Financial regulatory reform
Enforcement checks and balances

Financial regulatory reform is a hot topic, with much debate about the powers of the regulators within the proposed new regulatory system. Attention has focused on the detail of the new powers and the division of responsibility between the new regulators (the Financial Policy Committee, the Prudential Regulation Authority and the Financial Conduct Authority), but there has been less debate on the implications for enforcement. However, the proposals could have a significant impact on the ability to challenge an enforcement or regulatory decision.

Current process
The Financial Services Authority’s (FSA) objectives, disciplinary powers and certain requirements for enforcement are enshrined in the Financial Services and Markets Act 2000 (FSMA). Firms and individuals affected can challenge enforcement decisions and supervisory notices in the Upper Tribunal.

Additional safeguards incorporated into FSA procedures for firms and individuals subject to enforcement proceedings include the following:

- an enforcement case is reviewed by an FSA lawyer who is independent of the investigation (FSA Enforcement Guide 2.36), and the decision on an enforcement case is taken by an independent committee: the Regulatory Decisions Committee (RDC) (based on the general independence requirement in section 395(2) of FSMA);
- the opportunity for firms and individuals to comment on a preliminary investigation report (FSA Enforcement Guide 4.30) and present written and oral representations in response to a warning notice before a determination is made or an announcement of the decision is published (section 387(2), FSMA); and
- the fact that any settlement discussions conducted with FSA staff, and admissions during the settlement process, are without prejudice to the ongoing enforcement action (FSA Enforcement Guide 5.9).

Future regulation and enforcement
The proposals for future regulation, set out in a white paper and the draft Financial Services Bill 2011-2012 (the Bill), envisage a more proactive approach with intervention in a firm’s business at an earlier stage. The aim is to prevent consumer detriment or other negative outcomes from arising in the first place. However, while the current enforcement process is designed to ensure a degree of transparency and fairness for the subjects of enforcement proceedings, it is possible that the current safeguards will, in some respects, be diluted in the process of the regulatory reforms.

The change in approach will be facilitated by a combination of existing and new intervention powers including:

- new product intervention powers, including the power to make rules banning particular products across the market, or to prevent a firm from selling a product because of the risks inherent in the product or the firm’s sales processes;
- new powers to require a firm to withdraw or amend a financial promotion with immediate effect;
- the power to vary a firm’s permission to advance the regulator’s objectives; and
- use of the statutory consumer redress schemes that the FSA can now introduce by making rules without the approval of the Treasury.

New enforcement process
If a firm is required to take immediate action to amend or withdraw a financial promotion, it will then be subject to fast-track enforcement proceedings, giving the firm less than the existing 28 days to prepare and submit representations in response. This fast-track process, the immediate changes to the promotion itself and the publicity that could accompany changes to the promotion are said to be necessary to prevent ongoing consumer detriment. More generally, the Bill would reduce the time available for making representations on enforcement notices, from 28 to 14 days. This seems a rather short period and,
currently, it is the regulatory investigation and arranging and holding an RDC hearing that tend to cause greater delays.

In an environment in which supervisory staff will be making greater use of judgment to assess business models and products based on their knowledge of the firm, there is a suggestion that the logic for separation between regulatory staff gathering evidence during an investigation and staff reviewing a case for enforcement is reduced. Indeed, the Bill amends section 395 of FSMA to dilute the requirement for decision-making staff to be independent from the investigation.

In addition, as the RDC process is not enshrined in statute, it is, at present, unclear whether there may be further changes ahead that are not clear from the Bill. It is also unclear what the disciplinary process for decisions made by the new Prudential Regulatory Authority will be.

Concerningly, the most contentious decisions under the proactive interventionist approach may not engage the disciplinary process at all. A range of regulatory tools can be used with broadly equivalent effect; for example, to stop mis-selling, the regulator could use rules to ban sales of that product, variations of permission for relevant firms, enforcement action or an injunction.

Publicity

When the FSA came into effect, public announcements surrounding enforcement actions were limited to publishing a press release and final notice on conclusion of the action, which could come only after all challenges or appeals to the tribunal or court were exhausted. The Financial Services Act 2010 allowed the FSA to publish a decision notice without waiting for the outcome of a hearing by the Upper Tribunal or even waiting for the subject to make a decision whether to refer a case to the Upper Tribunal.

Further changes to the publicity surrounding enforcement are now planned, including allowing regulators to publish the fact that a warning notice has been issued, the subject of the notice and a summary of allegations. Although the subject of enforcement should have had some prior opportunity to put forward its position to enforcement staff, a warning notice is issued before the person has made representations to the RDC, and so this will significantly erode the right to challenge allegations before they are made public.

This will make it more important for a firm to prepare its case before formal enforcement action is taken and respond in full to all of the allegations raised in a draft investigation report. It will also place an increased onus on the FSA with respect to the allegations that are made in warning notices.

Challenges and appeals

The Upper Tribunal conducts full merits reviews of enforcement decisions on referral by the subject. Either the FSA or the affected party can appeal from the Upper Tribunal to the Court of Appeal on a point of law. However, the potentially greater use of intervention powers falling outside the usual disciplinary and enforcement process means that these avenues to challenge regulatory decisions will be largely unavailable for a growing area of regulatory decision making; for example:

- product intervention is likely to be imposed through rule making, which is subject to consultation rather than the enforcement process;
- variations of permission can be used to intervene in individual firms. Supervisory notices are used for variations of permission, which can be, but rarely are, challenged by referral to the Upper Tribunal. Supervisory notices often take effect when issued and can have a substantial reputational effect in advance of any challenge.
- Although affected parties can challenge a consumer redress scheme by referral to the Upper Tribunal, in many respects, challenge is possible only on judicial review grounds. There is scope for a full merits review on liability or causation issues but no challenge of the facts underlying the rationale for the scheme is possible.

The recent judicial review case brought by the British Bankers’ Association on behalf of its members in relation to the FSA’s action in the payment protection insurance (PPI) market demonstrates the difficulties faced by the industry in challenging the regulator’s use of rulemaking powers (British Bankers’ Association, R (on the application of) v the Financial Services Authority & another [2011] EWHC 999). The High Court found that it was lawful for the FSA to use its rule-making powers to force the industry to conduct past business reviews when it could have used formal powers under section 404 of FSMA to make a consumer redress scheme. Either route could have been used, but a consumer redress scheme has wider scope for challenge.

Implications

Taken individually, most of the changes to enforcement and disciplinary procedures may not seem hugely important and can be justified by the need for greater transparency, consumer protection and rapid action to remove disreputable firms from the UK financial sector. Taken together, however, they erode the safeguards designed to protect the rights of the firms and individuals that face serious consequences as a result of regulatory action. Much will depend on how the new powers are used. There is a risk that the uncertainty that this new environment may create could have unintended consequences to the market.
The team

Simon Orton
T +44 20 7832 7671
E simon.orton@freshfields.com

Sharon Grennan
T +44 20 7716 4775
E sharon.grennan@freshfields.com