witnesses can be subpoenaed if necessary). The hearing of live oral evidence by the decision-making body would be possible, if witnesses were willing. But it would add substantially to the formality, complexity, length and expense of the process. And it would inevitably duplicate to some extent what happens in the Tribunal.
21. In addition to the formal representations mechanism, there is an opportunity for those affected by enforcement action to comment at an earlier stage, before the matter goes to the RDC. A person under investigation is often sent a draft of the investigation report and is invited to comment on it.

Questions on which we seek views

- Should there be changes to the current way that representations are made, including the stages of the process at which they are made? Any changes would need to avoid unnecessary duplication between the FSA and the Tribunal (see paragraphs 9 and 20 above).
- Is current practice with respect to obtaining comments on a draft investigation report the right approach?

Settlement

22. Most Enforcement cases are resolved without a reference being made to the Tribunal. Settlement of a case is possible at any stage of the enforcement process. Where a decision notice is required in respect of a settlement (for example, because a financial penalty is imposed) then the RDC must currently make that decision. If settlement negotiations start prior to the issue of a warning notice, FSA staff will consult the RDC to obtain “settlement parameters” and will try to seek agreement with the firm or individual within those parameters. If agreement is reached, a settlement agreement will be signed that provides for the issuance of warning and decision notices by the RDC in an agreed form.

23. Settlement can also be reached following the issue of a warning notice. At this time, the firm can also seek to have the case mediated in an attempt to reach agreement. Again, whether a particular settlement is appropriate for the FSA will be decided by the RDC. Settlement is also possible following the issue of a decision notice, either before or after the matter is referred to the Tribunal. Generally the Tribunal does not actively engage in any settlement.

Questions on which we seek views

- Is this a fair and effective way to conduct settlement negotiations at each stage of the process? In what respects might it be improved?
- At present, settlement discussions take place directly with FSA staff but the final decision is taken by the RDC. Also, no member of the RDC is present at a mediation but one is available on the telephone to give views as necessary. Is it practical or desirable to give direct access to the decision-making body during settlement discussions? Does it make a difference if, instead of a Committee, an individual or very small group of individuals makes the decision?
- Should all settlement be the sole preserve of the executive and the decision-making body be involved only in the absence of agreement? Should the decision making body be involved in all settlements or only those at particular stages of the process (eg between warning and decision notice) or where the firm or individual is unrepresented?

Section 2: Accountability of decision-makers to the FSA Board

24. As set out in paragraph 13 above, the RDC is currently a committee of the FSA Board and is formally accountable to it. The Chairman of the RDC makes regular reports to the Board once a quarter. The FSA's annual report also gives some statistics about the activities of the RDC (and quarterly statistics appear on the FSA's website).
25. It is of primary importance that the decision-making process operates fairly in relation to individual decisions. Those subject to such decision, and their advisers, will form their own views, based on their own experience. However, transparency about how the process is working overall, provided it is done in such a way as to maintain confidentiality, may also help increase confidence in it, both for those who are subject to it and for those whose interests are protected by it.

Questions on which we seek views

- What additional information could the FSA publish about the operation of its decision-making process which would enable commentators to make a better informed assessment as to whether the process was operating fairly and effectively? (To the extent that this involves data that are not public, they would have to be either aggregated or anonymous or both.)

Section 3: Other matters covered by the terms of reference

26. This issues paper has concentrated on two elements of the Enforcement Process Review's terms of reference, as set out above. The remaining two elements of the review cover:
 - the processes followed by supervisors, enforcement staff and decision-makers when considering possible breaches of statutory or regulatory requirements, and the nature and extent of the communications and interactions between them; and
 - the role and involvement of senior FSA management throughout these processes.
27. These remaining elements are an important part of this review and will receive full attention in the report and recommendations we produce. However, rather than frame general questions on these issues, we would repeat our invitation to interested parties to make any specific points that they consider relevant. Many (although by no means all) of these points will be driven by individual experiences of the enforcement process. If interested parties have points which go beyond the terms of reference for the review, but which they nevertheless consider to be important for the outcome of the review, they should feel free to make them.

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