



Financial Services Authority

Enforcement process review

Report and recommendations

July 2005

Contents

	Foreword	3
1	Executive summary	5
2	The review process	11
3	Key principles for the FSA's enforcement review	13
4	The supervision – enforcement interface	16
5	Case investigation and preparation	26
6	Decision-making	39
7	Settlement	50
8	Accountability	58
9	Impact of the changes	63
	Annex 1: Enforcement process review: Terms of reference	
	Annex 2: List of the Review's recommendations	
	Annex 3: Summary of responses to the Issues Paper	
	Annex 4: List of non-confidential responses to the Issues Paper	
	Annex 5: FSA Organisation chart	

Foreword

1. This report sets out the recommendations of the Review conducted by the FSA of its enforcement process, and the changes which we propose to make. Since some of these changes require us to alter the FSA Handbook rather than internal processes, it also initiates the consultation which is legally required for such changes. There has, of course, been extensive discussion with those interested in the FSA's enforcement process in the course of the Review, based on the Issues Paper, published in March 2005.
2. The FSA Board commissioned the Review because our process had been subject to criticism by the Tribunal in the Legal & General case; and because it was evident that many affected by enforcement actions had doubts about the fairness of the process. Both the specific and the general concerned us. It is clearly important that the FSA should listen carefully, and react, to informed and considered criticism; and that those subject to FSA enforcement, and their advisers, should consider that the process has been fair, irrespective of whether they like a particular decision. This report demonstrates the FSA's determination to respond carefully and fully to well-founded criticisms.
3. In approaching this Review, we wanted to re-establish confidence in the fairness of the FSA's enforcement process. We are proposing a number of changes designed to make the process more rigorous, and to establish much more clearly the division of responsibility and separation of operations between those in the FSA who prepare an enforcement case and those in the FSA who make the decision on that case. Essentially, this means the separation between supervision and enforcement on the one hand and the Regulatory Decisions Committee on the other. But we also wished to maintain an administrative decision-making process which involves neither excessive cost, nor too much time. It is important for all affected by enforcement that the costs should be kept as low as possible, and that decisions should not be unnecessarily delayed. The changes we propose are designed to maintain that balance.

4. The FSA Board has endorsed the recommendations of this Review in full. The Board Committee which supervised this work was assisted by Tim Herrington, recently appointed Chairman of the Regulatory Decisions Committee, who was co-opted to the Committee, and by Michael Brindle QC and David Pritchard (recently retired Deputy Chairman of Lloyds TSB), who acted as advisers. The Review was led by David Strachan and his team comprised Daniel Thornton and Joanna Levene. I am grateful to all of them for the work they have done.

A handwritten signature in black ink that reads "Callum McCarthy". The signature is written in a cursive style with a large initial 'C'.

CALLUM McCARTHY

1 Executive summary

- 1.1 Enforcement is an essential and very visible component of the FSA's responsibilities. It is of great importance and interest to firms and their advisers, to markets and to consumers. The FSA's enforcement powers are wide-ranging and were debated extensively as the Financial Services and Markets Bill (as it then was) passed through Parliament. This is the most fundamental review of the FSA's enforcement and decision-making process since the Financial Services and Markets Act 2000 (FSMA) came into effect in December 2001. This Review was set up with the aim of it being careful, thorough and wide-ranging, taking in every stage of the process. Consistent with this aim, the Review invited comments on an Issues Paper¹ which covered the enforcement process in its entirety. In formulating our recommendations we have considered carefully the views put to us by those who responded to our Issues Paper and in discussions with many interested parties, including the Financial Services Consumer Panel, Practitioner Panel and Smaller Businesses Practitioner Panel. We are grateful to all of those who have contributed to the Review.
- 1.2 This report outlines our recommendations. We are consulting on those recommendations that would require changes to the FSA Handbook; these are indicated in the body of this report.

Fairness

- 1.3 From the outset, the FSA's objectives for its enforcement process have been that it should be fair and seen to be fair, and that it should be effective and efficient. This Review, and by far the majority of responses to our Issues Paper, have confirmed that these objectives remain valid. It is important to be clear that we are dealing here with decision-making by the FSA (currently primarily by the Regulatory Decisions Committee (RDC)) and not with the

1 The Issues Paper can be found on the FSA website: www.fsa.gov.uk/pubs/other/enf_issuespaper.pdf

role and processes of the Financial Services and Markets Tribunal, which is wholly independent of the FSA.

- 1.4 Some of the respondents contended that the FSA's fairness objective has not, in practice, always been met. In support of this they criticised various aspects of the operation of the FSA's enforcement and decision-making processes, often drawing on direct experience. In addition, in its judgment in the Legal & General case, the Tribunal made some observations about the general operating procedures of the RDC that went beyond the specifics of that case. At the same time, almost all responses to our Issues Paper supported the retention of a decision-making body such as the RDC, provided that changes were made to its manner of operation. In addition, the Financial Services Consumer Panel argued – and we agree – that the process needs to be fair not only to those who are subject to it, but must also take proper account of the interests of those consumers who have suffered detriment as a result of misconduct by regulated firms and individuals.
- 1.5 Three considerations follow from this. First, no matter how fairly the FSA's enforcement process may operate in practice, any perception of unfairness will undermine confidence in it. A lack of confidence on the part of regulated firms and individuals will lead to more references to the Tribunal, thereby adding to costs overall. Second, to the extent that additions to the FSA's own process and procedures are needed to improve fairness and the perception of fairness, these are likely to make enforcement proceedings lengthier and more costly. Third, any changes to processes that are made as a result of the Review should not undermine those aspects that currently work well and command support. As part of this, the Review has been very concerned to avoid, where possible, making recommendations which would undo the efficiency gains which resulted from the FSA's recent End-to-End Review of its enforcement process². This Review has sought to balance these considerations in making its recommendations.

Recommendations made to the FSA Board

- 1.6 The key principles that have driven the Review's recommendations are that the FSA should provide:
- a clear articulation of the FSA's overall approach to the use of enforcement;
 - sufficient checks and controls during the investigation phase to help deliver balance and fairness;
 - transparency for those subject to enforcement action about the case they have to answer and the evidence on which it is based; and

2 The results of the End-to-End Review were published in July 2004. The accompanying press release can be found on the FSA website at: www.fsa.gov.uk/Pages/Library/Communication/PR/2004/065.shtml

- clarity as to the separation (required by FSMA) between those who investigate a case and those who decide.

We would emphasise that these principles apply in the context of FSA decision-making, which does not (and cannot) replicate the processes of a court of law or a tribunal. The FSA cannot – as some have suggested – confer its decision-making responsibilities on a wholly independent body; rather, it must take the decisions itself in a fair process. The Review has therefore sought to improve the fairness of the FSA’s processes without needlessly duplicating the role of the Tribunal.

Investigation

- 1.7 The FSA is a risk-based regulator. In broad terms, this means that it must focus its limited resources on those issues which are likely to have greatest impact on its statutory objectives. This risk-based approach is as valid for enforcement as for the FSA’s other activities. One practical consequence of this is that the FSA cannot, and does not, attempt to pursue every rule breach. Instead it selects cases carefully, according to their seriousness and how they fit with its priorities. The Review recommends no change to this overall approach. But it is important that the FSA continues to explain how it will use enforcement to help meet its objectives and what the practical consequences of this are for firms and consumers.
- 1.8 In order to help ensure that the decision-making process functions most effectively, investigations must be of a high quality and any breaches alleged must be properly supported by the evidence. The Review makes a number of recommendations to strengthen the investigation process. In particular, the Review recommends that before a case is referred to the decision makers, there be a thorough legal review by lawyers in the Enforcement Division who are not part of the investigation team. This is not generally current practice.

Separation

- 1.9 If the FSA’s enforcement process is to operate fairly, and be seen to operate fairly, there must be separation between those who investigate possible rule breaches and those who decide whether the conduct in question should be sanctioned. This fundamental separation in respect of decision-making is required by FSMA, but its terms are sufficiently wide to allow the FSA considerable flexibility as to how it achieves this.
- 1.10 At present the FSA gives effect to this separation by having the more fundamental and contentious regulatory decisions made by the RDC. The RDC is a Committee of the FSA’s Board, but operationally independent of it. The Review recommends that the RDC be maintained and that its membership continue to include practitioners and non-practitioners, all of whom act in the public interest rather than as representatives of a particular sector or stakeholder group. The FSA Board

should also maintain its current policy of neither intervening in, nor otherwise attempting to influence, the RDC's individual decisions.

Objectivity of the decision makers

- 1.11 The principle of separation is essential if the decision makers are to be able to bring independence and objectivity to their deliberations. The current practices whereby the Enforcement case team provides legal advice to the RDC and is able to discuss the case with the RDC following the representations made by the subject of regulatory action have met with considerable criticism. The Review recommends a number of significant measures that will strengthen the RDC's objectivity and independence and bring greater transparency to the process:
- the creation of a small, dedicated legal function to assist the RDC in its decision-making will mean that the RDC will no longer have to look to the Enforcement Division for legal advice and support. Confidential communications between Enforcement and the RDC should therefore cease;
 - all substantive communications (whether oral or written) between the Enforcement case team and the RDC will be disclosed, to deal with criticism that those subject to enforcement action are not completely clear about the case that they have to meet; and
 - the current practice whereby the Enforcement case team has direct access to the RDC after the conclusion of the representations meeting without the firm or individual being present will end. Instead, RDC representation meetings will be conducted on a more interactive basis than now. Any further submissions to be made either by the case team or the firm or individual(s) involved will be disclosed to the other party.
- 1.12 These recommendations will inevitably introduce greater formality into the FSA's decision-making process, but not to the extent that the process will be indistinguishable from that operating in a court or tribunal. The process will continue to be capable of being operated with a degree of informality, as befits its nature. The FSA Executive and the RDC are committed to maintaining this informality in the interests of delivering fairness while containing costs; whether this is achievable will depend on the firms and individuals involved and their advisers being prepared to do likewise. It is also essential that the process remains one that can be operated flexibly and proportionately, given the very wide range of firms and cases which it must accommodate. A number of measures recommended by the Review improve the operational flexibility of the process.

Settlement

- 1.13 The Review also recommends that the principle of separation be applied to cases which are settled. At present, the RDC is involved in settlements, by setting ‘settlement parameters’ for the FSA staff tasked with conducting the settlement negotiations, and by approving the terms of the settlement. The involvement of the RDC in cases which are settled by agreement, rather than being contested, risks blurring its role and undermining the objectivity which the RDC may subsequently need to bring to a case should it fail to settle. We therefore recommend that settlement decisions, in future, be the sole preserve of the FSA Executive, with the RDC deciding matters in the absence of agreement. In making settlement decisions, the FSA’s Executive decision makers must, like the RDC, take an appropriate regulatory decision having regard to the FSA’s statutory objectives. This will include for example giving proper regard to any questions of consumer redress.
- 1.14 Moreover, and consistent with the FSA’s objective that the enforcement process needs to be effective and efficient as well as fair, the Review recommends the introduction of an explicit discount system for those who settle their cases early in the proceedings. Early settlement is, in our view, in the public interest. Settlements result in consumers obtaining compensation earlier than would otherwise be the case, the saving of FSA and industry resources, and messages getting out to the industry sooner rather than later. They are therefore to be encouraged, provided there are safeguards in place to prevent the process becoming, or being perceived to be, unfair and oppressive. These safeguards include the RDC and ultimately the Tribunal.
- 1.15 The maximum discount will be 30% of the financial penalty which would otherwise have been recommended to the RDC, having first taken account of the seriousness of the breach and the extent to which the firm had co-operated throughout the process. The discount will be stated on the face of the Final Notice in future, thereby improving transparency. The FSA will continue to take into account other forms of co-operation (such as a firm taking the initiative to compensate consumers who have suffered detriment) when deciding on the size of penalty (that is, before the early settlement discount is applied). ‘Co-operation’ here does not mean simply accepting the FSA’s case.

Performance measurement

- 1.16 The most significant influence on how fairly the enforcement process is perceived to operate will, as now, be the experiences of those who are subject to it. That said, the Review recommends that being more transparent to the public about how the RDC operates, including by publishing a wider range of data, will improve the overall understanding of the FSA’s enforcement process. It is also very important for the FSA to assess how well the new process is operating. Accordingly, the Review recommends that the FSA publish an

annual Performance Account for enforcement at the time of its Annual Report. A significant input into this account will be the feedback the Review is recommending should be gathered from those firms and individuals who have been subject to FSA enforcement.

Impact of the changes

- 1.17 An improved enforcement process will foster greater confidence in the FSA on the part of regulated firms and individuals, and encourage self-reporting, remedial action and co-operation. We anticipate that as a result of this Review's recommendations more cases will settle earlier in the proceedings. However, for those cases which do proceed to the RDC, the net effect of these recommendations will be to add to the overall cost of the FSA's enforcement process and will, inevitably, make it lengthier. We do not expect the recommendations to result in higher direct costs for firms and individuals involved in the enforcement process.

2 The review process

- 2.1 Since the creation of the Review team in February it has reported on a monthly basis to a committee of the FSA Board – comprising Callum McCarthy, John Tiner and three Non-Executive FSA Board members: James Crosby (Chief Executive, HBOS plc), Hugh Stevenson (Chairman, Equitas Ltd) and Clive Wilkinson (Chairman of the Birmingham & Solihull Heartlands NHS Trust). Tim Herrington (Chairman of the FSA’s Regulatory Decisions Committee) was co-opted to the committee and Michael Brindle QC and David Pritchard (recently retired Deputy Chairman of Lloyds TSB) acted as advisers to the committee. The Review updated the FSA Board on its progress each month.
- 2.2 Within our tight timetable, we have sought to provide as much opportunity as possible for interested and involved parties to contribute their views. We have appreciated greatly all parties’ willingness to participate and the openness they have shown in their discussions with us.
- 2.3 In the first instance, to gain an understanding of how enforcement and regulatory decision-making procedures currently operate, we held extensive discussions with colleagues from across the FSA: authorisation, supervision, and enforcement areas as well as the RDC. We also held discussions with overseas regulators about their approaches to enforcement.
- 2.4 To draw on the expertise within the financial services industry, we engaged in a series of bilateral discussions with a number of senior practitioners whose firms have had direct experience of the enforcement process. Discussions were also held with the Financial Services Consumer, Practitioner and Smaller Businesses Practitioner Panels, as well as with consumer representatives.
- 2.5 In formulating the Review’s recommendations, we have considered carefully recent judgments published by the Financial Services and Markets Tribunal. Separately we also contacted the Tribunal to ask whether it wished to make further views known to the Review; however, in accordance with its usual practice and in order to preserve its complete independence from the FSA, it did not think it appropriate to do so.

- 2.6 In March we published and invited comments on an Issues Paper, which set out questions relating to the areas covered by our Terms of Reference. A total of 43 responses was received, a summary of which can be found at Annex 3. The responses were generally detailed and of a high quality. To explore the matters raised, we held roundtable discussions with many of the respondents. It was not within the Review's mandate to verify independently many of the comments arising from responses and from these meetings; instead our general approach here was to attach due weight to those concerns emanating from multiple sources. In reaching our recommendations, we have considered carefully the matters raised in responses to the Issues Paper, but we will not be providing a point-by-point response.
- 2.7 We are consulting on those recommendations which require changes to the FSA Handbook. Consultation Paper 05/11 issued in conjunction with this report contains the relevant draft Handbook text. We expect all the changes to be implemented by the end of the year.
- 2.8 This report covers the issues set out in our Terms of Reference (Annex 1). The order of the following sections broadly reflects the sequence of the various stages of the enforcement process.

3 Key principles for the FSA's enforcement process review

- 3.1 This section outlines the four key principles which underpin the Review's recommendations. We have formulated these in the light of views put to us during the course of the Review. The recommendations themselves are set out in subsequent sections (and listed in their entirety at Annex 2), and a more comprehensive summary of the responses to the Issues Paper is at Annex 3.

A clear articulation of the FSA's overall approach to the use of enforcement

- 3.2 It became apparent early on that much stands to be gained from the FSA clarifying publicly, rather than necessarily changing, certain aspects of its enforcement process. This clarification centres around two areas: the process by which cases are referred to the Enforcement Division, and the operation of the RDC.
- 3.3 As one might expect, firms and their representatives were keen to understand the steps that they could take, should a problem be discovered, to obviate the need for enforcement action. Linked to this, they also wished to understand better the criteria used for case selection, who takes the decision to accept a case into Enforcement, and how conflicting opinions within the FSA Executive are reconciled. In particular, we received many questions about the role of the 'enforcement priorities' published in this year's FSA Business Plan. The questions stemmed from concerns that at case selection stage, the fact that a potential case falls within a priority area in effect 'outweighs' the criteria that would otherwise be used to determine whether or not a case is referred to Enforcement.
- 3.4 Another clear message we received from interested parties was the need to improve levels of awareness about the status, constitution and operation of the RDC. A particularly important point that the FSA needs to continue to explain is the extent to which the RDC is part of the FSA but operationally independent of the Executive.

Sufficient checks and controls during the investigation phase to help deliver balance and fairness

- 3.5 As articulated by some, ensuring that the right checks are in place can avert the need for a radically re-engineered process. A concern which was widely expressed about the investigation phase was that the quality and objectivity of the investigation documents are variable. To address this issue, it was suggested that Enforcement's senior management carry out quality control reviews of these documents before they are submitted to the RDC. In particular, there were calls for greater scrutiny of the sufficiency of the evidence in relation to the breaches being alleged. Notices of Investigation, although not provided to the RDC, were highlighted as another area in which it was felt additional checks should apply. Some felt that these notices are sometimes drafted too broadly, leaving open the possibility of the scope of an investigation being extended considerably, which firms feel is unfair. Several respondents were also of the opinion that Enforcement staff lack sufficient industry knowledge or experience; some suggested the involvement of 'Grey Panthers'³ to provide technical expertise and checks.

Transparency for those subject to enforcement action about the case they have to answer and the evidence on which it is based

- 3.6 The theme of transparency received frequent comment. Firms welcomed the increasing use of 'scoping meetings', largely because of the early indication of the nature of the investigation that they provide. However, the most widely-voiced concern about lack of transparency related to the fact that some material which Enforcement provides to the RDC – namely the case review paper – is not disclosed to the person under investigation. This practice fosters an acute sense of unfairness.
- 3.7 Once the case is before the RDC, firms made the point that at the oral representations hearings they would welcome an indication of the elements of the case which the RDC feels are the most important or require the most clarification. If the RDC communicated this, firms and their advisers would be able to focus the content of their oral representations accordingly.
- 3.8 Another recurring comment about the process's lack of transparency was that the FSA does not always explain to firms how it has dealt with the key points made in response to the draft Investigation Report and during representations. Respondents would like this explanation to be contained in decision notices. Some commented that the current lack of such feedback creates the impression that their submissions have simply been ignored.

3 Grey Panthers are former industry practitioners who act in an advisory capacity.

Clarity as to the separation (required by FSMA) between those who investigate a case and those who decide

- 3.9 Many we spoke to voiced strong opposition to the substantive case-specific discussions between Enforcement staff and the RDC, which take place both at warning notice stage and following the oral representations session, and are not disclosed to the firm or individual concerned. This contact, and the potential influence it may have, is felt to blur the separation between the investigation team and the decision makers. Some firms proposed that the person under investigation be present at all such meetings; however, the majority suggested that detailed minutes be taken at any such meetings and then disclosed.
- 3.10 Another practice which many perceived to undermine the separation between the two functions was the legal advice provided to the RDC by a lawyer from the Enforcement case team. Several commentators thought that any revised arrangements should provide the RDC with a degree of self-sufficiency in terms of procuring legal advice – particularly advice relating to the adequacy of the evidence. Others specified only that the legal advice should not come from Enforcement.
- 3.11 The principle of separation also extends to case settlement. The Review heard some concerns about the RDC's involvement in settlement discussions which subsequently prove unsuccessful: if settlement is not reached, the case proceeds to the RDC. However, having already been privy to the detail of settlement discussions, the RDC is considered by some to have had its objectivity compromised.
- 3.12 A final aspect of the current enforcement process that was highlighted as blurring the divide between the RDC and Enforcement was the drafting of statutory notices by the Enforcement case team. Some respondents would prefer the RDC itself to take a greater role in the drafting process.

4 The supervision – enforcement interface

Background

- 4.1 The terms of reference of the Review make it clear that our focus is on the enforcement process. Inevitably there are aspects of enforcement where it is difficult to separate consideration of the FSA's processes from aspects of the FSA's policy and supervisory approach. This was very clear when the Review came to deal with respondents' views on the early stages of the process – that is, the initial discussions around whether or not to refer a matter for investigation in the first place. Here we received a number of comments relating to the FSA's overall approach to enforcement and how it uses enforcement as one of the tools to help it achieve its statutory objectives.
- 4.2 It is not for this Review to redefine the FSA's overall approach to the use of enforcement. At the same time, it was clear from responses to the Issues Paper and subsequent discussions that more could be done to explain the FSA's overall approach to enforcement. The course that we have therefore taken is to (re)state elements of the FSA's existing approach, where relevant to the issues being considered. The Review has also identified aspects of the FSA's approach which could be communicated more clearly. These are included in the recommendations set out below.
- 4.3 The responses to the Issues Paper send a clear message, especially from firms, that the FSA should, whenever possible, seek to work with a firm that is involved in a possible breach of the FSA's requirements to remedy any deficiencies. Also, where necessary, the FSA will want to see redress for any consumers who may have suffered detriment. These responses are clear that enforcement should only be used in those circumstances in which it can be fully justified. There is a concern – implicit in some responses, explicit in others – that the FSA is too ready to resort to enforcement, especially in relation to its priority areas.
- 4.4 Since N2 (December 2001), 106 enforcement actions have resulted in a published disciplinary outcome, involving 59 authorised firms, 38 approved

persons, and eight listed companies. There are also currently 12 enforcement cases pending at the Tribunal. This compares with a total population⁴ of 10,200 authorised firms, some 165,000 approved persons and 2,877 listed companies. In addition, there have been 61 so called ‘threshold conditions’ cases which have resulted in enforcement action. These cases typically involve the FSA varying or cancelling the permission to carry out regulated business of firms that, for example, hold insufficient funds, have failed to comply with an Ombudsman ruling or are operating without professional indemnity insurance.

- 4.5 These statistics point to very selective use of the enforcement tool by the FSA, consistent with the fact that the FSA is not an enforcement-led regulator. It also provides evidence that the FSA has addressed the vast majority of rule breaches by firms through supervisory tools rather than enforcement action. Although the absolute number of enforcement cases in progress at any one time will no doubt rise in future because of the increase in M&GI⁴ firms, this should not be taken as any indication of a change in the FSA’s overall approach.
- 4.6 However, the number of enforcement cases does not, of itself, determine whether or not a regulator is perceived to be enforcement-led. Industry perception will be influenced by how cases are selected. This subject attracted considerable attention in a number of responses to the Issues Paper, with calls for greater clarity as to the FSA’s approach. Particular concerns were voiced about the FSA’s ‘enforcement priorities’, and the linkages between thematic work and enforcement.

The linkage between supervision priorities and use of enforcement

- 4.7 The Enforcement Division participates in the annual budgeting and business planning round in the same way as any other FSA division. It does, however, rely on inputs from the FSA’s supervisory divisions as to what type and quantity of cases it should expect to receive. The inputs are based on the supervision priorities agreed for the supervisory divisions, the three Business Units and ultimately the FSA. The supervision priorities will see an above-average supervisory resource allocation and, should evidence emerge of potential breaches, are more likely (than non-priority areas) to be supported by enforcement action.
- 4.8 This planning process feeds the production of the ‘enforcement priorities’ included within the annual Business Plan (although only described as such in the 2005/06 plan). These enforcement priorities will be known to supervisors and used as a guide for them and Enforcement Relationship Managers⁵ (ERMs) in the identification of possible enforcement cases. As the FSA is operating in a resource-limited environment, the existence of enforcement

4 In order to provide a proper basis for (historical) comparison, the population data exclude the recently authorised firms and approved persons connected with mortgage and general insurance intermediation (‘M&GI firms’).

5 Each ERM is a designated contact point within Enforcement for a particular FSA referring department or division. The ERM advises the relevant department or division about Enforcement’s procedures, and helps the division draft the documentation which accompanies referrals.

priorities (which, as explained above, are a subset of the FSA's overall priorities) means that choices have to be made between accepting:

- cases in a priority area as against a non-priority area (there will always be scope for an egregious case in a non-priority area to be taken into Enforcement);
- cases in one priority area against cases in another priority area.

4.9 It is clear from the description set out above that the FSA, as a risk-based regulator, has to make difficult choices about how it deploys its enforcement resources, as with its other resources. The FSA has consistently made it clear that one element in the selection process is how important it is to send a message to a particular sector or the industry as a whole. It is also a logical consequence of its risk-based approach that more of the FSA's supervisory resources will be devoted to its supervision priorities and, within this framework, to the larger financial firms and groups. This in turn makes it more likely that the FSA will identify rule breaches in these priority areas, and that relatively more of these will be within the larger firms and groups. But, to be quite clear, the fact that a firm is large is not by itself a reason for contemplating enforcement action.

4.10 Since N2, the great majority of enforcement cases have been in a priority area. Table 1 allocates the number of financial penalties imposed on firms compared with the impact category⁶ of the firm or group concerned. Again it shows that the majority of actions have involved higher impact firms.

Table 1

Size of authorised firms/groups which have received a financial penalty since N2		
FSA impact rating	Number	Percentage
High	26	53%
Medium High	12	25%
Medium Low	3	6%
Low	8	16%
Total	49	100%

This table excludes the 61 threshold conditions cases, almost all of which will have involved low impact firms.

Small firms – enforcement strategy

4.11 As explained in paragraph 4.4, the Enforcement Division has for some time dealt with a number of cases where firms no longer meet the threshold conditions for authorisation. In such cases firms are first given an opportunity

⁶ Using its risk assessment methodology, the FSA places all firms regulated by it into four groups based on the size of the firm and the volume of activity it undertakes: High, Medium High, Medium Low and Low.

to correct the failure. If the firm does not take the necessary remedial action, the RDC is asked to consider whether its authorisation should be cancelled. In 2004/05 the RDC issued final notices in relation to 33 ‘threshold conditions’ cases. Given the recent increase in the population of small firms following the start of mortgage and general insurance regulation, the FSA expects the number of these cases to increase substantially.

- 4.12 In addition, the Enforcement Division supports supervisory priorities developed by the recently established Small Firms Division. Where the supervisors conduct visits and identify a particular industry-wide issue, the Enforcement Division will – where necessary – take action against those firms in the group visited that are identified as posing the most serious threat to the FSA’s statutory objectives in relation to that issue. Other firms are dealt with using supervisory tools. The joint supervisory and enforcement action taken to resolve such issues of concern will subsequently be communicated to the industry at large so as to provide firms in general with the incentive to change their behaviour in the key areas of concern.

Thematic work

- 4.13 Thematic work involves looking at a particular issue or set of issues across a sample of firms. There are several reasons for carrying out work in this way: to identify the scale and nature of risks which emerge from intelligence and surveillance and to deal with particular sector or industry-wide risks, including when these have crystallised.
- 4.14 When the FSA contacts firms as part of its thematic work they often automatically assume that, because they have been selected, this implies that the FSA has already decided that there is a problem in that firm. This is not the case. The decision to select a firm for thematic work takes into account a number of factors. These include:
- how many and what type of firms are active in the market or product that the FSA is interested in;
 - the desire to find a sample of firms that is representative of the various different sizes or structures in the market the FSA is considering;
 - the desire to create a representative sample. This will include some firms which the FSA considers are likely to set the highest standards in terms of systems and controls and practices more generally in that area. But the sample may also include some firms about whose practices the FSA has concerns;
 - how the FSA can most efficiently use its resources to obtain sufficiently robust information for its needs; and
 - whether any of the firms are – or have recently been – involved in any other areas of FSA’s work, so that where possible thematic work is spread

across firms. Achieving this spread can be a particular challenge when it comes to the largest groups. Where firms have dedicated supervisors, the supervisor will be involved in decisions about which thematic projects the firm takes part in.

- 4.15 As noted above, thematic work does not start with the presumption that some of the firms in the sample will, ultimately, be referred to Enforcement. But if significant issues are found, these will be considered for referral to Enforcement in the normal way and against the usual criteria. It is clear from responses to the Issues Paper and other discussions we have had that firms (particularly those whose business is predominantly retail) feel that being included in a sample for thematic work makes them more likely to be considered for enforcement action than a firm which is not in the sample. We recognise that this may increase perceptions of unfairness, yet it is a logical consequence of the FSA adopting the most efficient and effective approaches to cross-firm work in a resource-limited environment. At the same time, some firms (including wholesale firms) see thematic work as going with the grain of the market, providing a useful means of spreading good practice and giving an opportunity for dialogue between the FSA and the industry.
- 4.16 The combination of more resources being devoted to priority areas and the application to enforcement of the FSA's risk-based approach may give rise to an external perception of unfairness or 'rough justice'. One firm which believes its standards to be no different to those of its peers may be aggrieved if it is subject to enforcement action while its peers are not. Some may regard the setting of 'enforcement priorities' as an indication that the FSA is pre-disposed to use enforcement tools in these areas, even when other (supervisory) tools may be more appropriate, or that the FSA has enforcement 'quotas' to meet. Higher impact firms may question why they are more likely to be subject to enforcement action than medium or lower impact firms. The fact that these concerns have been put to the Review gives a clear signal that the FSA could usefully restate its overall policy approach to enforcement and augment it in certain areas.

Recommendations

1. The FSA should continue to set out publicly its risk-based approach to enforcement and the consequences that flow from it, especially for case selection. The FSA Board and the Executive should consider at least annually the approach to enforcement and how this tool is best used to help the FSA achieve its overall priorities.
2. The FSA should refine and communicate its enforcement approach for medium-sized and smaller firms, to complement its approaches for the larger and for the smallest firms.

3. The FSA's 'enforcement priorities' are a subset of the FSA's overall priorities. Potential rule breaches in these areas will continue to take precedence over rule breaches in other areas in terms of allocating scarce enforcement resources. However, there should be no pre-disposition on the FSA's part always to resort to enforcement when issues are identified in priority areas.

The relationship between Supervision and Enforcement

4.17 Referrals to Enforcement can be made by the following FSA divisions⁷:

- Major Retail Groups, Retail Firms, Small Firms and Wholesale Firms;
- Markets, including for market abuse cases and Listing Rule breaches;
- Retail Themes, both for financial promotions cases and possible enforcement action arising from visits to firms as part of thematic reviews (see above);
- Contact Revenue and Information Management, if firms fail to pay their fees or do not submit returns when they are due.

4.18 It is therefore possible that the conduct of an authorised firm or approved person which gives rise to the question of whether the firm should be referred to Enforcement is identified by staff in a division other than that which is responsible for supervising the firm. The role of the supervisor in the formal decision on whether to refer the matter to Enforcement is covered in paragraph 4.23.

Consistency of treatment of referrals to Enforcement

4.19 Respondents to the Issues Paper expressed concern about what they perceive as inconsistency in the way in which firms are referred to Enforcement. In particular the point has been put to us that some firms have failed to understand why they have been subjected to enforcement action when they believe their practices to be no different to those of their peers.

4.20 As explained above, the combination of the priority given to certain types of misconduct over others and the FSA's risk-based approach to enforcement means that certain cases will be subject to enforcement action and others not, even where they may be similar in nature or impact.

4.21 But none of this diminishes the effort the FSA should make to try to ensure there is consistency within each of the referring divisions and across the FSA in applying the published criteria for determining whether to take disciplinary action⁸. The delivery of consistent approaches is greatly assisted by ERMs who, as well as providing the main interface between the referring divisions and Enforcement, also form a network within the Enforcement Division. This promotes good practice across the ERM group.

⁷ Readers wishing to refer to the FSA's organisation chart will find it reproduced at Annex 5.

⁸ These criteria are set out in Chapter 11.4 of the FSA's Enforcement manual.

- 4.22 The ERMs have counterparts in the referring departments and divisions, but it is clear that they do not form such a cohesive group. There is little opportunity to share good practice across these divisions and there is some divergence in the role of these individuals within their respective departments and divisions. In particular, they are not always used as a source of expertise for less experienced colleagues involved in preparing referrals to Enforcement.

Recommendations

4. There should be a forum which brings together the counterparts to the ERMs in the referring divisions to share good practice. This forum should meet periodically to share experience of what is working well and less well and should also meet the ERMs as a group.
5. The FSA should consider developing a fuller description of the core responsibilities of both the ERM and their counterparts in the referring divisions. This would improve understanding of the nature of the role and would promote consistency.
6. The FSA should draw up procedures governing the supervision-enforcement interface to promote consistency of approach.

The referral decision

- 4.23 The referral decision is built around the Enforcement Referral Document (ERD). This is a key discipline, both for the referring division and for Enforcement. The document requires the referring area to justify why use of the enforcement tool is right for the particular circumstances of the case and for this firm – i.e. to explain why the use of other regulatory tools is not appropriate. The ERD is the property of the referring division, and must be signed off by the relevant manager, although the relevant ERM is closely involved in its production. Where the referring division is not the same as the division responsible for supervising the firm concerned, the ERD stipulates that the firm’s supervisor be informed of the referral and requires reasons to be given if the supervisor does not support the referral.

Recommendation

7. If the referral is being generated by a division other than that which is responsible for supervising the firm or individual concerned, the supervisor should be informed promptly and the ERD should also be signed by the relevant supervisor.
- 4.24 An important consideration before any referral to Enforcement is made is the nature of a firm’s overall relationship with the FSA and whether, against that background, the use of the enforcement tool is likely to further the FSA’s aims and objectives. So, for any similar set of facts, use of the enforcement tool will

be less likely if a firm has built up over time a strong track record of taking its senior management responsibilities seriously, being open and communicative with the FSA and, if problems do emerge, taking prompt remedial action. In addition, a firm's conduct in response to the specific issue which has given rise to the question of whether a referral should be made will also be relevant. On its website the FSA gives a number of anonymised examples of where it has decided not to take enforcement action in relation to a possible rule breach because of the way in which the firm has conducted itself in putting the matter right. The fact that the possible rule breach has occurred in one of the FSA's priority areas does not affect the considerations set out in this paragraph, and certainly does not diminish the weight the FSA attaches to them.

Recommendation

8. The FSA should continue to publish on its website examples of the types of responses by firms which may obviate the need for enforcement action.

- 4.25 If, at any stage of the process, Enforcement is unwilling to take on a case, it is open to the referring area to escalate the matter within the FSA⁹. Ultimately such disagreements will be settled by the Case Referrals Committee (CRC) which is chaired by a Managing Director and whose membership comprises Directors drawn from the supervisory and other divisions from across the FSA. Although most differences of view are settled without the matter being referred to the CRC, this is an important safeguard which ensures that the FSA's senior management is fully involved when the circumstances warrant it.

Communication in the period up to and including the point of referral

- 4.26 Some respondents to the Issues Paper noted that some firms have been surprised to find themselves being referred to Enforcement. Others complained of delays from being first informed that enforcement action is being contemplated to the final decision as to whether to take the matter into Enforcement. The point was also made very strongly that once a firm has been told by its supervisor that a matter is not going to be referred to Enforcement, this should not be overturned in the absence of material new information. Against this, other respondents are concerned that placing requirements on FSA staff about what and how they communicate may well lead to a reluctance on their part to express any views on matters relating to a potential enforcement referral.
- 4.27 The Review is in no doubt that communication during this sensitive period is particularly important and will always have to be handled carefully. Although

⁹ Escalation could also be necessary in other cases of disagreement, for example if there was a disagreement between the referring division and the division responsible for the supervision of the firm or individual concerned.

it is difficult (and, as noted above, potentially counterproductive) to be prescriptive in this area, the following considerations are relevant:

- in the period up to the point of referral to Enforcement, the main channel of communication with the firm or individual concerned should be the referring division. If the referring division is not responsible for the supervision of the firm or individual, the two areas within the FSA should keep in close communication;
- there is a fine balance to be struck between informing a firm that a matter is being considered for referral to Enforcement and causing unnecessary concern (in cases where the issue is subsequently not referred)¹⁰. A commonsense approach is needed. There are at least two stages. First, when the supervisor has identified a possible concern and communicates to the firm that the matter will be discussed with Enforcement. The second is when a referral to Enforcement becomes a realistic prospect. In these circumstances, a 'realistic prospect' means, at the very least, there has been an initial discussion with the relevant ERM which has established that on the face of it the conduct in question meets the referral criteria;
- the delay between the first mention of the possibility of a referral to Enforcement and a final decision should be kept to a minimum. The FSA should keep the firm or individual informed of progress;
- supervisors need to be particularly careful when communicating to firms or individuals that a matter will not be referred to Enforcement and should not do so without first consulting other interested parties in the FSA. If there is any doubt over this, either because this has not been agreed with Enforcement and other relevant areas of the FSA or at senior levels within the FSA, no such assurance should be given. There may, of course, be new information that changes the situation. But provided these procedures have been followed, once a firm or individual has been informed that a matter is not being referred to Enforcement, that decision should not be reversed in the absence of new information.

The involvement of Enforcement staff in supervisory visits

4.28 Some of the respondents to the Issues Paper expressed concern about the involvement of Enforcement staff in supervisory visits. This is not a new issue. At the same time, and as discussed in the next section, concerns have been expressed about the lack of experience which some of our Enforcement staff have of the types of business which they are investigating. In this context, the participation of Enforcement staff in supervisory work can be an important component of their learning and development programme.

¹⁰ There may be circumstances in which it is not appropriate to inform a firm or individual at an early stage, because of concerns about 'tipping off'. This could well arise in market abuse cases.

4.29 The Review has found no reason why the FSA should not continue to use Enforcement staff in supervisory work, making it clear on each occasion to the firm concerned in what capacity they are acting. In particular the FSA will continue to make a clear distinction when using Enforcement staff as a member of the supervisory team and when they are present because the supervisors have concerns about a specific issue which may in due course lead to a referral to Enforcement. In the latter case, the FSA should explain the basis of its concerns to the firm involved.

5 Case investigation and preparation

Commencement of the investigation

- 5.1 Once the Enforcement Division has accepted a case, a Project Sponsor, Project Manager and case team are put in place. Each case team will include a case lawyer. The size, composition and experience of the team will depend on the nature and complexity of the case.
- 5.2 As part of the End-to-End Review of Enforcement, completed in the summer of 2004, the FSA concluded that an initial scoping meeting with the firm or individuals close to the start of the investigation should be an integral part of the planning process. The purpose of these meetings is to enable the FSA to give the firm or individuals concerned in the investigation a clear indication of: the scope of the investigation; how the process will unfold; the individuals and documents the team will need access to and so on. The Notice of Investigation is typically handed over at this meeting.
- 5.3 Respondents welcomed the principle of holding such meetings, but also suggested that they could be made to work more effectively, in particular that the FSA could and should be more forthcoming about the nature of its concerns from the outset. Some also noted the mismatch that can arise if the firm is fielding very senior and experienced management, supported by internal or external counsel, when the FSA is not. In addition, some firms and advisers criticised Notices of Investigation for being unspecific. They also expressed concerns about the need for the FSA to make better use of existing information it holds, including the knowledge held by a firm's supervisor, about the regulatory history of the firm and the FSA's overall relationship with it.
- 5.4 A number of the recommendations in this section include elements of the Enforcement Division's existing practices. However, responses to the Review indicate that not all of these practices are being applied in all appropriate cases or always with sufficient rigour. But it is also clear that some firms and their advisers have unrealistic expectations of what the FSA can deliver in

some of these areas. Hence we have decided to include and build on these practices in the Review's recommendations, set out below. This will have the added benefit of clarifying expectations.

Recommendations

9. The FSA should hold initial scoping discussions as a matter of course for cases involving authorised firms or approved persons (and may do so in other cases). The FSA team should include the supervisor if the firm concerned is a relationship-managed firm. The composition of the FSA team should also take into account the seniority of the team fielded by the firm.

10. The FSA should continue to give an information pack to the firm at the outset explaining the key stages of the enforcement process and the possibility of mediation and settlement.

11. The FSA team should, at a minimum, when dealing with an authorised firm or approved person, set out the nature of, and reasons for, its concerns and provide a clear explanation of why the matter has been referred to Enforcement. This must take account of the fact that there is a limit as to how specific the FSA can be about the nature of its concerns before any formal investigation has begun.

12. If, as the investigation progresses, the nature of the FSA's concerns change significantly from those that it originally notified to the firm, the FSA should reassess these concerns against its referral criteria so as to satisfy itself that it remains appropriate to continue the investigation. If it does decide to continue, the FSA should notify the firm or individual of the change in scope.

- 5.5 At the beginning of an investigation, and before seeking information and documentation from the firm or individual, the case team and the supervisors (where relevant) will – where appropriate – obtain from the FSA's own records any relevant information and documentation. This will minimise the need for duplication of existing material.

Experience of investigation teams

- 5.6 A number of those we heard from referred to the experience and ability of the FSA's Enforcement staff. Several noted the presence at the FSA of very able and experienced investigators and lawyers who bring a high degree of professionalism and understanding of financial services and markets to their work. At the same time, concerns were expressed at the turnover of FSA Enforcement staff, particularly at the more senior levels, but not confined to that tier, and at the lack of experience of the relevant business line of some staff involved in investigations.

- 5.7 These concerns echo some of the findings of the Practitioner Panel survey about FSA staff in general¹¹. The survey reported a sense of frustration on the part of practitioners at FSA staff's 'poor awareness of the way in which [practitioners'] businesses work' and criticised FSA staff for 'poor knowledge of [retail and wholesale] markets'. The FSA responded to these comments by highlighting that during 2004 the majority of staff recruited by the FSA joined from regulated firms. In addition, the FSA emphasised that it continues to hire senior practitioners from the industry as 'Grey Panthers' to share their knowledge and experience with regulatory staff. The FSA's response also mentioned that at any one time there are also around 100 staff either on secondment to the FSA from firms, or vice versa, and around 10% of staff studying for additional industry and professional qualifications. Overall, the FSA spends around £3 million per year on training to ensure that all staff have the skills and knowledge to understand and work constructively with the sectors and firms that the FSA regulates.
- 5.8 Table 2 below sets out the average length of FSA service of staff within the division and for the FSA as a whole, broken down by grade, as at end-April 2005. As can be seen, the Enforcement Division continues to be able to draw on considerable FSA experience, albeit in almost all cases at levels below the FSA average. It is important to note, however, that neither set of averages includes experience gained outside the FSA, which – for many staff in the Enforcement Division – is significant. It is also undeniably the case that senior management turnover in the Enforcement Division exceeded the FSA averages in both 2003/04 and 2004/05.

Table 2

Grade	Total in Enforcement Division	Average number of years at the FSA (or predecessor bodies)	FSA average
Head of Department	6	5.5	11.8
Manager	31	8.9	11.1
Technical Specialist	3	15.1	9.4
Associate	151	4.7	6.3
Business Support	57	6.0	6.4
Total	248	5.7	7.2

11 'Third Survey of the FSA's Regulatory Performance', published 16 December 2004, available at www.fs-pp.org.uk.

In terms of professional competency, 113 staff (including 15 paralegals) have a background in law and 97 work as forensic investigators (many with a background in accountancy).

- 5.9 The Enforcement Division has an established and comprehensive training and development programme. This comprises an enforcement core skills and processes training programme which has been designed and is delivered by experienced Enforcement staff. Although originally intended for new joiners to the division, it is now also being delivered to existing staff. Training in the underlying business activities of the firms regulated by the FSA is also provided. This is supplemented by training run by the professional competency groups for the division's lawyers and forensic investigators. A key component of this is to ensure that the division's staff keep abreast of the latest developments. External speakers are regularly invited in to cover the most topical issues in their sphere. All the division's internal training is accredited by both the Law Society and Bar Council.
- 5.10 Enforcement staff are encouraged to acquire relevant professional qualifications. Currently 27 staff have the Financial Planning Certificate (including two at advanced level), 19 have Securities Institute qualifications and four have the Investment Management Certificate.
- 5.11 In addition there is a programme of internal and external secondments. Staff from the Enforcement Division are seconded to other areas of the FSA, primarily to supervisory divisions, to gain first-hand experience of regulation. And staff from supervisory divisions are also seconded to Enforcement. As at end-April 2005, the Enforcement Division had ten of its staff seconded to other parts of the FSA and had three staff taken in from other areas. In addition, one member of the Enforcement Division was on external secondment and there were 11 secondees from other organisations, including two lawyers, six accountants and three who worked as investigators.
- 5.12 Despite the experience and expertise that Enforcement staff can bring to investigative work, it is clear that ongoing investigations will benefit from early input by those who are familiar with the type of business concerned, including from (former) industry practitioners. The work undertaken by the Review shows that there is scope to increase the use made of expertise outside the Enforcement Division. This will help focus the investigation and give an early view as to how the facts emerging from the investigation stand up against market practice and standards. Such expertise could be provided from within the Enforcement Division or from other parts of the FSA. For example, expertise from the Markets Division is often used in enforcement market conduct investigations. The Enforcement Division has already drawn on the expertise of the FSA's Grey Panthers – advisers who have extensive and senior experience of a variety of the businesses and markets which the FSA regulates – in the conduct of certain investigations. There is scope for this to be

increased and extended into coaching and mentoring of staff (as Grey Panthers do in other areas of the FSA), particularly as the FSA is currently recruiting additional Grey Panthers to its Retail and Wholesale & Institutional Markets Business Units. In addition the recruitment of a Grey Panther with experience of forensic accounting and complex investigations would increase the specialist resource available to the Enforcement Division. Such an individual would be a source of expert advice, but could also take on a more general coaching role for less experienced staff.

Recommendations

13. The Enforcement Division should continue to harness expertise from within the division and across the FSA, where relevant, for advice on the substance and focus of investigations.
14. The Enforcement Division should continue to draw on the expertise of the FSA's Grey Panthers and should look to recruit a Grey Panther with a background in forensic accounting and complex investigations.
15. The Enforcement Division should expand its internal and external secondment programme.

Involvement of supervisors during the investigation phase

- 5.13 As a general rule the supervisors of a firm are not directly involved in an investigation which is being pursued by Enforcement. This approach has its advantages in that it maintains a clear division between the conduct of the investigation on the one hand and the need to maintain the supervisory relationship with the firm on the other. The value attached to this division of responsibility comes across very clearly in some of the responses to the Issues Paper.
- 5.14 At the same time this division of responsibility may mean that the investigation does not benefit as much as it might otherwise do from the knowledge of the firm or individuals that the supervisor will have built up, nor from the general understanding of the firm's business or sector that the supervisor may be able to contribute.
- 5.15 This is an area in which the Review has concluded that it would be counterproductive to attempt to be too prescriptive. Instead, the following general considerations should be taken into account:
 - while it is clearly essential for the day-to-day supervisory relationship to continue during the course of any enforcement action, this need not, of itself, preclude a firm's supervisor from assisting in an investigation;

- such assistance will include making the case team aware of the firm's history and compliance track record, the current supervisory approach to the area concerned, the status of current issues and acting as a sounding board on questions that emerge from the investigation about industry practices and standards. All this is consistent with the responses to the Issues Paper which pointed to the need for the FSA to avoid calling on the firm to provide information which it already holds and for there to be sufficient understanding of market practices and standards available to the case team;
- equally, there may be circumstances in which information on the current supervisory approach to the area under investigation or current market standards and practices can be provided more effectively and efficiently by someone other than the firm's supervisor, for example from Markets Division in relation to market conduct cases. In this case, it makes good sense to draw on that other source of expertise;
- in the unlikely event that a firm's supervisor becomes part of the investigation team, the FSA should notify the firm of this in the normal way.

5.16 Throughout the investigation, the channel of communication for matters relating to the investigation will be from the case team to the firm or individual concerned. Nonetheless, it is important that the supervisor is kept informed of the progress of the investigation, and consulted in advance if there are significant developments or changes, unless there are very good reasons not to do so. This is both to ensure that any relevant history is made available to the case team and also that any implications for the continuing supervision of the firm are taken into account.

Keeping the firm or individual informed during the investigation

5.17 Some responses to the Issues Paper suggested that the case team should communicate better with the firm or individual as the cases progresses, thereby avoiding the impression that the 'shutters have come down'. At the same time, there was a recognition of the limits to how forthcoming the FSA could be on matters still under consideration or the subject of further investigation. The FSA's aim of being an open and responsive regulator is as relevant to enforcement as to any other area. When asked a specific question, the FSA's case teams should provide either an answer or an explanation why they are unable to do so.

Quality assurance as the investigation progresses

5.18 Many responses to the Issues Paper noted that the quality of any decision-making process depends heavily on the quality of the material – in particular the investigation report – supplied to the decision makers. Clearly the quality of the input will in part reflect the degree of quality assurance (QA) that is

provided as the investigation progresses. This QA has at least two aspects – to ensure that investigations that are not worth pursuing are dropped as soon as this becomes apparent, and to focus investigations on the most important aspects of a case.

- 5.19 The FSA recognises the importance of having a robust and effective challenge and QA process for investigations. This was considered extensively as part of the recent End-to-End Review (including subjecting all cases to an early focused review). At present, there is a QA process within the Enforcement Division in which the Project Sponsor (usually a Head of Department, but sometimes a Manager) has a key role to play. The Enforcement Management Committee (EMC)¹² has an additional challenge and monitoring role, focusing in particular on the more resource-intensive and complex cases.
- 5.20 The Review has concluded that there is scope to do more here, including adopting some of the ‘hot review’ and ‘four eyes principle’ approaches that characterise the way in which many accountancy and consultancy firms carry out QA of higher risk assignments. However, any changes in this area would certainly entail additional costs for the FSA and could well have structural implications for the Enforcement Division. Consequently, the structure of any additional QA during the conduct of an investigation will be addressed by the incoming Director of Enforcement.

The draft investigation report

- 5.21 A number of the responses to the Issues Paper underlined the importance of the practice of sending firms or individuals copies of the draft investigation report. This is seen to provide an essential safeguard in that it enables firms to correct any factual errors in the draft report.
- 5.22 Respondents also suggested that the draft investigation report should make clear the rule breaches which form the basis of the FSA’s proposed actions. In the absence of such information it is claimed that firms may be unwilling to provide comments at this stage for fear that they will be ‘perfecting the case against themselves’.

Recommendation

16. The FSA should continue to send draft investigation document(s) setting out the facts found by the investigation and the rule breaches alleged to those who are the subject of investigation for their comments. The FSA should publish criteria which set out when it will depart from this practice.

12 EMC consists of the Director of Enforcement and the Enforcement Heads of Department

Legal review

- 5.23 A number of responses to the Issues Paper stressed the importance of a proper legal review of a case being undertaken before the case is referred to the decision makers. Some suggested that such a review should be undertaken by lawyers wholly outside the Enforcement Division. Others suggested that the Division be split between those who investigate and those who review the product of the investigation.
- 5.24 At present, legal review of a case is usually conducted by the case lawyer(s), who have often been involved in the matter throughout the investigation. In the more complex cases, outside counsel may be engaged. The Review considers it important that there is proper legal support for the investigation. However, lawyers that have been intimately involved in the investigation from the start may lose the necessary degree of detachment to give a genuinely objective view of a case. We therefore recommend that a legal review of a case be undertaken before the case is referred to the RDC, by lawyers who have not been part of the investigation team. The precise nature and extent of such a review clearly will vary according to the nature and complexity of the case. In the more complex cases, much of this role may be performed by outside counsel. We would expect the lawyers who conduct the legal review usually to be concerned with the further conduct of the matter before the RDC and ultimately the Tribunal. This helps ensure that the review is conducted by those with adequate experience and that it is done with due thoroughness.

Recommendation

17. There should be a legal review of a case before it is referred to the RDC by lawyers who have not been part of the investigation team.

Involvement of FSA senior management in cases under investigation

- 5.25 A number of responses to the Issues Paper argued for greater involvement of FSA senior management in the enforcement process (i.e. as cases progress from supervision through the Enforcement Division, but before they enter the RDC mechanism). This was regarded as a very important element of the overall control and monitoring framework.
- 5.26 Clearly at present the FSA Chairman and senior management (defined in this case to mean the Chief Executive and the three Managing Directors) do become involved in individual cases. The frequency and extent of this will depend in large part on the seriousness, complexity and profile of the case. It is important that this involvement should continue.

5.27 The Review sees benefit in there being a clear framework for the escalation of cases to senior management, while recognising that ultimately a degree of judgment will be required. Our view is that a case should be escalated if it is high impact, precedent-setting, or requires significant commitment of FSA resources. Each of these has several facets: a case can be high impact in terms of the number of consumers involved, the scale of potential detriment or market impact, the size or reputation of the party involved or the size of the financial penalty proposed. Or it may be high impact in terms of risk to the FSA's reputation (in particular the degree of legal risk, including the likelihood of success or the likelihood of possible litigation against the FSA). A case can be precedent-setting in terms of the FSA policy to which it relates, the size or nature of the penalty sought by the FSA Executive, or the underlying legal principles involved. Finally, commitment of FSA resources can relate to either direct or indirect resources; examples of the latter would be the hiring of skilled persons, consultants or outside counsel. These factors are reflected in the recommendation below.

Recommendation

18. A case should be escalated during investigation stage to FSA senior management if the case is high impact, precedent-setting, or requires significant commitment of FSA resources.

5.28 Cases which are escalated according to the framework described above will, in effect, form a list of 'priority cases'. It is important that senior management reviews this list periodically, to complement the QA reviews that take place within the Enforcement Division. This will help ensure that these cases are reviewed in the light of the FSA's overall priorities.

Recommendation

19. The FSA's Executive Committee should review periodically the list of all outstanding cases that meet the escalation criteria.

5.29 As in relation to the FSA Board's oversight function (see recommendations 1 and 41), we recommend that senior members of the FSA Executive consider regularly the FSA's overall use of enforcement. This exercise would include consideration of the outcomes of cases, including those that have settled.

Recommendation

20. The FSA's Executive Committee should review periodically how effective the enforcement function has been, including the referral process, and the outcome of cases, including those that have settled.

Feedback on the conduct of investigations and subsequent decision-making

- 5.30 The firms and individuals which have participated in this Review or responded to the Issues Paper have welcomed the opportunity to make known to the FSA their views about the enforcement process, in particular which aspects have worked well and less well. These comments have made a significant contribution to the recommendations which we have made.
- 5.31 It is important that the FSA should continue to benefit from such comments and feedback on a continuous basis so that any learning points can be reflected in its processes and procedures sooner rather than later. The usual conduit for such feedback for relationship-managed firms should be a meeting between the CEO of the firm involved in the case (or the individual in cases involving only individuals) and a senior member of the FSA's staff who has not been directly involved in the case. This should allow a full and frank exchange of views between the parties at a senior level. This discussion may also be used by the FSA to give its views on the conduct by the firm or individual during the case. These discussions will also be a major component of the new accountability framework (see section 8). We would not expect such a meeting to take place if a case was discontinued at a very early stage.

Recommendation

21. No later than two months after the conclusion of an enforcement case, the FSA should usually give those concerned the opportunity to comment on their experience of the FSA's enforcement procedures and subsequent decision-making. This will concentrate on the handling of the practical and procedural aspects of the case by the FSA staff and decision makers, not on the outcome of the case.

Skilled person reports

- 5.32 Seven responses to the Issues Paper made comments about the use of skilled person reports, as defined under s166 of FSMA.
- 5.33 These comments have highlighted the importance of being clear from the outset about the nature and purpose of the report being commissioned, in particular as to whether the output may ultimately be used in enforcement

proceedings. This clarity is important in its own right, but the answer also has an impact on the nature and quality of the evidence required to support a skilled person report's conclusions when it is to be used in such circumstances. One response questioned whether it is an appropriate use of s166 reports effectively to outsource 'investigative' work.

- 5.34 The use of skilled person reports must be compatible with the circumstances envisaged by s166 of FSMA and with the further guidance set out in the Supervision and Enforcement manuals. The SUP5.3 and ENF2.3.11 sections of the FSA Handbook set out the wide range of circumstances for which a skilled person report may be suitable. The use of such a report for investigative (i.e. information gathering) purposes is, in the FSA's view, clearly contemplated both by FSMA and its own guidance. That said, the FSA makes relatively sparing use of skilled person reports (a comparatively expensive regulatory tool) overall, and particularly for enforcement purposes. Accordingly, since N2 there have been 84 skilled person reports of which the Enforcement Division has initiated only six.
- 5.35 We recognise the need for clarity from the outset as to both the scope of the skilled person report and also the purpose to which the results of the report are likely to be put. This should be straightforward for those reports which are either initiated directly by Enforcement or by one of the supervisory divisions in conjunction with Enforcement. In these circumstances the FSA will make it clear both to the firm and the skilled person the nature of the concerns that have given rise to the decision to appoint a skilled person and to the possible use of the results of the report. This will enable a discussion to be held, before the work begins, about the record-keeping and evidence needed to support the conclusions of the report.
- 5.36 However, it is conceivable that a report which is commissioned by one of the supervisory divisions for purely diagnostic purposes identifies issues which the firm or skilled person believes could affect the future direction of the work, possibly leading to enforcement action. The statistics indicate that this is rare: of the 84 skilled person reports since N2, only two of those commissioned by supervisory areas subsequently resulted in enforcement action¹³.

Recommendation

22. While work on a skilled person report is in progress, there should be regular liaison meetings between the firm, skilled person and the FSA to identify any material new information which might affect the future direction of the work, consistent with SUP 5.5.4G. If necessary the firm's supervisor should involve Enforcement at an early stage and agree with them what the appropriate response is to the change of circumstances.

13 For these purposes, 'enforcement action' is defined as cases that have resulted in a Final Notice.

- 5.37 This recommendation will enable the FSA, in conjunction with the firm and skilled person to decide on whether changes need to be made to the scope of the work, or indeed whether the matter should be investigated by FSA staff.

Drawing conclusions from skilled person reports

- 5.38 The initial discussions between the FSA and the firm which lead to the production of the scope of the skilled person report will cover the nature of the opinion which the skilled person will be required to give. It is important to be clear that the presence of an opinion from a skilled person does not relieve the FSA from reaching its own decision regarding a firm's compliance with a particular set of rules. But such an opinion will of course inform the FSA's own decision-making.
- 5.39 In some cases a skilled person report will be used to assess whether or not compensation is due to a class of customer (who may have been mis-sold a particular product) or whether the amount of compensation has been properly calculated. In this event, the FSA would expect to be able to rely on the contents of the report, or supplement it with additional work of its own if necessary.
- 5.40 The FSA has looked very carefully at the comments made by the Tribunal in the Legal & General case and will take these into account, where relevant, in the scoping of future skilled person reports. In particular, the FSA is considering which approaches and methodologies to adopt for work that may require a statistically significant sample.

Consistency of approach to skilled person reports

- 5.41 Some responses to the Issues Paper noted that the approach to skilled person reports and the clarity of scoping etc can vary considerably depending on who in the FSA has commissioned them. There have also been suggestions that, on occasion, reports are commissioned informally when use of the formal s166 power would be more appropriate.
- 5.42 The FSA's own internal procedures are designed to ensure consistency of approach in the use of skilled person reports. In particular they stress that if information is required which is best obtained through a skilled person report, then that route should be favoured over any other route. This is because of the control which s166 gives the FSA over the scope of the report, the FSA's right of access to it and any underlying working papers and the co-operation and disclosure requirements which attach both to the firm and third parties.
- 5.4 It is important that any concerns about inconsistent approaches being adopted by different parts of the FSA or any departures from the FSA's stated policies are brought to the FSA's attention. The relevant feedback mechanism is the annual meeting which the FSA aims to have with the main firms used for skilled person work. If any serious concerns emerge that cannot wait for these

meetings, they should be raised with the relevant supervisor, who can ensure that the points are transmitted to the FSA's policy expert on skilled person reports.

Private warnings

- 5.44 Many enforcement investigations do not result in sanctions and are discontinued. However, in some instances, the FSA will give the firm or individual a private warning in accordance with section 11.3 of the Enforcement manual. A private warning does not constitute a determination against a firm or individual that misconduct has occurred or a requirement has been breached. Private warnings are not only issued following an enforcement investigation and can be issued by supervisors. The Review does not recommend any change to the practice of issuing private warnings.
- 5.45 Enforcement have for over a year been operating a 'minded to' procedure on the issue of private warnings to improve the fairness of the process. This involves the FSA setting out its concerns to the firm or individual concerned, stating that it is minded to issue a private warning, and inviting comments. This procedure is dispensed with if the substance of the FSA's concerns has already been put to the firm or individual concerned and comments invited (for example, by the provision of a draft investigation report). The Review recommends that this procedure be adopted across the FSA for private warnings and that such letters should be approved by a Head of Department.

Recommendation

23. The FSA should apply a 'minded to' procedure to the issue of private warnings across the FSA. Private warnings should be approved by a Head of Department

6 Decision-making

Background

- 6.1 The Review has looked in detail at the FSA's processes for making regulatory decisions, in particular those concerned with enforcement. These decisions are currently taken by the RDC. Such processes need to comply with FSMA and we have borne in mind throughout that they must be fair, and seen to be fair, as well as being efficient and effective.
- 6.2 FSMA requires the following:
- the FSA must first give a **warning notice** to the person (that is the firm or individual) concerned, setting out the action the FSA is proposing to take and the reasons for it. In most cases, 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 to issue the notice;
 - following the warning notice, the FSA must allow the person concerned at least 28 days in which to make **representations**;
 - following the representations, 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**, 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; and
 - within 28 days of the decision notice, the person concerned may refer the matter to the independent **Financial Services and Markets Tribunal**. This is not an appeal against the FSA's decision; rather, the Tribunal considers the whole matter afresh and decides what the appropriate action is for the FSA to take.
- 6.3 All that FSMA requires concerning the decision-making procedures for the issuing of warning and decision notices is that 'the procedure must be

designed to secure, among other things, 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'¹⁴.

6.4 Although FSMA gives considerable flexibility to the process, it does set out some important constraints. In particular, there are the following consequences:

- the FSA must issue a warning notice and this notice must not only set out the proposed action (including, for example, the size of any proposed penalty) but also the reasons for it. A warning notice cannot therefore merely consist of the 'charges' that the FSA is pursuing and leave the penalty and reasons to the decision notice stage. It is therefore very different to an indictment in criminal proceedings or a statement of claim in civil proceedings;
- the decision must be taken by the FSA, not by some other body. The FSA cannot therefore simply decide there is a case to answer and leave it to the Tribunal to resolve the issue in the absence of agreement. In addition, the FSA cannot confer the decision on an independent body. FSMA requires these functions to be 'discharged by a committee, sub-committee, officer or member of staff of the [FSA]'¹⁵. Any decision-making body must therefore be part of the FSA and cannot be entirely independent of it.

6.5 FSMA does not therefore allow a system whereby the FSA pursues its cases before an entirely independent body, in a similar way to a criminal prosecution before the courts. The FSA is required to take these decisions itself. Clearly, the process by which it does so must be fair. However, that does not mean that its internal process can or should operate like a tribunal. It is easy to fall into the trap of thinking of the RDC (or any other decision maker) as a tribunal, akin to an independent body making a judicial determination between two sides: the FSA staff and the firm or individual. The decision maker must be part of the FSA and take a decision on behalf of the FSA, not make a determination as between two or more parties. If the firm or individual wishes to challenge the FSA's decision, it can refer the matter to the Tribunal. The FSA staff cannot refer the matter to the Tribunal: the decision maker is making the decision on behalf of the FSA and the FSA cannot challenge its own decision.

Current procedure

6.6 Before setting out the Review's recommendations for changes to the existing process, it is necessary to explain briefly the current procedure. The FSA's decision-making procedures are set out in the decision-making manual (DEC),

14 See section 395(2) FSMA.

15 See FSMA Schedule 1 paragraph 5. In our view, paragraph 6(2) (which permits some functions to be performed on behalf of the FSA) does not relate to decisions to issue statutory notices.

part of the FSA's Handbook. Those decisions which have the greatest impact on the person involved, such as imposing a financial penalty, are taken by the RDC. The RDC is a committee of the FSA's Board to which it is accountable, and its members are appointed by the Board. It consists of a Chairman, one or more Deputy Chairmen and other members. Apart from the Chairman, none of the other members is an FSA employee and the RDC operates outside the FSA's management structure (see section 8).

- 6.7 The members of the RDC represent the public interest and comprise current and recently retired practitioners with financial services industry skills and knowledge, and non-practitioners. Members of the RDC do not therefore represent particular stakeholder groups but are all required to make appropriate regulatory decisions in the public interest, bringing to bear their particular skills and experience.
- 6.8 When the RDC started in December 2001, there were 40 members (plus the Chairman), organised into four groups of ten. This proved to be too many for the volume of work that arose and there was a substantial reduction in numbers in 2003. In addition to the Chairman, there are now 24 members (including three deputy chairmen), organised into three groups of eight who generally meet one day per month. Warning notice decisions are usually taken by the group of eight (plus a chairman), with a smaller panel of around three drawn from the wider group considering the matter at decision notice stage. Details of the current membership with short biographies are on the FSA's website¹⁶.
- 6.9 The current procedure for an enforcement case at the RDC stage is broadly as follows:
- if Enforcement staff consider that action is justified following an investigation, the matter is presented to the RDC to decide whether to issue a warning notice. An investigation report (setting out the facts found), the firm or individual's response to the draft investigation report, a case review paper (giving legal and policy advice, as well as material on penalty) and a draft warning notice are provided to the RDC members in advance of a meeting with Enforcement staff. The underlying documents are not usually provided but are available if necessary. The decision whether or not to issue a warning notice is taken by the RDC following a meeting with Enforcement staff. The settling of the warning notice is usually delegated to the RDC Chairman;
 - the warning notice, together with the investigation report, the underlying documents (but not the case review paper or draft warning notice shown to the RDC) are then provided to the firm or individual concerned. The firm or individual can make written representations on the matter and

16 www.fsa.gov.uk/pages/about/who/accountability/rdc/rdcml/

arrange to make oral representations direct to the RDC. Enforcement will provide a written commentary on the firm or individual's written representations to the RDC but much of this is not usually disclosed in advance of the oral representations meeting. Sometimes a supplemental case review paper is given to the RDC, consisting of further legal and policy advice, but this is not disclosed to the firm or individual;

- the firm or individual makes oral representations direct to the RDC panel with Enforcement staff present. The RDC (and sometimes Enforcement staff through the RDC Chairman) will ask any questions necessary to clarify the representations made but will not seek to challenge the representations, cross-examine the person concerned or give any response to what is said. After the firm or individual has left and following any private deliberations by the RDC, the panel will meet again with Enforcement staff to discuss its provisional views and to ask Enforcement any questions the panel may have. The panel will then decide whether to issue a decision notice and will again usually delegate the settling of the notice to the Chairman.

The decision makers

- 6.10 The Review has considered whether the FSA should retain a decision-making body like the RDC, comprising decision makers who are not otherwise involved in the FSA. We have concluded that a committee like the RDC remains the appropriate model. Members of the RDC provide valuable knowledge and experience in the cases they consider. It is important that members of the RDC continue to act as decision makers themselves. If they were to act solely as advisers to others, we do not believe the FSA would get the same level of commitment and engagement. Responses to the Issues Paper showed strong support for RDC members continuing to act as decision makers rather than as advisers.
- 6.11 When the RDC was set up, the FSA was concerned that there should be a balance between 'practitioners' and 'non-practitioners' to prevent any impression that decisions would be dominated by any particular interest group. In practice, the RDC has not operated in a factional way. Decisions have been reached by consensus, with all members contributing to achieving the best possible decision, rather than pushing a particular position or standpoint. Some responses to the Issues Paper expressed concerns that there is not enough representation on the RDC by consumers or smaller firms. In our view, the overriding objective is that RDC members have the right skills, knowledge and experience to make the best regulatory decision and that it would be a mistake to have quotas or representatives of particular interest groups. We are however recommending some changes to composition (see below) and at that time, the FSA can consider applications from any suitable candidates.

- 6.12 The current arrangement of fixed standing groups, with eight deciding on the issue of warning notices and a smaller panel drawn from that at decision notice stage, assists diary management, in particular the timing of the oral representation meeting (usually) two months after the warning notice decision. However, we believe that this structure does not allow enough flexibility in putting together the most suitable panels to consider particular cases. In addition, a panel of eight is too many for the warning notice decision. Instead, we recommend that more discretion be given to the Chairman or Deputy Chairman to determine the appropriate panel size at both warning and decision notice stage. Such an approach is already being adopted by the RDC in some complex cases. We also do not consider that it is necessary for there to be an equal number of ‘practitioner’ and ‘non-practitioner’ members on any particular panel (although there should not be a total absence of one or the other).
- 6.13 It is important that RDC members have enough work to have relatively frequent involvement with RDC business. Otherwise there is an increased risk of inconsistency in decision-making and less familiarity with the issues that arise. We therefore recommend that the number of RDC members be reduced to around 16 from the current 24. All current members’ terms expire in November. It will be important to maintain some continuity from the current membership while at the same time recruiting some new members.

Recommendations

24. The number of RDC members should be reduced, from the current 24 to around 16. There should be some continuity in membership following the expiry of current terms in November 2005. New members should be recruited through an open competitive process.
25. The current rigid group system should not continue. The RDC Chairman or one of the Deputy Chairmen should select RDC members for any particular case based on the appropriate mix of skills and experience required.

Increased separation and transparency

- 6.14 As we explained above, the RDC is not an independent body or a tribunal but part of the FSA. Nevertheless, because the RDC is separate from the FSA Executive and because firms or individuals can make oral representations to the RDC, many expect it to operate with some of the characteristics of a court or tribunal. The elements of the current procedure that have therefore come under considerable criticism are:

- the giving of confidential legal advice by Enforcement to the RDC (and the non-disclosure of the case review paper to the firm or individual);
- the non-disclosure of other communications between Enforcement and the RDC (e.g. at the warning notice stage and commentary on written representations is not usually disclosed until the issue of the decision notice);
- the discussions that take place between Enforcement and the RDC in the absence of the firm or individual following oral representations; and
- the lack of explanation in the decision notice as to how the RDC has dealt with the key points made by the firm or individual.

6.15 What fairness requires (and what is provided for in FSMA) is that the person concerned is aware of the case to be met (by receipt of the warning notice, setting out the reasons for the proposed action), sees the evidence on which it is based and is able to make representations. The current procedure meets these requirements in full. However, in matters as contentious as the imposition of significant public sanctions, the current procedure has come under considerable strain and often leaves those subject to it with a sense of unfairness. This perception has been very apparent to the Review, both from the responses to the Issues Paper and in our discussions with interested parties. We consider it highly desirable to have a system that does not just comply with the law but also does not leave those who are subject to it with any justifiable sense that they have been dealt with unfairly. It is nevertheless important that any procedure remains efficient and effective and does not become indistinguishable from a trial before a tribunal.

6.16 The package of the Review's recommendations in this area seeks to increase separation between Enforcement staff and the RDC and ensure complete transparency as to communications between them.

Recommendations

26. All substantive communications between the Enforcement case team and the RDC (whether oral or written) should be disclosed to the firm or individual. Enforcement should no longer provide legal advice to the RDC but make legal submissions that are disclosed.

27. The RDC should have its own small dedicated legal function, as part of the RDC secretariat. This function should assist the RDC to finalise draft warning notices and to draft decision notices, ensure that any substantive communications with the Enforcement case team are recorded and disclosed, assist the RDC in considering the case and underlying material and provide any legal advice required.

28. The Enforcement case team should no longer meet with the RDC following the oral representations meeting. Instead, oral representations should be conducted on a more interactive basis.
29. Decision notices should set out how the RDC has dealt with the key points made by the subject of regulatory action.

- 6.17 These recommendations will remove one of the key concerns about the current system: the non-disclosed case review paper. There will no longer be a non-disclosed case review paper. Any legal and policy points that the Enforcement case team wish to make will therefore be disclosed to the firm or individual. The only exceptions to this will be comparative penalty material which is not yet public (where anonymised material could be provided) and the extremely rare cases where material would be protected by public interest immunity (for example, very sensitive material about informants or whistleblowers). In addition, the RDC, with the assistance of its legal function, will have unambiguous responsibility for finalising warning notices and drafting decision notices. All substantive communications between the Enforcement case team and the RDC legal function will be disclosed. Discussions that take place between the RDC legal function and the RDC will not be disclosed to either the subject of regulatory action or the Enforcement case team. This means that the RDC will need to ensure that it does not rely on any new points raised by the RDC legal function that are not put to the Enforcement case team and the firm or individual. The RDC legal function will also assist the RDC in taking an impartial and objective view of the case, enabling a greater degree of challenge to the case presented by Enforcement than can be done at present. It is not however intended to duplicate the legal review carried out within Enforcement (see recommendation 17).
- 6.18 The RDC will remain master of the precise procedure to be adopted in any particular case. This is particularly important at the oral representations meeting. Our expectation is that such meetings should not become overly formal or adversarial. Witnesses will not be heard at such meetings: this would make the process indistinguishable from a trial in the Tribunal. We expect that the RDC will, when it considers it appropriate, give an indication before or at the start of the meeting of the points that it considers the most important or that it wants clarified. All the key issues should have already been canvassed in the firm or individual's written representations and Enforcement's response. The Enforcement case team will also have a more active part to play in these meetings than currently. In some instances, it may not be possible for a particular point to be dealt with at the meeting, in which case it can be dealt with subsequently in writing (with disclosure). The proper running of these meetings will demand a considerable amount of co-operation

from both the subjects of regulatory action (and their advisers) and the Enforcement case team to avoid undue formality.

- 6.19 The drafting of press releases will remain the preserve of the Executive but in order to ensure that these are not inconsistent with the decision made by the RDC, we recommend that they be approved by the RDC Chairman or relevant Deputy.

Recommendation

30. Press notices should be approved by the RDC Chairman or relevant Deputy.

Composition of panels

- 6.20 Some have argued that those who decide on the issue of the warning notice should be entirely different from those who decide on the issue of the decision notice. This is principally because of a perception by some that the decision makers have made up their minds about the matter at the warning notice stage, before the subject of regulatory action has a chance to meet the RDC. The Review has considered the following permutations:

- the warning notice decision is taken by the Executive, the decision notice decision is taken by the RDC;
- both decisions are taken by the RDC with identical panels;
- both decisions are taken by the RDC but with entirely different panels;
- both decisions are taken by the RDC but additional members are added to the warning notice panel at the decision notice stage.

- 6.21 We have found this one of the most difficult issues to resolve. Although Executive decision-making at the warning notice stage has attractions, we do not think this is desirable or practicable for enforcement decisions. Entirely separate RDC panels would similarly give rise to significant practical problems in the operation of the RDC. As, under this model, the RDC Chairman would only be able to participate at one stage or the other, it would make it very difficult for him to perform his role. However, we do see advantage in bringing in fresh members at the decision notice stage and recommend that this be the usual practice in cases where representations are made.

- 6.22 The other recommendations we have made should remove any perception that the RDC has made a final decision at the warning notice stage. The disclosure of everything that is put by Enforcement to the RDC (including the draft warning notice), the more interactive oral representations meeting and the requirement that the firm or individual's key points are dealt with in the decision notice all assist. It is current practice to disclose to the RDC the

unedited version of the firm's response to the draft investigation report. This is necessary in order to deal with any complaint that the firm or individual's position has not been made clear to the RDC at the warning notice stage. This practice should continue: in all cases any response the firm or individual submits to draft documents (such as the investigation report) should be provided in full to the RDC so that it is able to see directly and unedited the points being made by the firm or individual.

- 6.23 We would usually expect the warning notice decision to be taken by the Chairman or Deputy together with two RDC members. DEC sets out a quorum requirement of two members, plus the Chairman or Deputy. We recommend that in straightforward cases (such as simple cases involving threshold conditions), the decision be taken by the Chairman or Deputy alone or with one other. For cases where representations are made, the decision notice panel would usually then have two members in addition to the Chairman or Deputy. The final decision on composition would be up to the RDC Chairman or Deputy.

Recommendations

31. The RDC Chairman or Deputy alone or with one other should be able to take decisions in straightforward cases. **CONSULTATION REQUIRED**
32. The composition of RDC panels should be a matter for the Chairman or Deputy. The warning notice panel should usually consist of the Chairman or Deputy plus two others. In cases where representations are made, the warning notice panel should usually be supplemented by two new members at the decision notice stage. If no representations are made, the warning notice and decision notice panels would usually be the same.

Authorisation and approval cases

- 6.24 The other major category of matters that are decided by the RDC apart from those from the Enforcement Division are authorisation and approval rejections from the Regulatory Transactions Division (RTD). RTD deals with applications by firms for authorisation and for the approval of persons to perform controlled functions. If the FSA decides to grant such applications, this is done at staff level. However, if RTD decides to reject such applications (for example, because it is not satisfied that the applicant is fit and proper) then the decision is taken by the RDC. These cases are significantly different from enforcement decisions. These are applications to the FSA for the grant of authorisation, approval or permission, as opposed to the FSA imposing some constraint or sanction on a firm or individual for misconduct or because they are no longer fit and proper. The statutory test

is therefore different. For example, the FSA may grant an application for approval only if it is satisfied that the candidate is a fit and proper person to perform the function in question. In an enforcement matter on the other hand, for the FSA to withdraw approval, it must show that the person in respect of whom approval was given is not a fit and proper person to perform the function in question. The other main difference from enforcement cases is that the FSA is not required to disclose documents in authorisation and approval cases unless and until the matter reaches the Tribunal.

- 6.25 Apart from more straightforward rejection cases, applications are considered by a senior staff committee, the Regulatory Transactions Committee (RTC) before they are considered by the RDC. General Counsel's Division (GCD) provides advice to the RTC and assists RTD staff in presenting rejection cases before the RDC. If the matter reaches the Tribunal, it is then handled by the Enforcement Division. Apart from the warning and decision notices, no other disclosure is usually given to the applicant during the RDC process.
- 6.26 The Review considers that the efficiency and fairness of this process could be improved in two respects. First, the Executive should make the warning notice decision (through the existing RTC) with the RDC considering the applicant's oral and written representations and making the decision notice decision. Second, the material that is provided by RTD to the RDC should be disclosed to the applicant. This will enable the applicant to understand in more detail than is set out in a warning notice the reasons why the FSA is not satisfied that the requirements for authorisation or approval have been met. This does not mean that there should be an elaborate and expensive disclosure exercise (which has to take place if the matter reaches the Tribunal). It simply means that the selection of documents and points made to the RDC should be disclosed to the applicant. GCD should continue to assist RTD with such cases but the RDC legal function should assist the RDC at the decision notice stage as for enforcement cases.

Recommendation

33. In authorisation and approval decisions, the warning notice decision should be taken by the Executive and the decision notice decision by the RDC. The material provided by RTD to the RDC in such cases should be disclosed to the applicant before the applicant is required to submit representations. **CONSULTATION REQUIRED**

Other regulatory decisions

- 6.27 The Review has considered the other statutory regulatory decisions that are set out in DEC 2 Annex 1. We do not recommend that the split between

Executive Procedures and the RDC be altered in relation to these other decisions. In particular, we have concluded that decisions concerning change in control should continue to be taken by Executive Procedures. However, there are sometimes cases where at the time a decision on change in control is being taken there is also a parallel application for approval. For example, an individual may attempt to take over a firm and at the same time the firm may apply for approval for that individual to perform the role of a director. If the FSA is not satisfied that that individual is fit and proper, it will want to reject the change in control application as well as reject the approval application. The approval rejection will be decided by the RDC but the change in control decision by the Executive. In order to avoid possible complications in the rare cases where this arises, we recommend that in such cases the FSA Executive have discretion to refer the change in control decision to the RDC.

Recommendation

34. Change in control decisions should continue to be taken by Executive Procedures. In cases where there is a parallel approval rejection being considered by the RDC, the Executive should have discretion to refer the change in control decision to the RDC. **CONSULTATION REQUIRED**

7 Settlement

Background

- 7.1 Most enforcement cases settle, either before the issue of a warning notice, between warning and decision notice or even during Tribunal proceedings¹⁷. It is in the public interest for matters to settle (and settle early) if possible. Enforcement investigations and proceedings can be very resource intensive and time consuming for both the firm or individual concerned and the FSA. Settlement results in consumers obtaining compensation earlier than would otherwise be the case, the saving of FSA and industry resources, in messages getting out to the market sooner and assists in a public perception of timely and effective action. These settlements are not the same as ‘out of court’ settlements in the commercial context. An FSA settlement is a regulatory decision, taken by the FSA, the terms of which the firm or individual concerned accepts. The FSA must therefore have careful regard to its statutory objectives when agreeing the terms of a settlement. Redress to consumers who may have been disadvantaged by a firm’s misconduct is particularly important in this respect. FSA settlements also result in publicity (as opposed to commercial out of court settlements, which are usually confidential).
- 7.2 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), currently the RDC must make that decision. Because of this, FSA staff consult the RDC to obtain ‘settlement parameters’ during settlement negotiations and try to seek agreement with the firm or individual within those parameters. If agreement is reached, a settlement agreement is signed that provides for the issuing of a decision notice by the RDC in an agreed form. Settlement is also possible following mediation. In some difficult cases, mediation has proved successful in achieving agreement where negotiations have failed.

¹⁷ Since October 2003, around 80% of disciplinary cases that resulted in a financial penalty have been concluded by settlement. (Threshold conditions cases are not ‘disciplinary cases’ for these purposes.)

The identity of the decision maker in settlements

- 7.3 Generally, the settlement process works well. However, the way the RDC is involved in the settlement process has given rise to problems. Some responses to the Issues Paper expressed a concern that the RDC is tainted or compromised by its involvement in settlement negotiations if the negotiations break down and the RDC then has to decide the matter on a fully contested basis. Negotiations between Enforcement staff and the firm cannot therefore take place on a 'without prejudice' basis with respect to the RDC. In addition, some firms complain about lack of access to the decision makers: negotiations take place with FSA staff (perhaps at a very senior level) but the firm is not party to the discussions that take place between FSA staff and the RDC concerning the terms of any settlement. This is particularly acute in mediations, where a member of the RDC does not attend the mediation but is available on the telephone to discuss settlement terms with FSA staff.
- 7.4 We asked in the Issues Paper whether settlement should be the sole preserve of the Executive and the RDC should be involved only in the absence of agreement. Responses on this have been mixed, with some supporting Executive settlement decisions but many considering the continued role of the RDC in settlements to be important.
- 7.5 The Review has considered this issue carefully and has concluded that the RDC should no longer take decisions on statutory notices that result from settlement. Instead, such decisions should be taken by the Executive by means of two decision makers of at least director of division level (one of whom would usually be the Director of Enforcement). In particularly important cases, the Managing Directors, the Chief Executive or even the Board could become involved. We have reached this conclusion principally because of our recommendations for increased separation and transparency between the Enforcement Division and the RDC. That separation would immediately be breached if the RDC were to become involved in settlement discussions where the case does not ultimately settle. Involving the RDC in settlement discussions also means that it is not possible for Enforcement and the firm or individual to have discussions 'without prejudice' to the RDC. If the RDC is not involved in settlement discussions then it would not be told about the content of such discussions or even know in most instances that they had taken place¹⁸. If the RDC remained involved in settlements, it would be very difficult for Enforcement to continue to have discussions with the RDC about the outcome or progress of negotiations if the content of such discussions were disclosed to the firm or individual. Executive decision-making in this area will also allow the party concerned to have direct access to the decision makers during negotiations or a mediation.

18 The RDC might know about the fact of negotiations if Enforcement or the firm told the RDC about them in the context of extending time limits for making representations or wanted to delay the issue of a decision notice to give settlement discussions a chance. However, what was said in such discussions would not be disclosed and would remain 'without prejudice'.

- 7.6 We have considered whether the RDC could retain some role in settlements, for example to approve the final terms reached. We do not see this in practice as any different from the current system. Either the RDC will effectively ‘rubber stamp’ the settlement (meaning that it is not adding anything to the process) or there is the possibility of it rejecting the proposed settlement. The possibility of rejection is the reason for involving the RDC in the discussions as now and in the process of seeking parameters.
- 7.7 It will be important to ensure that there is consistency between the terms reached by the Executive in settlements and the decisions made by the RDC in contested cases. The Review therefore recommends that regular discussions take place between Executive decision makers and the RDC to discuss completed cases to improve consistency of approach in the future.
- 7.8 We do not believe that these proposals will put increased or unfair pressure on firms or individuals to settle or mean that the terms of proposed settlements will be unfair or inappropriate. As explained above, the FSA Executive will have to have careful regard to all of the FSA’s statutory objectives when agreeing to the terms of settlements. Executive decision makers will be able to obtain advice on these matters from Enforcement or other FSA staff. The full RDC process and ultimately the Tribunal are available in cases where agreement is not reached. Settlement on appropriate terms will continue to be possible at all stages of the process.

Recommendation

35. Settlements should be approved by two Executive decision makers of at least director of division level, leaving the RDC to decide cases that are contested. The content of settlement discussions should not be disclosed to the RDC in the absence of agreement between the FSA Executive and the firm or individual concerned. **CONSULTATION REQUIRED**
36. There should be regular discussions between Executive decision makers and the RDC about decisions reached in completed cases to ensure consistency in levels of penalty in cases.

Multiple parties and third party rights

- 7.9 Enforcement cases often involve multiple parties, for example a firm and individuals in the firm. Enforcement action may be appropriate against both the firm and the connected individuals or against just the firm or against just the individuals. In these cases, it is often possible to reach agreement with some parties but not all. For example, early agreement with the firm may be possible but the individuals may wish to contest the matter, ultimately in the Tribunal.

- 7.10 Even where action is not taken against connected parties, these parties may have what are called ‘third party rights’ under FSMA. Broadly, if any of the reasons contained in a warning notice or decision notice identifies a person (the third party) other than the person to whom the notice is given, and in the opinion of the FSA, is prejudicial to the third party, a copy of the notice must be given to the third party. The third party has the right to make representations and ultimately can refer the matter to the Tribunal.
- 7.11 In practice, third party rights have not caused undue difficulty for settlements. This is because third party rights either do not arise at all because of the way the notice is drafted or the third party has agreed not to exercise such rights. On very rare occasions, the FSA has reached settlement with the firm but has been unable to agree the form of the notice with the third party. This means that the settlement cannot be completed or implemented until the third party has made representations and these have been considered (or, if there is a reference to the Tribunal by the third party, until the Tribunal has ruled on the matter). In these cases, the settlement agreement with the firm or individual would only provide for a warning notice to be issued in agreed form since the form of the decision notice would depend on how the third party rights were dealt with.
- 7.12 Representations by third parties are currently considered by the RDC as it is the decision maker for the settlement. Consistent with our recommendation that such settlement decisions are taken by the Executive, the consideration of representations by third parties where agreement has not been reached with them should also be considered by the Executive. It would not be possible to involve the RDC in considering these representations since that would effectively result in the RDC becoming fully involved in the underlying settlement decision. We believe that this would arise very rarely and that the two decision makers concerned could deal with the issue properly and fairly. We envisage that the firm or individual that had settled would be present and be able to make representations itself when the third party does so¹⁹. This is to be distinguished from the situation where the FSA is seeking to take enforcement action against parties that have not settled: in these circumstances, the decision whether to impose sanctions will continue to be taken by the RDC.

Recommendation

37. Where settlement has been reached in the underlying matter (and a warning notice issued) but third party rights arise, the Executive decision makers who have decided on the settlement (and issue of the warning notice) should also consider representations by the third party and determine the form of the decision notice. **CONSULTATION REQUIRED**

¹⁹ If changes were made to the warning notice as a result of third party representations that were not acceptable to the party that had settled the warning notice then the settlement would collapse and the RDC would have to decide the case afresh.

Discounts for early settlement

- 7.13 Early settlement is already, and should continue to be, encouraged. Even without any FSA incentives, many firms will wish to settle early in any event in order to put an issue behind them and to save on their own costs. We believe there is a strong case for giving some further incentive beyond that. We wish to make the principles behind incentives for early settlement clearer, and to distinguish this from the encouragement of co-operation between the firm or individual affected and the FSA. The present guidance combines the two under the general heading of ‘co-operation’, with early settlement being one of a number of factors comprising any discount for co-operation in a particular case. We believe this is unhelpful. Instead we see advantage in there being a clear scale of discount of penalty for early settlement, with that discount varying in accordance with the stage at which settlement is reached. This would be different and separate from any change to the penalty which reflected broader questions of co-operation – the firm’s willingness to establish the facts, to make changes to its systems to prevent the recurrence of mistakes, or to make prompt and full arrangements to compensate affected consumers. It should be noted that co-operation does not necessarily mean acceptance of the FSA’s view of there having been a breach of principles or rules, nor acceptance of any proposed penalty: a firm or individual could contest both these and still have co-operated in other ways. The fact of settlement and the discount applied would be made clear in the published final notice.
- 7.14 This discount for early settlement should not become over dominant and should not dwarf in significance other important matters such as a proper remediation plan put in place by the firm (there is no suggestion that the compensation to consumers that is payable is discounted as part of this scheme). A proactive plan to pay redress to consumers disadvantaged by a firm’s misconduct is one of the most important forms of co-operation. These factors will be taken into account in setting the proposed penalty to which the discount for early settlement will then be applied. The proposed system needs to be sufficiently simple so that it can be effectively operated and give clear incentives. The incentive to settle should be significant but not of such an amount as to give rise to allegations of unfairness.
- 7.15 Under this proposal, an enforcement case is split into four stages.
- Stage 1.** This stage is the ‘early settlement’ phase, before the drafting of detailed documents but after sufficient work has been done that the FSA can be comfortable that the settlement is on a sound basis.
- Stage 2.** This stage involves the detailed drafting of the investigation report, conducting a thorough legal review and presenting documents to the RDC for a decision on whether to issue a warning notice, ending when written representations by the firm or individual are due

(usually 28 days following the warning notice) or when they are provided if earlier.

Stage 3. This stage involves the consideration of and response to written and oral representations, ending with the issue of the decision notice.

Stage 4. The period following the issue of the decision notice (including Tribunal proceedings).

7.16 Settlements in stage 1 often involve the firm commissioning its own report into what went wrong and seeking to agree a warning notice at a very early stage (sometimes before significant investigation work has been carried out by the FSA). In order to settle at this stage, the FSA needs to be comfortable about the basis on which the matter is being settled, sometimes by spot checking the results of the firm’s own review or sometimes by carrying out a certain amount of investigation work. By settling at this stage, through negotiation of a draft warning notice, a lot of time and effort in drafting detailed documents can be saved. Early discussions can establish whether this route is worth pursuing. In some cases, it is clear at an early stage that agreement is not likely to be possible because the FSA and the firm disagree on a fundamental issue. Where there is not fundamental disagreement, the FSA and the firm can seek to negotiate a warning notice. The FSA will need to set a fixed period for stage 1 to end, for example, one month from production of the first draft warning notice. It will be necessary to avoid extensions of time before the matter proceeds to stage 2, to avoid stage 1 being extended almost indefinitely.

7.17 The border between phase 2 and phase 3 is the time when written representations are due or provided (this will usually be 28 days following the warning notice). This gives sufficient time for the warning notice to be considered and agreement reached. Phase 4 begins on the issue of the decision notice.

7.18 We consider the correct maximum starting point for a discount for settlement is 30%. We do not think that an overall discount in a case for co-operation together with the discount for early settlement should be more than around 50% in total and setting the level for the discount scheme at less than 30% leaves too little room to give any real incentives. Our proposed discounts taking into account the time and effort involved in each stage is as follows:

Stage	Discount applied
Stage 1 (early settlement phase)	30%
Stage 2 (up to written representations)	15%
Stage 3 (up to decision notice)	5%
Stage 4 (following decision notice)	0%

- 7.19 At present, one of the co-operation factors as set out on the FSA website is ‘Did the firm or individual quickly agree the facts and actively seek to agree a basis on which enforcement action could be concluded?’²⁰ As noted earlier, this blurs the distinction between general co-operation and early settlement that the express discount scheme is designed to cover. A firm or individual can in theory contest a case (even as far as the Tribunal) but nevertheless receive credit for co-operation. There should be credit for narrowing the issues in dispute, even if settlement is not reached. For example, a firm may be willing to admit to the facts and breaches but not settle because of disagreement about the level of penalty. In those circumstances, it will not get a settlement discount but its conduct may result in some credit for co-operation as a mitigating factor. A redrafting of this factor rather than its wholesale deletion is therefore recommended. For example, ‘Did the firm or individual actively narrow the issues and seek to resolve these at an early stage?’
- 7.20 One side effect of having fixed discounts for settling at various stages of the process is that this could give rise to arguments by firms that they have been unfairly disadvantaged because of the FSA’s alleged unreasonable attitude at an earlier stage. For example, during stage 1 a firm may say that it is prepared to settle for a Principle 5 breach but not market abuse. The FSA presses for market abuse and the matter is not resolved but proceeds to a later stage. On further consideration, the FSA decides to drop its insistence on a market abuse breach and the matter settles. The firm will then contend that it should get the full 30% discount, rather than the 5-15% it actually gets. There will be complications to this example where it is not clear precisely what terms a firm might have been prepared to settle for at an earlier stage, or allegations that the complete picture has not been made clear by the firm, leading to similar disagreements.
- 7.21 There are two possible ways to address this problem in the very rare cases where there might otherwise be significant injustice. First, the discount could be kept fixed but an adjustment made to the underlying penalty to reflect the potential unfairness to the firm by the way the negotiations went (an additional mitigating factor). Such an approach is not transparent and could make the penalty misleading as a precedent because of this additional discount. The alternative, which we recommend, is to change the level of discount, effectively ‘backtracking’ it to the earlier stage where settlement ‘should’ have taken place. This would introduce an element of discretion into the discount scheme but modifying the fixed scale in this way would only take place in exceptional circumstances.
- 7.22 In order for this discount system to work, the FSA will have to be very disciplined about setting levels of penalty. First, the FSA must not start from a higher figure which, in effect, nullifies the discount. Second, the FSA must

20 www.fsa.gov.uk/Pages/doing/regulated/law/focus/co-operating.shtml

ensure that an appropriate settlement is not lost at a particular stage solely because a figure is put forward as a basis for negotiation rather than a proper figure at which the FSA is prepared to settle.

Recommendation

38. The FSA should introduce a discount scheme for early settlement, giving a fixed scale of percentage discounts to the penalty that would otherwise be appropriate, determined in accordance with the stage at which settlement is reached. **CONSULTATION REQUIRED**

8 Accountability

- 8.1 This section covers the accountability of the RDC to the FSA Board. In the broader sense of ‘accountability’, it also considers what further material about the enforcement process the FSA, as a transparent organisation, should make public.

Accountability of the RDC to the FSA Board

- 8.2 Responses to the Issues Paper and discussions with firms revealed that awareness of the RDC’s status, role and operating procedures varies considerably. As set out in section 6, the RDC is not an independent body or a tribunal but part of the FSA: it is a committee of the FSA Board, to which it is formally accountable. The Board confers on the RDC responsibility for certain regulatory decisions (set out in the decision-making section of the FSA Handbook). Within these parameters, in the interest of fairness, the RDC was set up to be as separate from the FSA Executive as possible in relation to its decision-making. For instance, the RDC sits outside the FSA’s Executive management structure, and none of the RDC members apart from the Chairman is an employee of the FSA. We are not proposing to change this framework; however, within it we do wish to draw attention to three specific points:

Recommendation

39. The RDC should remain accountable to the FSA Board in respect of its procedures, policies and general arrangements, while retaining its independence in relation to its individual decisions. In particular, it should be emphasised that:

- the RDC is separate from Executive management;
- the Board will not intervene in individual RDC decisions; and
- the Board is responsible for ensuring that the RDC is adequately briefed on relevant FSA policies (although in practice this will be provided by the Executive).

- 8.3 Expanding on the third of these points, we recommend that briefings to the RDC on new or complex policy issues happen more frequently than is currently the case. This is to ensure that the RDC's knowledge of FSA policy is fully up to date and its interpretation is consistent with that of the wider FSA. Policy briefings in relation to particular cases should be recorded and disclosed to the firm or individual concerned, in the manner described in recommendation 26.

Recommendation

40. The RDC should receive more policy briefings than in the past, particularly on new and complex areas of policy.

- 8.4 In terms of the substance of the reporting arrangements of the RDC to the Board, we recommend that additional information be provided to the Board, either as part of the existing quarterly reports made by the RDC Chairman, or through periodic internal audit reports. This information and the more detailed oversight it provides will be particularly important in the period following implementation of the revised procedures resulting from this Review.

Recommendation

41. Information should be provided to the Board periodically on:

- costs of the RDC and its secretariat, including its legal function;
- whether the RDC is satisfied that it is adequately resourced to operate separately from the Executive;
- whether the RDC is satisfied that it is being properly informed about FSA general policies to be able to operate, in its opinion, consistently with them;
- whether the RDC wishes to recommend changes to its or the FSA's procedures, in the interests of better, fairer or more efficient decision-making;
- aggregated feedback of comments relating to the performance of the RDC, gathered from Feedback Meetings (recommendation 21); and
- any formal complaints against the RDC (made through the FSA complaints scheme).

- 8.5 The monitoring of the RDC's costs relates to one aim of both the enforcement process and the wider FSA: to be effective and efficient. There are two aspects to this monitoring: first, the FSA Board needs to satisfy itself that the RDC

and its secretariat have sufficient resources to enable them to discharge their responsibilities; and second, the Board must satisfy itself that the RDC is indeed making economic and efficient use of these resources. The information referred to in the recommendation above means that some of the matters considered as part of this Review will be built into the FSA's regular reporting and monitoring activities.

- 8.6 As set out in recommendation 1, we recommend that the Board consider regularly the FSA's overall use of enforcement and how the enforcement tool is best used to help the FSA achieve its overall priorities. The form this takes and its substance are matters for the Board and the Executive management, including the Director of Enforcement to determine. It may be felt that this exercise should be timed to coincide with the production of the annual performance account (recommendation 44, below).
- 8.7 A further piece of information that relates to the pre-RDC stage of the process is the list of enforcement cases meeting the criteria in paragraph 5.27. We propose that this list be provided to Board members to inform them of those cases which are receiving input from senior FSA management.

Additional information to be published

- 8.8 A recent poll of 100 corporate counsel working in the financial services industry²¹ found that 35% confessed to being 'not really sure' what the RDC does. Our discussions with firms and their representatives confirmed that additional information about aspects of the enforcement process, in particular the operation of the RDC, is much needed.
- 8.9 We believe that greater transparency about the enforcement and decision-making process, provided it is done a way that maintains confidentiality, will help increase confidence in the process, both for those who are subject to it and for those whose interests are protected by it. In this context, we are referring to the publication of information that is non case-specific; the disclosure to the subject of the enforcement action of case-specific information is dealt with in earlier sections.
- 8.10 The following recommendations take into account the specific requests for information made by respondents to our Issues Paper. The information in question consists both of text describing the FSA's approach to a particular aspect of enforcement, and of statistics (the latter would clearly need to be aggregated or suitably anonymised). We would also note that certain of the elements in the following recommendations entail little more than moving existing information to a more prominent location, or presenting existing data in a consolidated, more accessible form.

21 *Legal Week* Benchmark Survey, March 2005.

Recommendation

42. The following information should be published on the FSA website:

- a fuller description of the RDC, including the types of decisions the RDC takes, how the panels are constituted and how they operate, how representations are received, and how the RDC reports to the FSA Board;
- further anonymised case studies of post-breach responses from firms which led to the use of supervisory remedial tools, thus obviating referral to the Enforcement Division;
- text explaining the FSA's approach to private warnings, numbers issued and anonymised descriptions of circumstances in which they have been issued; and
- statistics showing numbers of cases completed, analysed by case type (as is set out at Appendix 9 of the 2004/05 annual report), average case-length, and the proportion of investigations that are discontinued before reaching the RDC.

- 8.11 We recognise that there are practical difficulties in collecting quantitative data on certain aspects of the FSA's enforcement work and that the resulting statistics could be interpreted in one of several (conflicting) ways. We therefore recommend that further consideration be given to publication of the statistics below.

Recommendation

43. The FSA should give consideration to the publication of the following information:

- the proportion of cases in which the RDC took a significantly different view of the nature of a case from that submitted by the case team;
- the proportion of cases in which the decision makers took significantly different views at warning notice stage and decision notice stage.

- 8.12 This information will help illuminate the objectivity and rigour of the decision-making process.

Performance measurement

- 8.13 We have considered how the success of the changes resulting from this Review can be measured; this is on the basis that the FSA Board will both

want and need to satisfy itself that the new enforcement process is working well. We have also considered performance measures for the enforcement process per se. We recommend that the FSA assess its enforcement performance against the two objectives for the enforcement process first set out in CP17 and recently reaffirmed by the responses to the Issues Paper. These are that the enforcement process should be:

- efficient and effective; and
- fair and seen to be fair.

8.14 In addition to an analysis of firms' comments at the Feedback Meetings (recommendation 21) and analysis of decisions from the Tribunal, it is difficult to devise reliable performance indicators to assess the process's 'fairness and perception of fairness'. Nonetheless we feel it is important that the FSA attempt to combine elements of the data contained in the recommendations above with various performance measures currently used by the Enforcement Division, to produce a meaningful consolidated account of how well the revised enforcement process is working:

Recommendation

44. An annual performance account of the fairness and effectiveness of the FSA's enforcement process should be published at the time of the FSA's Annual Report. This will consist of, as a minimum:

- statistics relating to cases (see Appendix 9 of the 2004/05 annual report);
- an overall qualitative assessment of the FSA's enforcement work, including a summary of main issues and lessons drawn from the Feedback Meetings (recommendation 21);
- an analysis of the number and trend of referrals to the Tribunal.

9 Impact of the changes

- 9.1 An improved enforcement process will foster greater confidence in the FSA on the part of regulated firms and individuals, and encourage self-reporting, remedial action and co-operation. If firms and individuals currently have concerns about the FSA's enforcement process (in terms of case selection, conduct of the investigation or the decision-making process itself), there is a danger that some may react by introducing over-elaborate procedures to protect themselves from any risk of being thought to have breached an FSA requirement. The changes recommended by the Review will help reduce any such 'over-compliance' that may exist. Consumers will also benefit in that the more credible and well respected the enforcement process is, the more it may encourage better compliance by regulated firms and individuals without recourse to enforcement action.
- 9.2 We anticipate that as a result of this Review's recommendations more cases will settle earlier in the proceedings. This will help reduce costs and will assist consumers, both in terms of securing redress earlier and sending clear reminders to firms about the standards which the FSA expects of them. However, for those cases which do proceed to the RDC, the net effect of these recommendations will be to add to the overall costs of the FSA's enforcement process and will, inevitably, make it lengthier.
- 9.3 However, overall we expect these increases to be modest. Although it is difficult to estimate exactly how much these changes will add to the FSA's costs, our working assumption is that the increase should not be more than around £2.5million per annum. This figure includes £2million in respect of the Enforcement Division's costs, principally as a result of the recommended legal review, secondments and recruitment of a Grey Panther. The remainder comprises additional RDC costs, largely as a consequence of its new legal function. We do not expect the recommendations to result in higher direct costs for firms and individuals involved in the enforcement process. Although there will always be some cases that proceed to the Tribunal, if, as we hope will be the result of a system which commands greater public

confidence, the new system ultimately results in fewer references to the Tribunal, this would deliver cost savings overall to both the firm or individual affected and the FSA.

- 9.4 Both the costs and the effectiveness of the changes will be considered as part of the annual performance account (recommendation 44).

Enforcement process review: Terms of reference

To review the use of, approach to and decision-making process for supervisory actions and enforcement actions to address breaches of regulatory requirements and, where appropriate, to make recommendations. The review will assess the lessons from the FSA's experience of the last three years operating under the Financial Services & Markets Act 2000 (FSMA) regime including the comments of the Tribunal in the Legal & General case. It will not explore any options which would require changes to FSMA. The review will consider:

- 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;
- the role and involvement of senior FSA management throughout these processes;
- options for making regulatory decisions based on a fair procedure by persons separate from the investigators; and
- the accountability of decision makers to the FSA Board.

The review will be led by David Strachan (Director of Retail Firms Division and Insurance Sector Leader, FSA). He will report to a committee of the Board comprising Callum McCarthy (Chairman, FSA), John Tiner (Chief Executive, FSA), James Crosby (Chief Executive, HBOS plc), Hugh Stevenson (Chairman, Equitas Ltd) and Clive Wilkinson (Chairman of the Birmingham & Solihull Heartlands NHS Trust), who will make recommendations to the Board. Tim Herrington, who took up his duties as the new Chairman of the FSA Regulatory Decisions Committee on 1 February, is co-opted to the committee. The committee will be advised by Michael Brindle QC and Mr David Pritchard.

The conclusions of the Board will be made public in July and any changes to the FSA's approach will be subject to consultation, as necessary.

List of the Review's recommendations

1. The FSA should continue to set out publicly its risk-based approach to enforcement and the consequences that flow from it, especially for case selection. The FSA Board and the Executive should consider at least annually the approach to enforcement and how this tool is best used to help the FSA achieve its overall priorities.
2. The FSA should refine and communicate its enforcement approach for medium-sized and smaller firms, to complement its approaches for the larger and for the smallest firms.
3. The FSA's 'enforcement priorities' are a subset of the FSA's overall priorities. Potential rule breaches in these areas will continue to take precedence over rule breaches in other areas in terms of allocating scarce enforcement resources. However, there should be no pre-disposition on the FSA's part always to resort to enforcement when issues are identified in priority areas.
4. There should be a forum which brings together the counterparts to the ERMs in the referring divisions to share good practice. This forum should meet periodically to share experience of what is working well and less well and should also meet the ERMs as a group.
5. The FSA should consider developing a fuller description of the core responsibilities of both the ERM and their counterparts in the referring divisions. This would improve understanding of the nature of the role and would promote consistency.
6. The FSA should draw up procedures governing the supervision-enforcement interface to promote consistency of approach.
7. If the referral is being generated by a division other than that which is responsible for supervising the firm or individual concerned, the supervisor should be informed promptly and the ERD should also be signed by the relevant supervisor.

8. The FSA should continue to publish on its website examples of the types of responses by firms which may obviate the need for enforcement action.
9. The FSA should hold initial scoping discussions as a matter of course for cases involving authorised firms or approved persons (and may do so in other cases). The FSA team should include the supervisor if the firm concerned is a relationship-managed firm. The composition of the FSA team should also take into account the seniority of the team fielded by the firm.
10. The FSA should continue to give an information pack to the firm at the outset explaining the key stages of the enforcement process and the possibility of mediation and settlement.
11. The FSA team should, at a minimum, when dealing with an authorised firm or approved person, set out the nature of, and reasons for, its concerns and provide a clear explanation of why the matter has been referred to Enforcement. This must take account of the fact that there is a limit as to how specific the FSA can be about the nature of its concerns before any formal investigation has begun.
12. If, as the investigation progresses, the nature of the FSA's concerns change significantly from those that it originally notified to the firm, the FSA should reassess these concerns against its referral criteria so as to satisfy itself that it remains appropriate to continue the investigation. If it does decide to continue, the FSA should notify the firm or individual of the change in scope.
13. The Enforcement Division should continue to harness expertise from within the division and across the FSA, where relevant, for advice on the substance and focus of investigations.
14. The Enforcement Division should continue to draw on the expertise of the FSA's Grey Panthers and should look to recruit a Grey Panther with a background in forensic accounting and complex investigations.
15. The Enforcement Division should expand its internal and external secondment programme.
16. The FSA should continue to send draft investigation document(s) setting out the facts found by the investigation and the rule breaches alleged to those who are the subject of investigation for their comments. The FSA should publish criteria which set out when it will depart from this practice.
17. There should be a legal review of a case before it is referred to the RDC by lawyers who have not been part of the investigation team.
18. A case should be escalated during investigation stage to FSA senior management if the case is high impact, precedent-setting, or requires significant commitment of FSA resources.

19. The FSA's Executive Committee should review periodically the list of all outstanding cases that meet the escalation criteria.
20. The FSA's Executive Committee should review periodically how effective the enforcement function has been, including the referral process and the outcome of cases, including those that have settled.
21. No later than two months after the conclusion of an enforcement case the FSA should usually give those concerned the opportunity to comment on their experience of the FSA's enforcement procedures and subsequent decision-making. This will concentrate on the handling of the practical and procedural aspects of the case by the FSA staff and decision makers, not on the outcome of the case.
22. While work on a skilled person report is in progress, there should be regular liaison meetings between the firm, skilled person and the FSA to identify any material new information which might affect the future direction of the work, consistent with SUP 5.5.4G. If necessary the firm's supervisor should involve Enforcement at an early stage and agree with them what the appropriate response is to the change of circumstances.
23. The FSA should apply a 'minded to' procedure to the issue of private warnings across the FSA. Private warnings should be approved by a Head of Department.
24. The number of RDC members should be reduced, from the current 24 to around 16. There should be some continuity in membership following the expiry of current terms in November 2005. New members should be recruited through an open competitive process.
25. The current rigid group system should not continue. The RDC Chairman or one of the Deputy Chairmen should select RDC members for any particular case based on the appropriate mix of skills and experience required.
26. All substantive communications between the Enforcement case team and the RDC (whether oral or written) should be disclosed to the firm or individual. Enforcement should no longer provide legal advice to the RDC but make legal submissions that are disclosed.
27. The RDC should have its own small dedicated legal function, as part of the RDC secretariat. This function should assist the RDC to finalise draft warning notices and to draft decision notices, ensure that any substantive communications with the Enforcement case team are recorded and disclosed, assist the RDC in considering the case and underlying material and provide any legal advice required.
28. The Enforcement case team should no longer meet with the RDC following the oral representations meeting. Instead, oral representations should be conducted on a more interactive basis.

29. Decision notices should set out how the RDC has dealt with the key points made by the subject of regulatory action.
30. Press notices should be approved by the RDC Chairman or relevant Deputy.
31. The RDC Chairman or Deputy alone or with one other should be able to take decisions in straightforward cases. **CONSULTATION REQUIRED**
32. The composition of RDC panels should be a matter for the Chairman or Deputy. The warning notice panel should usually consist of the Chairman or Deputy plus two others. In cases where representations are made, the warning notice panel should usually be supplemented by two new members at the decision notice stage. If no representations are made, the warning notice and decision notice panels would usually be the same.
33. In authorisation and approval decisions, the warning notice decision should be taken by the Executive and the decision notice decision by the RDC. The material provided by RTD to the RDC in such cases should be disclosed to the applicant before the applicant is required to submit representations. **CONSULTATION REQUIRED**
34. Change in control decisions should continue to be taken by Executive Procedures. In cases where there is a parallel approval rejection being considered by the RDC, the Executive should have discretion to refer the change in control decision to the RDC. **CONSULTATION REQUIRED**
35. Settlements should be approved by two Executive decision makers of at least director of division level, leaving the RDC to decide cases that are contested. The content of settlement discussions should not be disclosed to the RDC in the absence of agreement between the FSA Executive and the firm or individual concerned. **CONSULTATION REQUIRED**
36. There should be regular discussions between Executive decision makers and the RDC about decisions reached in completed cases to ensure consistency in levels of penalty in cases.
37. Where settlement has been reached in the underlying matter (and a warning notice issued) but third party rights arise, the Executive decision makers who have decided on the settlement (and issue of the warning notice) should also consider representations by the third party and determine the form of the decision notice. **CONSULTATION REQUIRED**
38. The FSA should introduce a discount scheme for early settlement, giving a fixed scale of percentage discounts to the penalty that would otherwise be appropriate, determined in accordance with the stage at which settlement is reached. **CONSULTATION REQUIRED**

39. The RDC should remain accountable to the FSA Board in respect of its procedures, policies and general arrangements, while retaining its independence in relation to its individual decisions. In particular, it should be emphasised that:
- the RDC is separate from Executive management;
 - the Board will not intervene in individual RDC decisions; and
 - the Board is responsible for ensuring that the RDC is adequately briefed on relevant FSA policies (although in practice this will be provided by the Executive).
40. The RDC should receive more policy briefings than in the past, particularly on new and complex areas of policy.
41. Information should be provided to the Board periodically on:
- overall costs of the RDC, its secretariat including its legal function;
 - whether the RDC is satisfied that it is adequately resourced to operate separately from the Executive;
 - whether the RDC is satisfied that it is being properly informed about FSA general policies to be able to operate, in its opinion, consistently with them;
 - whether the RDC wishes to recommend changes to its or the FSA's procedures, in the interests of better, fairer or more efficient decision-taking;
 - aggregated feedback of comments relating to the performance of the RDC, gathered from Feedback Meetings (recommendation 21); and
 - any formal complaints against the RDC (made through the FSA complaints scheme).
42. The following information should be published on the FSA website:
- a fuller description of the RDC, including the types of decisions the RDC takes, how the Panels are constituted and how they operate, how representations are received, and how the RDC reports to the FSA Board;
 - further anonymised case studies of post-breach responses from firms which led to the use of supervisory remedial tools, thus obviating referral to the Enforcement Division;
 - text explaining the FSA's approach to private warnings, numbers issued, and anonymised descriptions of circumstances in which they have been issued;
 - statistics showing numbers of cases completed, analysed by case type (as is set out at Appendix 9 of the 2004/05 annual report); average case-length; the proportion of investigations that are discontinued before reaching the RDC.

43. The FSA should give consideration to the publication of the following information:
- the proportion of cases in which the RDC took a significantly different view of the nature of a case from that submitted by the case team; and
 - the proportion of cases in which the decision makers took significantly different views at warning notice stage and decision notice stage.
44. An annual performance account of the fairness and effectiveness of the FSA's enforcement process should be published at the time of the FSA's Annual Report. This will consist of, as a minimum:
- statistics relating to cases (see Appendix 9 of the 2004/05 annual report);
 - an overall qualitative assessment of the FSA's enforcement work, including a summary of main issues and lessons from the Feedback Meetings (recommendation 21);
 - an analysis of the number and trend of referrals to the Tribunal.

Summary of responses to the Issues Paper

1. This section is a summary of the responses that we received to the Issues Paper.
2. The general view of the respondents is that the current enforcement model is essentially correct. However, in order to ensure that the process is (and is seen to be) in broad terms fair, objective, efficient and proportionate, there are certain areas where the respondents believe improvements could be made. They believe that this would benefit the industry as a whole and raise the reputation and integrity of FSA enforcement in the future, thereby increasing overall confidence in the regulator.

The objectives of the decision-making process

3. The objectives of the decision-making process are set out in Consultation Paper 17 – *Financial services regulation: Enforcing the new regime*. 26 of the respondents agreed that the objectives remain valid. The remaining respondents did not offer an opinion. None of the respondents stated that they thought the objectives had been superseded.

Is there scope for efficiency gains from a wider range of decisions being taken by the Executive?

4. Several respondents believed that less serious, non-contentious cases could be decided by the Executive without referral to the RDC. They suggest that this would be appropriate where the parties are agreed that action needs to be taken and, broadly, on the evidence upon which the need for action is based, and, specifically, on the enforcement sanction.
5. Respondents also identified certain factors that could be taken into consideration, including whether the decision is likely to affect:
 - the authorisation or approval of the respondent;
 - the reputation of the respondent;

- the likelihood of a significant penalty if the warning notice is upheld;
 - a large number of firms being dealt with together; or
 - a very substantial part of the business of the firm e.g. a decision to increase the firm's regulatory capital.
6. One respondent suggested that the RDC set particular 'benchmarks' relating to liability and associated penalties which the Executive could then follow.
 7. Several respondents proposed including a system to monitor the decisions made by the Executive. They suggested an appeal process to the RDC when necessary. One respondent also recommended a monthly report of decisions made by the Executive being submitted to the RDC.
 8. Not all respondents agreed that there was scope for efficiency gains from a wider range of decisions being taken by the Executive. There was concern that any final decisions made by the Executive would result in a loss of independence in the decision-making process. One respondent believed that this would lead to a greater number of referrals to the Tribunal. Another respondent also said that such a change would risk reinforcing industry perceptions of an unfair process.

The RDC

9. A number of respondents proposed a larger pool of members for the RDC. They argued that this would increase the working capacity of the RDC, allowing it to assemble more often and deal with its business more quickly. One respondent believed it would be appropriate to limit the number on any given RDC panel to three members.
10. Several respondents proposed that there should be more transparency about the basis upon which decisions are made. One respondent suggested that the panel should contain an odd number of members and a vote should be taken rather than reaching a consensus.
11. A number of respondents believe that members of the RDC who approve the issue of a warning notice should be different from the panel members who receive the written and oral representations from a firm and consider issuing a decision notice. If this were the case, the same people would not be asked effectively to 'change their minds' when considering additional material and representations from the firm. The respondents view the warning notice and the decision notice as separate statutory decisions, each needing to be taken fairly and with no perception of bias. Only one respondent specified that the same members should be involved at both stages.

12. There was concern that the RDC does not currently have sufficient time to conduct a detailed review of the evidence. In those respondents' view, this leads to the risk that the RDC are swayed by private advice made by the FSA staff after the firm has made its representations.
13. The majority of respondents were concerned that FSA Enforcement staff have 'special access' to provide information or observations to the RDC which the firm does not see. They believed that this aspect is unfair and that any information provided by the FSA to the RDC should be disclosed to the firm, which should then have an opportunity to respond. One respondent made the point that the current approach is not consistent with the fact that if the matter goes before the Tribunal then the parties will be on a completely level footing; both parties will know that the Tribunal is only provided with information that they have both seen.
14. Some respondents went further and stated that it is not appropriate that the FSA hold meetings with the RDC without the firm present. This impacts on the perception of objectiveness, fairness and independence of the RDC.
15. Many respondents believed that the RDC requires legal guidance from a dedicated team in order to ensure that RDC members obtain an independent legal perspective on the quality and sufficiency of the evidence under consideration. They suggested that the legal guidance should come from outside of the Enforcement Division: either from the FSA's General Counsel's Division or externally.
16. A number of respondents believed a firm should be able to make representations to the RDC before it makes the decision to issue a warning or supervisory notice. This, they felt, would enable the firm to have a real chance of influencing the decision before it is made, rather than being forced to argue against a decision that has already been made.
17. Many respondents believed that the information included in a warning notice relating to the reasons for the FSA's action varies in quality and quantity. Frequently there was felt to be an insufficient connection between the facts determined and why, having regard to the FSA's published policy, the action is being taken.
18. A couple of respondents suggested that notices issued by the RDC should be prepared and drafted by the RDC itself and its own staff without any direct or indirect involvement of Enforcement staff.
19. A very small number of respondents thought that the RDC was not the correct model at all. They believed that the RDC is an obstruction, with the true judicial process being provided by the Tribunal. One respondent suggested that an alternative would be for decisions currently taken by the RDC to be taken by the FSA senior management. The Enforcement team

would produce its final report to the FSA senior management. The firm would then have the opportunity to provide a formal response document directly to the FSA senior management. If, following representations, FSA senior management felt that there was a case to answer it would issue a final notice. The firm could either accept this or remit the matter directly to the Tribunal.

Involvement of practitioners in the decision-making process

20. Although some members of the RDC who are industry practitioners may find it difficult to find time to attend RDC meetings, and some former practitioners may find it difficult to keep up to date with industry developments, only a very small number of respondents believed that these are reasons to discontinue practitioner involvement in enforcement decisions.
21. A few respondents believed that although participation in the RDC of non-practitioners is important for the perception of fairness, the balance should be more heavily weighted towards industry practitioners. Several respondents supported the current arrangement of having an equal split of practitioner and non-practitioner members in any meeting of the RDC.
22. A large number of respondents commented that RDC members sometimes appear to have (through no fault of their own) an insufficient understanding of the evidence when representations are made to them. To resolve this, they suggested that each RDC panel contain at least one member who has experience of similar business to the firm's. The suggestion was also made that the RDC operate through focus groups, each specialising in industry sectors, or relating to the various Technical Knowledge Groups within the Retail and Wholesale teams in the Enforcement Division.
23. One respondent suggested that the FSA should place open advertisements in the national and financial press seeking nominations to the RDC. Another respondent also commented that improvements to the reputation of the RDC will lead to an increased willingness on the part of the industry to participate.

Representations

24. There was support for the current practice of giving recipients of warning notices the opportunity to make both written and oral submissions.
25. One respondent believed that the length of time a firm is given to prepare for the representations is too short. Several respondents also believed that the length of time that a firm has to make representations is too limited. They suggested that a person should be able to request a longer slot so that he can, if he wishes, make a more detailed submission.

26. One respondent believed that the firm should have the right to seek the voluntary attendance of witnesses at the RDC hearing. However, another respondent did not consider it appropriate to hear witness evidence as this would essentially turn the current administrative process into one that is more judicial in nature.

The practice of obtaining comments on a draft investigation report

27. A large number of respondents supported the opportunity often currently given to firms to obtain comments on draft investigation reports. They pointed out that factual inaccuracies can often be cleared up at an early stage. A few respondents also stated that this should be done within a tight timeframe so as not to delay the decision-making process.
28. Several respondents commented that providing firms with draft investigation reports is currently at the discretion of the individual investigation team. They believe this approach is inconsistent and the FSA should revert to a general policy of disclosing draft investigation reports and inviting comments from the firm concerned.
29. There was also some concern that the firm's response to the draft investigation report is not always given proper consideration. One respondent believed that the firm's comments should be incorporated into the investigation report that is presented to the RDC to a greater extent than is currently done, so that the RDC is presented with a balanced report based on all the facts of the case.

Settlement

30. A number of respondents specifically endorsed the FSA's use of settlement and believe it should be actively promoted. However, they also emphasise that the process must be a true and genuine settlement process ensuring that firms and individuals are not pressurised into accepting a settlement on the basis of 'accept this or worse will befall'.
31. A large number of respondents supported the FSA's policy of agreeing to consider an acceptable settlement at any stage of the enforcement process. One respondent opposed this view and believed it would be prudent to limit the time for settlement so that reference to the RDC is not unduly delayed.
32. As set out in the Issues Paper, the final decision on settlement is made by the RDC, although no member of the RDC is present during the settlement discussions. Many respondents commented that they find this current settlement process unsatisfactory.
33. One respondent commented that the continual referral back to the RDC leads to delay and expense. Another respondent observed the practical difficulty of

conducting a negotiation if the people participating in it do not have full authority to negotiate a settlement. Several thought that it should be the responsibility of the Executive to negotiate and finalise a settlement, provided that firms are not inhibited from pursuing the full RDC route if they so wish.

34. However, a large number of respondents believed that the final decision should continue to be taken by the RDC, believing that a single body should provide oversight of all cases, whether or not they are concluded by settlement. One respondent's rationale for this view was that the Executive is closer to the investigation team than the RDC is, so there would be a risk that new evidence or a new argument put forward by a firm may not be assessed in a completely independent light. The RDC are generally thought to provide greater consistency to the decision-making process than the Executive.
35. Within this position, a few respondents believed that an RDC member (with the authority to bind the full RDC) should be present during settlement negotiation. If this is not practical, they thought it acceptable for an RDC member to be at the other end of a telephone.
36. Several respondents believe that the FSA and the respondent should have equal access to the RDC during the settlement discussions. They argued that having the Enforcement team act as the sole link to the RDC during settlement leads to suspicion that the information provided to the RDC, and the RDC's response, can be filtered by the Enforcement team to support its own agenda.
37. Where a warning notice has already been issued, a few respondents specified that the members of the RDC who issued the warning notice should be directly involved in settlement discussions. On a related point, a few respondents also stated that if the negotiations fail, then formal representations should be made to a different RDC panel to the one involved in the prior settlement discussions.
38. The view of one respondent was that any settlement negotiations should be conducted by a professional mediator.

The process followed by supervisors, enforcement and decision makers

39. A few respondents noted that firms report an increasing reluctance among supervision staff to offer an opinion or suggest improvements that might potentially undermine any future enforcement investigation. The result is that firms can be of the understanding that they are operating correctly, only subsequently to find themselves subject to enforcement proceedings.
40. Several respondents commented that there needs to be a better understanding of the types of circumstances in which supervisors will be able to work with a firm to resolve an issue, rendering unnecessary the need to refer the matter to Enforcement.

41. Several respondents believed that the FSA's regulatory objectives and outcomes can usually be achieved satisfactorily through supervision procedures. Accordingly, they make the point that supervisory solutions should be treated as the norm, with enforcement only being used where absolutely necessary.
42. A number of respondents believed that there is more scope for the use of supervision procedures where the facts are not being contended. This would include greater use of private warnings, in particular when dealing with minor issues or 'first time offenders'. One respondent pointed out that there should also be strict controls relating to the issue of private warnings as they form part of a firm's compliance record.
43. A large number of respondents believed that the FSA should be transparent at an early stage about whether a referral to Enforcement was being considered, even if it was subsequently determined that a matter would not be referred.
44. Many respondents suggested that Supervision staff should remain involved in the Enforcement process as much as possible. This would allow Enforcement staff to benefit from the experience of Supervision staff in the relevant sector.
45. Several respondents also advocated an extra layer of 'filter' when cases are referred from Supervision to Enforcement. A few respondents recommended that a team of investigators be established within Supervision or, alternatively, some form of cross-department 'management panel'. This would, effectively, create a three stage process whereby the supervisory team come across an issue, refer it to the investigation team within Supervision or the management panel who would try to resolve the problem. Only if it could not be resolved by that team would it be referred to Enforcement.
46. One respondent believed that the ad hoc addition of Enforcement staff to Supervision visit teams should be avoided, apart from in exceptional circumstances where the seriousness and urgency of the issue requires immediate joint consideration by Supervision and Enforcement. In such exceptional cases, it should be made clear to the firm that Enforcement staff were present because referral of the issue to them for investigation was being actively considered.
47. Several respondents believed that there was not always enough 'joined-up thinking' between Supervision and Enforcement. For example, when a firm was referred to Enforcement it had to repeat many months of dialogue previously had with supervisors. This typically included an explanation of how its business worked and how the issues arose.
48. There was concern that there appears to be a lack of clarity and consistency in the criteria being used by the FSA when determining whether a particular matter should be referred to Enforcement. One respondent illustrated several examples, including why poor record-keeping was treated as seriously as breaches felt to be more substantive, or when cases involving no loss to clients

attracted as large fines as cases where loss had occurred. Another respondent highlighted a perception that referral standards differed where the referral was not from a front line supervisory division (such as thematic work, or work of the Financial Promotions Unit). This led to a perception of unfairness and a lack of consistency.

49. In relation to ‘thematic’ enforcement initiatives, several respondents believed there should be a full and transparent sweep of all potentially implicated firms to ensure that some firms are not unfairly discriminated against in the selection process for enforcement action. Unless it is justified in the individual circumstances, the practice of selecting a couple of cases and then subsequently issuing a Dear CEO letter to all the other implicated firms was generally not felt to be appropriate.
50. The point was made by a small number of respondents that it would be of great assistance if a timetable could be issued for the conduct of the investigation. The timetable need not be fixed and may be amended by agreement at any time. Several respondents believed that the FSA should also take into account the resources of different firms and ensure that its demands are proportionate for smaller firms and for individuals.
51. Several respondents believed that the Notices of Investigation are not sufficiently detailed to give a proper understanding of the FSA’s concerns or the scope of the investigation. There is, therefore, a danger that the investigation will lack focus and its scope will gradually be extended during the course of the investigation. The reasons for the investigation need to be better particularised and disclosed. In addition, alleged breaches should cite specific FSA Rules rather than the broader Principles.
52. One respondent believed that any extensions of scope should be subject to the approval of the appropriate senior manager, who should also comment on the future direction of the investigation. This should also be disclosed to the firm.
53. A few respondents reported a perception that the FSA does not wish firms to involve their legal advisers. Although respondents acknowledged that legal advisers may sometimes slow the process, they stressed that the consequences of failing to do everything possible to protect one’s personal reputation compel senior management to use legal advisers. They believed that the FSA needs to accept this reality and be more willing to work with legal advisers.
54. A couple of respondents noted that there is a long history of the use of ‘skilled person’ (FSMA s.166) appointments in a supervisory context. However, it was felt that there is often a lack of clarity as to the terms of reference for such appointments and, in particular, the use that may be made of skilled person’s reports in subsequent enforcement proceedings.

55. One respondent also made the point that these reports must provide the FSA with opinions or answers that are clear and unambiguous and which are succinct and easily readable. Another respondent noted that the skilled person's report often costs the firm more than the fine imposed by the RDC.

Enforcement staff

56. Many respondents commented on the conduct of the staff in the Enforcement Division. These comments may, broadly, be divided into the following three categories:
- attitude and behaviour of the Enforcement staff;
 - industry knowledge or experience of the Enforcement staff; and
 - working practices and deployment of the Enforcement staff.
57. One respondent reported that, in its experience, the approach of Enforcement staff during an investigation is unnecessarily aggressive and confrontational. Enforcement staff also sometimes appear unwilling to admit to mistakes that they might have made in the early analysis of the facts. A firm may have been open and co-operative with the FSA during its contact with Supervision but, upon referral to Enforcement, they notice a change in attitude with the FSA seemingly disregarding the firm's co-operative attitude and adopting a more hostile stance. The respondent emphasised that it would be desirable if good relations could be maintained, so far as practicable, throughout the process.
58. A few respondents pointed out that the Enforcement staff should at all times act objectively and courteously. They should not start out with the idea that a breach has occurred and that it is a matter of using the investigation to find evidence to prove their case. Respondents believed that this culture needs to be addressed through staff training programmes, internal procedures and controls, staff performance appraisal etc. Enforcement staff should not be appraised or rewarded on the basis of successful enforcement actions. Nor should they feel that their career prospects depend on securing the most severe possible sanction; the fact that an investigation is closed with a recommendation not to take public enforcement action should not be regarded as a failure.
59. In relation to the industry knowledge or experience of the Enforcement staff, a large number of respondents commented that while Enforcement staff may possess forensic and legal qualifications, they frequently do not have the required industry knowledge or experience. At the investigatory stage of the process in particular, knowledge of the industry and its issues would help considerably in ensuring efficiency and objectivity.

60. A few respondents thought that the Enforcement team should also consider taking advice from 'grey panthers' on the understanding of industry practices, as well as planning, monitoring and managing investigations.
61. One respondent reported that Enforcement staff charged with the investigation or negotiations on occasions appear not to have been properly briefed by more senior FSA staff. For example, they are unfamiliar with statements made by senior FSA staff to the firm's management.
62. A large number of respondents stated that the quality and consistency of the investigation work by Enforcement staff varies significantly. Particularly, they felt that too much responsibility is given to junior staff who lack the appropriate expertise when conducting the investigation and when interviewing senior executives.
63. Several respondents believed that draft investigation reports vary significantly in terms of quality and style and are often too argumentative. It is often the case that the report fails to explain what, in practical terms, the FSA staff consider that the firm has failed to do or that it ought to have done. They proposed that the draft investigation report should set out how the FSA Rules that are being applied (rather than the broader Principles), how those rules have been interpreted and the full particulars of the alleged breach.
64. A few respondents also believed that the draft investigation reports should be subject to a detailed review by FSA lawyers who have not been involved in the conduct of the investigation. This should bring objectivity and ensure that the conclusions are supported by reliable evidence.
65. Several respondents believed that the low ratio of managers to investigators means there is an overall lack of managerial control. It was felt that managers should attempt to spend more time on fewer cases, taking a more active role in the proceedings.
66. One respondent believed that there is over-reliance on manager grade in the Enforcement Division to ensure the overall quality of the investigations and to act as project sponsors. In its view, the responsibility for the oversight of investigation should rest with more senior management. This responsibility may be delegated only in instances where the manager has significant experience.
67. A couple of respondents pointed out that there is also a risk that staff attrition (across the FSA as a whole) could lead to a reduction in the depth of technical knowledge and expertise as well as shortages in certain key skill sets or industry experience.

The role and involvement of senior FSA management

68. Several respondents believed that senior management from Supervision and Enforcement should have a greater involvement in the enforcement process. This would improve the perception of fairness significantly.
69. One respondent believed that in addition to the investigation team within Enforcement, the firm should be assigned a designated contact point from within FSA senior management to enable direct discussion.
70. A couple of respondents pointed out that, following the recent market timing investigation and the splits settlement, FSA senior management should take care to avoid making public statements about current investigations or disciplinary cases. This may have the effect, in practice, of raising expectations or impeding settlement negotiations.
71. One respondent believed that consideration should be given to introducing a regular review of the Enforcement Division's approach and policy by senior management outside of the Enforcement Division. They would be able to check for continued consistency with other divisions and also compliance with the FSA's overall objectives.

Other

72. Whilst the FSA's intention to give a firm credit for co-operation was welcome, several respondents believed that the approach to co-operation lacks clarity and transparency. The FSA should explain the benefits of co-operation at an early stage and make it clear that credit can include the FSA deciding not to commence enforcement proceedings, as well as reductions in financial penalties. A couple of respondents proposed that there should be a clear difference – in terms of both the process and level of penalty – between those cases in which a firm has identified issues themselves or are working to rectify compliance problems, and those where this is not the case.
73. A couple of respondents also contended that where a firm applies a different interpretation of the evidence, facts, laws or rules from that adopted by the FSA, this is not, of itself, a failure to co-operate and it would be improper for the FSA to suggest this is the case.

74. The following suggestions were made regarding additional (non case-specific) information relating to the decision-making process that the FSA could publish:

- The types of circumstances in which formal investigations have resulted in private warnings
- Statistical information on the proportion of cases that have been resolved through non-enforcement action
- Guidelines to determine when a case is referred to Enforcement
- A user-friendly guide to the enforcement and RDC process
- Formal guidelines on evidential standards of the RDC
- Comprehensive information on the operation of the RDC
- Further statistical information relating to the RDC
- Details of a greater number of public appearances by the RDC Chairman
- RDC 'Practice Directions'
- Further statistical information on the Enforcement Division in the FSA's annual report
- The FSA policy for drafting press releases

List of non-confidential responses to the issues paper

Mr David Aaron

Association of British Insurers

Association of Private Client Investment Managers and Stockbrokers

Axa UK plc

Bank of Ireland UK Financial Services

Barclays plc

Beachcroft Wansbroughs Consulting

Better Regulation Task Force

Mr Michael Blair QC

British Bankers Association

City Liaison Group

City of London Law Society Regulatory Committee

CMS Cameron McKenna

Compliance Institute

DLA Piper Rudnick Gray Cary UK LLP

Ernst & Young LLP

Fidelity Investment Services Ltd

The Financial Services Consumer Panel

Freshfields Bruckhaus Deringer

Hargreaves Lansdown

IFA Defence Union

International Underwriting Association
Investment and Life Assurance Group
Investment Management Association
KPMG LLP
The Law Society of Scotland
Lawrence Graham LLP
Legal & General Group plc
Lloyds TSB Group plc
Morgan, Lewis & Bockius LLP
Office of Fair Trading
The Pensions Regulator
Reynolds Porter Chamberlain
Royal & Sun Alliance Insurance Group plc
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