A review of recent developments and trends in FCA Enforcement

Alex Irvine, associate

In July 2017, the FCA published its Enforcement annual performance account for 2016/17. The account includes a summary, together with statistics, of the Enforcement outcomes the FCA has achieved for the year and those areas of the financial services industry that have been a particular focus for its Enforcement team.

In this edition, we will consider some of the more important developments and trends in FCA Enforcement over the past year, including policy changes and the conduct that the FCA is particularly keen in investigate.

Reform of the FCA's Enforcement decision-making process

Following publication of the Treasury's review of the FCA's Enforcement decision-making and of Andrew Green QC's report into the FSA's (as it then was) Enforcement actions after the failure of HBOS, the FCA consulted on and implemented a number of important changes to its Enforcement decision-making process. The changes, effective since 1 March 2017, are intended to bring greater flexibility to Enforcement proceedings.

The first of those changes is the introduction of Focused Resolution Agreements (**FRAs**). Subjects of investigation may use FRAs to refer a sub-set of the FCA's findings against them to the FCA's Regulatory Decisions Committee (**RDC**). These findings may be in relation to the FCA's proposed sanction, the FCA's factual findings and/or the FCA's characterisation of what breaches a firm or an individual has committed.

The second important change is the reform of the early settlement discount regime. Under the previous regime subjects of investigation were able to benefit from varying discounts on financial penalty depending on at what point in the investigation process a settlement was reached, from 30% at Stage 1, to 20% at Stage 2 and 10% at Stage 1. The old settlement regime represented an "all or nothing" approach. If a settlement of an entire investigation was not achieved in Stages 1-3, no further discounts were available.

That approach to settlement discount has been replaced with a more flexible approach, linked to the introduction of FRAs. The new settlement regime allows subjects of investigation to agree on certain issues, but dispute others, whilst still being entitled to benefit from a discount on financial penalty. However, the settlements available and the window in which the subject of an investigation has to reach a settlement (on at least some of the issues) is now more limited.

- Those who use FRAs to challenge the FCA's proposed penalty will still enjoy a 30% early settlement discount.
- Those who use FRAs to challenge the FCA's characterisation of what breaches they have committed will enjoy an early settlement discount of between 15% to 30%.
- Things will be less certain for those who use FRAs to challenge the facts of a case, as they may enjoy an early settlement discount of 0% to 30%.

If a firm or individual is to reach a settlement, it must be achieved at Stage 1 (28 days after receipt of an annotated Warning Notice). If a firm or an individual does not settle an FCA investigation within Stage 1 or agree a FRA during Stage 1, they will not be eligible for any early settlement discount.

The FCA says that these changes bring significant flexibility in proceedings and will help narrow issues in dispute, preserving important incentives to encourage sensible resolutions as early as possible. In practice, this is likely to result in an increase in the number of (at least partially) contested cases being referred to the RDC and a commensurate increase in the work load of the FCA investigation team and the RDC members.

The FCA's changing approach to commencing investigations

Beyond structural changes to the Enforcement process, the FCA report that in the last 12 months there has been an approximate 75% increase in the number of FCA investigations that have been opened. This is an Enforcement trend that is significantly impacting, and will continue to impact, firms and individuals. The increase is attributable to a number of factors, but perhaps the most significant is the FCA's new more open-minded approach to fact finding and information gathering.

In his report into the FSA's Enforcement actions following the failure of HBOS, Andrew Green QC made an important finding which partly explained why the FSA did not conduct further investigations into the failure of HBOS when it could have. The view the FSA took at the time was that the investigations would not have been successful, i.e. they would not have led to successful Enforcement actions so it was not viable to conduct them.

The problem with this approach was the difficulty in accurately evaluating the prospects of success in proceedings before an investigation had even begun. This approach had a tendency to discourage the FSA from starting investigations even though the threshold test for investigating was met and the public importance of investigating was high. While the 'prospects of success' is an important element in considering whether Enforcement resources should be deployed, the merits of a case cannot be assessed before the FCA has the relevant evidence.

This was alighted upon in a recent speech by Mark Steward, the FCA's Director of Enforcement and Market Oversight, who has been vocal about the need for the FCA to approach Enforcement investigations with an open mind, rather than focusing on finding evidence that supports the case it wants to bring. There are a couple of key passages from that speech that are worth noting.

- First, the Financial Services and Markets Act 2000 (**FSMA**) *"creates some very low thresholds and that is deliberate, I think, giving the FCA wide discretion to act where there are serious concerns but not much hard evidence to really go on."*
- Secondly, *"…the function of an investigation is essentially diagnostic, to enable us to understand, when serious misconduct may be in issue, what has really happened and what we need to do about it. It is a fundamentally different process to litigation where we have a view about what has happened. When we are investigating, we have not concluded any view about what has happened. Importantly, while all litigation we conduct should be premised on a proper investigation of the evidence, an investigation does not mean litigation is inevitable."*

The conclusion to draw from this, borne out in the statistics I cite a little later on, is that the FCA is opening more Enforcement investigations into firms and individuals so as to properly understand the facts of a particular matter before reaching a decision as to whether to take formal Enforcement action in relation to that matter. This trend is likely to continue with the introduction of the Senior Managers and Certification Regime which the FCA and PRA are consulting on extending to all financial services firms in 2018.

You might argue that a corollary of this is that more investigations might be dropped without any formal Enforcement action being taken. However, the very fact of an FCA investigation presents a risk of subsequent Enforcement action, regardless of how serious any misconduct uncovered is. Any investigation into a firm also presents a risk to individuals working for that firm, particularly in light of the Senior Managers and Certification Regime.

Furthermore, apart from the risk of formal Enforcement action being taken, an FCA investigation presents obvious resourcing challenges for firms, both in terms of the time that is diverted away from a firm's everyday business to dealing with and responding to an investigation, and the financial cost of having to instruct external advisers to advise and assist with that process. Firms should review their business practices, policies and procedures and identify the key regulatory areas of risk and take preventative steps to ensure those risks are minimised and mitigated against.

Focus of FCA Enforcement

Beyond changes to the FCA Enforcement process, 2016/17 has been another busy year for the FCA's Enforcement team. With the fallout from the Libor and FX scandals largely behind it, the FCA has been refocussing its sights on other issues of importance to maintaining the integrity of the UK financial services industry. I will now look at two of the more important areas that have attracted the attention of the FCA in the last year: financial crime and market abuse.

Financial crime

Financial crime has been at the top of the list of the FCA's priorities for a couple of years now and it continues to be one of its key priorities as set out in its 2017/18 Business Plan. That was reinforced by Mark Steward in a speech he gave on the topic of financial crime in November last year, in which he said "*from an Enforcement perspective at the FCA, we'll look at systems and controls and if they are working effectively. We'll look for egregious instances*". Consequently, the industry is starting to see a number of concluded Enforcement cases brought against firms and individuals for financial crime related breaches.

In the 2016/17 financial year, the FCA opened 43 cases concerning financial crime related breaches. The number of cases open as at 31 March 2017 was 56. That latter figure compares with 20 financial crime cases that were open as 1 April 2016. During this period, the FCA has imposed three financial penalties on firms and individuals for financial crime breaches. Two of these are particularly noteworthy.

In October last year, the FCA fined Sonali Bank (UK) Limited £3.25m and imposed a restriction on it from accepting new business for 168 days for failing to have adequate anti-money laundering (**AML**) controls in place, despite there being no evidence of actual money laundering.

The FCA found serious and systemic weaknesses affected almost all levels of its AML control and governance structure, including its senior management team, its money laundering reporting function, the oversight of its branches and its AML policies and procedures. The firm failed to comply with its operational obligations in respect of customer due diligence, the identification and treatment of PEPs, transaction and customer monitoring and making suspicious activity reports. It had previously received clear warnings about serious weaknesses in its AML controls and a skilled person identified potential under-reporting of suspicious activity, which the FCA viewed as serious. Consequently, Sonali Bank was found to have breached Principle 3 of the FCA's Principles for Businesses.

Although the penalty of £3.25m is not as high as previous fines against banks for AML controls related breaches, it was a high proportion of the bank's turnover in the relevant year (reported as £10m) in addition to a very serious restriction.

Furthermore, responsibility for the firm's breaches was attributed partly to the money laundering reporting officer (**MLRO**) at the time, who the FCA prohibited and fined £17,900. Even though the MLRO was short of resources to perform the function adequately, the FCA highlighted steps that he could have taken, such as escalating the issue to senior management and ultimately the FCA, responding to the issues raised by internal audit and recruiting other staff to assist. Instead, the MLRO failed to tackle the issues raised and reassured the board about compliance.

The FCA is focusing increasingly on all financial crime systems and controls, not just AML processes, in particular sanctions and transaction screening, and the treatment of PEPs. Firms should ensure they have effective and, importantly, proportionate and risk-based systems and controls in place. Individuals responsible for implementing and/or overseeing those systems and controls, or aspects of them, should ensure that they are clear about their areas of responsibility and lines of reporting and these are appropriately documented.

Market abuse

Albeit, part of the broader financial crime picture, the FCA views market abuse as a subject on its own. In the 2016/17 financial year, the FCA opened 120 cases concerning market abuse issues. The number of cases open as at 31 March 2017 was 122. That latter figure compares with 54 market abuse cases that were open as 1 April 2016; a more than 50% increase. During this period, the FCA has imposed three financial penalties on firms and individuals and secured six criminal convictions for market abuse offences.

The FCA are particularly concerned to eradicate market abuse by City professionals. In December 2016, a former Equity Portfolio Manager at an investment management firm was sentenced to 18 months imprisonment reduced with credit to 12 months on two counts of insider dealing. This followed Operation Tabernula which resulted in the conviction and sentencing of a senior investment banker and chartered accountant to 4.5 years and 3.5 years imprisonment respectively for insider dealing. The investment banker sourced inside information from within the investment banks at which he worked, either through working on transactions himself or through being able to glean what his colleagues were working on, and passed this to his accountant friend who then affected secret dealing for each of their benefit.

Enforcement action in respect of market abuse investigations has not been restricted to individuals. The FCA is increasingly investigating companies, including those listed on the UK's primary market and the sponsor regime in relation to Premium Listed companies.

In August 2016, a sponsor firm was fined £530,500 for having failed to have appropriate systems and controls in place, and, on a particular transaction, represented that a client was eligible for a Premium Listing when it had not carried out the requisite due diligence.

Earlier this year the FCA secured agreement from Tesco to pay compensation to investors following inflated share prices as a result of trading data published in 2014 which gave a false or misleading impression about the value of publicly traded shares and bonds. This was the first time that the FCA has used its powers under section 384 of FSMA to require a listed company to pay compensation for market abuse.

It is not just firms in the financial services sector that are exposed to the risk of market abuse, but listed firms where the FCA has remit to undertake investigations pursuant to its powers under the Listing Rules (acting as the UK Listing Authority) and the Disclosure and Transparency Rules. Firms (and individuals) must guard against the risk of market abuse such as insider dealing or market manipulation. A review of control information flows should be carried out, and insider lists maintained and effective restrictions on employee dealing set.

Conclusion

2016/17 has been a busy year for FCA Enforcement. Changes in Enforcement policy and process have given the FCA greater impetus to open and pursue investigations, reflected by a 75% increase, presenting ever greater risks for firms and individuals. This is reinforced by investigations that increasingly concern Premium Listed firms as well as those in the financial services sector. The FCA continues to focus on a range of retail and wholesale conduct issues, but financial crime and market abuse matters remain front and centre of those.

Firms should understand the regulatory risks of their businesses and ensure that appropriate systems and controls are in place to mitigate those risks and, for individuals, responsibilities are clear, properly allocated and documented. 2017/18 is likely to follow the trend of increasing FCA investigations.