

The Jurisprudence of Financial Regulation



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Abstract

This paper analyses the enforcement (ie disciplinary) decisions made by the Financial Conduct Authority since its creation in 2013 with the aim of discerning the messages which the Authority is attempting to send to the financial services industry. It provides a qualitative survey of the decisions underpinned by a statistical analysis. The paper finds that the jurisprudence of the decisions is dominated by the Authority's Principles for Businesses rather than by the rules in the Authority's Handbook. Principle 3 which requires proper organisation and risk management dominates the jurisprudence.

Keywords: Financial Conduct Authority, Enforcement/Discipline, Fines, Principle based Regulation, Risk, Customer care

Introduction

This paper is based on a comprehensive analysis of the Final Notices (ie disciplinary decisions) issued by the Financial Conduct Authority (FCA) since its creation in 2013. The paper aims to identify the messages that the Authority is attempting to send to the financial services industry in this area of its work.

Value of the research

It should be recognised at the start that an approach which concentrates on the disciplinary decisions of the FCA has limitations. In particular, it concentrates on only one aspect of the Authority's work: those cases exhibiting the most serious misconduct. It ignores the large amount of the work performed by the Authority by means of market studies and guidance as well as in the course of its supervision of firms. These activities may well improve conduct without the use of regulatory penalties. They are at the core of the FCA's regulatory function. In its 2015-16 Annual Report the FCA stated that:

'Our regulatory role is, inevitably, often focused on identifying and tackling instances of poor conduct. But our role is also an enabling one; we seek to provide firms with information, guidance and best practice to help them operate fairly and effectively, with the interests of customers and the markets at the centre of their business.'¹

In addition, an FCA investigation into a problem may not result in disciplinary action: misconduct may not be revealed or it may be deemed unnecessary to penalise any misconduct which is discovered. In 2016/17, 62% of investigations started by the FCA did not result in disciplinary action.² The FCA's 'Dear

¹ FCA, *Annual Report 2015-16*, p 10.

² FCA, *Enforcement Annual Performance Account, 2016/17*, p 32.

CEO' letter in relation to the selling of contracts for difference³ revealed significant failings in the 34 firms the authority had investigated. But, the authority indicated that the failings of only one of those firms was 'so poor' that further action was merited.

Final notices resulting in regulatory fines are also only one of the disciplinary mechanisms available to the FCA. In appropriate circumstances it can initiate criminal proceedings⁴ or can require a firm to pay redress to its clients.⁵ Its power to prohibit or cancel a permission to conduct regulated business⁶ can have drastic consequences on firms or individuals.

This research does pose the question whether FCA Final Notices can be relied on as establishing norms of conduct if, as is commonly the case, they express an agreement between a firm and the authority to settle the case as part of the former's cooperation with the aim of achieving a discount on any fine. The answer to this is that enforcement decisions are clearly phrased in a way which is intended to send general messages to the industry as to the standard of conduct expected⁷ even if the published facts of the case have been agreed as part of a settlement. The FCA's Enforcement Guide is clear that enforcement is part of its 'credible deterrence' strategy. It states that, enforcement 'can ...be a particularly effective way, through publication of enforcement outcomes, of raising awareness of regulatory standards.'⁸ The authority has repeatedly criticised firms which have failed to learn the lessons to be drawn from previous enforcement cases.⁹

It is, therefore, argued that a study of published enforcement decisions has considerable value as part of an assessment of the FCA's work at a time when there is public and political disquiet about practices in the industry. The regulator wants the industry to understand the standards of conduct which it now expects to see and the public to receive the message that the banking system is, as a result, subject to effective regulation which requires high standards of management and conduct. Indeed, the regulatory penalties imposed on banks (and the levels at which they have been imposed) have attracted a considerable level of press and public attention.¹⁰

At a more theoretical level, a study of these decisions illustrates the abandonment of 'light touch' regulation and the more demanding approach which has replaced it. It may thus help the discussion as to whether the regulatory system which we now have will protect consumers from misconduct and help the financial system to develop successfully whilst protecting society from the risk of another crash.

³ FCA, *Providers and distributors of contracts for difference (CFD) products: resolving failings which may cause significant consumer harm*, available at <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-cfd-review-findings.pdf> (accessed 26th February 2018).

⁴ Financial Services and Markets Act 2000 (FSMA) s 401.

⁵ FSMA s 404.

⁶ FSMA ss 56, 55J.

⁷ FCA, *Enforcement Annual Performance Account*, 2016/17, p 6.

⁸ FCA, *Enforcement Guide*, para 2.1.

⁹ FCA, Final Notice, *Towergate Underwriting Group Limited*, 13th July 2016.

¹⁰ The LIBOR fines were given to Armed Forces and Emergency Services charities. See at HM Treasury, *Autumn Budget 2017 Banking fines – grant commitments* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661497/Banking_fines___grant_commitments.pdf. (accessed 17th April 2018).

Finally, as all lawyers will assert, a study of decided cases aids our understanding of rules. This is important because the rules being applied here are central to the regulatory system.

The theory

Modern financial regulation has a number of distinct features. Its most important characteristic is that it aims to be forward looking and proactive: prevention is better than cure.¹¹ It is hoped, for example, that a problem such as payment protection insurance would nowadays be identified and dealt with before it could develop into a major one. The strategies being adopted by firms are therefore considered to be a way of detecting emerging risks.¹² Underlying this approach is the notion that improving culture and practices within firms is the best way to protect consumers and to ensure that the industry attracts business.¹³

The other major feature of the modern system is that the 'light touch' approach which ruled prior to 2008 has been replaced by a much more demanding and intrusive form of regulation. Self regulation by banks and market discipline are no longer trusted as the appropriate mechanisms to achieve a sound financial system.

Other features are also present. Because the resources available to the FCA are limited, it is important that it operates a proportionate and 'risk based' approach which concentrates attention on the most significant issues.¹⁴

Finally, as we will see, the combination of these approaches gives rise to elements of meta-regulation whereby those being regulated assume a significant self-regulatory role within the system.

The data under review will also show clearly that the FCA's disciplinary work is dominated by a 'principles based' approach. Its aim is to identify general themes which are relevant to the whole industry rather than to base disciplinary action on rules which only concern a limited number of firms. The FCA operates a 'credible deterrence' approach which is designed to send lessons to the whole industry.

Data

The survey has considered all final notices (751) issued by the FCA from the date of its taking over responsibility for regulating the financial services industry on 1st April 2013 to 31st December 2017.

The data has been configured in two ways with the result that the concentration is on larger firms and thus the messages being issued on the ways in which the FCA wishes to see business conducted. First, the data excludes enforcement action taken against individuals. Such action, whilst of great importance, raises rather different considerations than that dealing with firms. The rules governing individuals have been revised considerably with the roll out of the Senior Managers' Regime: they

¹¹ Griffiths-Jones, J, *Accomplishments of the last five years*, speech 14th March 2018, available at <https://www.fca.org.uk/news/speeches/accomplishments-last-5-years> (accessed 13th April 2018).

¹² FCA, *FCA Mission: Our approach to supervision*, 2018, p 8.

¹³ *Ibid*, p 8.

¹⁴ *Ibid*, p 9.

require separate treatment. Secondly, the vast majority of the Final Notices issued by the FCA in recent years have been cancellations or refusals of permissions to conduct regulated business. These commonly involve a cancellation under Financial Services and Markets Act 2000 (FSMA) s 55J of the permission previously granted to a consumer credit adviser or a payment services provider. The basis of the cancellation is commonly a breach of Principle 11 in that the firm is held to have failed to be open and cooperative with the regulator. These 'licensing' decisions, which occur in areas in which the FCA grants firms approval to trade, have a significant impact on the data in increasing the apparent importance of Principle 11. For example, in 2017 Principle 11 featured in 210 (82.3%) Final Notices if these cases are included but in none if they are excluded. The reality is that these Principle 11 decisions are not important in developing the principles which govern the provision of financial services in the UK and are better excluded from the data. They have therefore been excluded.

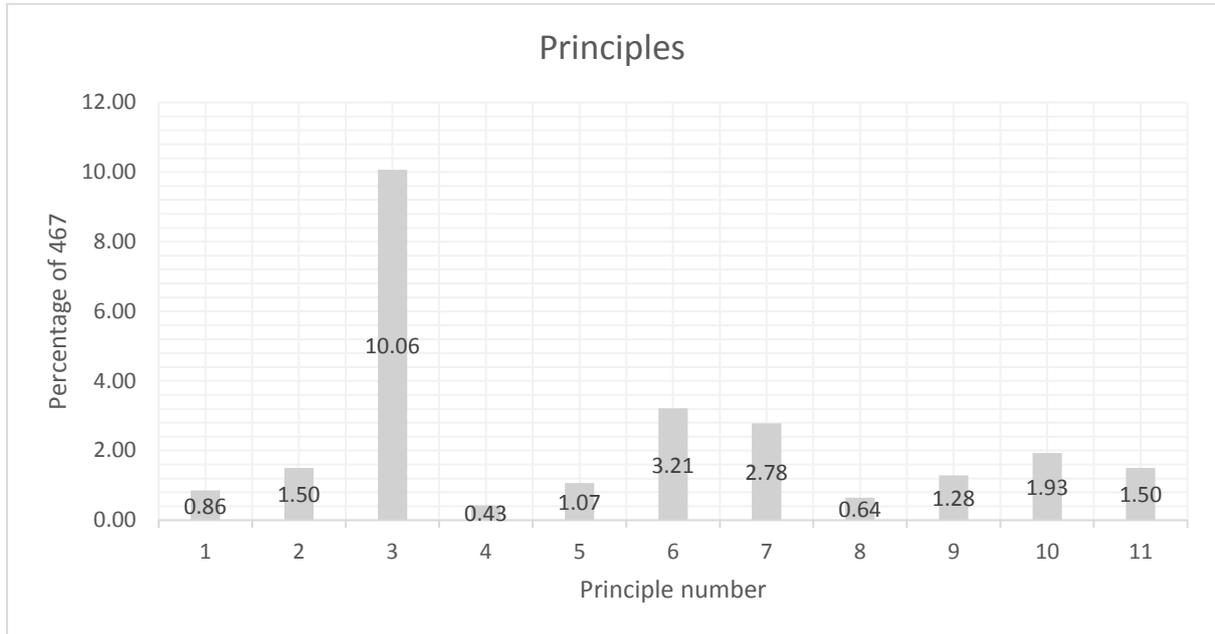
As a result of this, only 467 Final Notices are the subject of this research.

A central plank of the FCA's regulatory system are the eleven Principles for Businesses set out in the FCA's Handbook. They are:

1. A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.
8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. A firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the firm of which that regulator would reasonably expect notice.

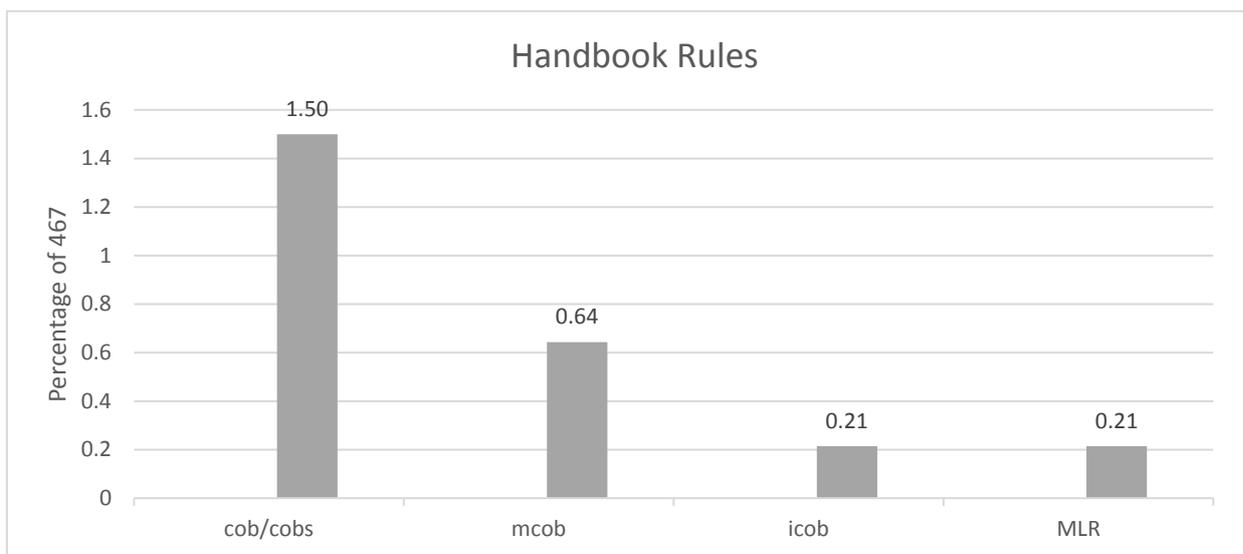
Figure 1 shows the frequency with which these Principles for Businesses are used in the decisions. It should be noted that decisions often use more than one Principle.

Fig 1: Use of Principles



The Handbook also contains many detailed rules. Applying the same methodology to a selection of the most important areas of the Handbook (Figure 2) reveals that they are little used in Final Notices. Indeed, when they are, they tend to appear as support for decisions founded on the Principles. Thus, the Conduct of Business Sourcebook (COBS) which governs investment services appears in only 7 decisions (1.5%) and the Money Laundering Regulations (MLR) in only one (0.21%).

Fig 2: Use of Rules



As we have seen in relation to Principle 11, frequency of use does not automatically indicate the importance of a Principle. However, the importance of Principle 3 is emphasised by the fact that the 47 breaches of it attracted an average fine of £53.2 million.

What the data tells us

There are two notable features revealed by this data: the dominance of the Principles and the role played by Principle 3.

The data shows clearly that the Principles for Businesses are at the centre of enforcement action and that they are used as the basis for enforcement to a much greater extent than the detailed rules found in the Handbook. Even when rules are cited, they tend to play a subsidiary role to Principles.

The dominance of Principles over rules enables the FCA to build a general jurisprudence and thus to send messages which are not tied to specific areas. Also, as happened in the LIBOR decisions, this 'principles based' approach enables enforcement action to be taken in areas which are not subject to any express rules. The fact that the Principles are expressed in wide terms also means that misconduct can justify enforcement being taken for breach of more than one Principle. For example, an organisational failure which breaches Principle 3 may also show a failure to conduct the business with due skill, care and diligence which amounts to a breach of Principle 2. In addition, the result of such breaches may also be a failure to treat customers fairly which amounts to a breach of Principle 6. Failures to operate proper anti-money laundering procedures have, in recent years, been treated both as a breach of Principle 2¹⁵ and of Principle 3.¹⁶ The fact that it may be difficult, in advance, to predict which principle will be used by the regulator against a firm shows that the regulators have a wide range of overlapping tools available to support their enforcement work. As a result, it is difficult to envisage many forms of misconduct which could slip through the regulatory net.

Principle 3 is fundamental to this area. It is used in many of the highest profile cases: those concerning LIBOR and foreign exchange manipulation, the RBS IT failure and money laundering. It is also, as the embodiment of the proactive approach, fundamentally different from the other principles. It does not demand a result, such as to take care or give suitable advice. It demands that firms adopt an organisational structure which is itself proactive as to risks. The FCA cannot avert all risks confronting all firms. Liability is therefore based, for example, not so much on misconduct than on a failure to have mechanisms in place to identify and eliminate misconduct and other risks. Banks are not being fined for assisting money laundering but for not having sufficient enhanced due diligence processes in place to counter the possibility of their systems being used by money launderers. There is a further significance of this approach. Principle 3, by requiring firms to embed a proactive compliance and risk management system throughout the business, is making a significant contribution to building a better culture within firms: regulation is seen as a tool which can help to build a better culture in the industry.¹⁷

¹⁵ FCA, Final Notice, *Barclays Bank PLC*, 25th November 2015.

¹⁶ FCA, Final Notice, *Deutsche Bank AG*, 31st January 2017.

¹⁷ A Bailey, speech, *Transforming culture in financial services*, 19th March 2018, available at <https://www.fca.org.uk/news/speeches/transforming-culture-financial-services>. Last accessed 17th April 2018.

The small, but significant, group of ‘non-licensing’ Principle 11 cases are also important as they express the requirement that the FCA needs to understand the business of firms and the strategies they are adopting and to be kept informed of significant developments. In practice, the FCA cannot be everywhere or be able to identify every emerging problem itself. It follows that firms have a positive obligation to volunteer information: this includes self-reporting of breaches of rules. A proactive supervisory system needs to be supported by a good intelligence system if it is to work.

Messages

I now propose to consider the most important messages contained in these decisions in more detail: concentrating on the ‘organisational’ Principles 3 and 11 and the customer orientated Principles 6, 7 and 9.

Organisation: management and risk

As we have seen, a central element in the modern regulatory system is the emphasis placed by the proactive approach on the management of firms and the identification and management of risk affecting the firm. As the survey data shows, Principle 3, which requires a firm to ‘take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems,’ is the basis of liability in many of the important enforcement decisions. The logic underpinning this area of regulation needs to be understood. If, for example, a LIBOR submitter manipulates the market by making a submission based on extraneous factors, such as his employer’s liability to pay on a derivatives contract, the bank is not vicariously liable for that person’s conduct: it is primarily liable for its own failure to control and eliminate the risk of this happening.

It is difficult to see how a firm can be run properly without management having put in place systems which enable its affairs to be overseen effectively so as to deal with risks and to satisfy regulatory requirements. Principle 3 (and Principle 2) can be applied to a variety of situations in which a firm has been found to have inadequate controls in place to manage risk. The enforcement action taken concerning the manipulation of Foreign Exchange markets¹⁸ and LIBOR¹⁹ and some anti-money laundering²⁰ and conflicts of interests²¹ cases provide examples of decisions based on a finding that management had failed to exercise effective controls over parts of their firms with the result that misconduct had occurred. Enforcement action can be taken under these principles even though there is no evidence of actual misconduct by employees or loss suffered by customers. The existence of a defective organisational structure which creates a vulnerability to misconduct or risks suffices.²²

Principle 3 fits with the general modern approach to regulation but it requires firms, as well as the regulators, to be proactive. It requires firms to challenge (and that word recurs regularly in decisions) the conduct of their staff. This is a species of meta-regulation: it is for firms to manage their business and control their staff proactively. The approach allows for the facts that differently organised institutions may operate different models of risk management and that regulators lack the capacity to

¹⁸ For example, FCA, Final Notice, *UBS AG*, 12th November 2014.

¹⁹ For example, FCA, Final Notice, *Lloyds Bank plc, Bank of Scotland plc*, 28th July 2014.

²⁰ For example, FCA, Final Notice, *Deutsche Bank AG*, 31st January 2017.

²¹ FCA, Final Notice, *Arch Financial Products LLP*, 31st March 2015.

²² FCA, Final Notice, *JLT Specialty Limited*, 19th December 2013.

do everything. The modern approach which says that the regulators work is to be 'intensive and intrusive' appears to be reflected in the regulator's expectations of firms' internal controls. In practice, this will involve many firms having an effective 'three lines of defence' model of risk control (of front office supervision by those undertaking the work, compliance staff overseeing the work of the former and internal audit reporting to the Board and Audit Committee) which actively challenges work practices. Back office compliance staff are expected to challenge explanations of problems offered by staff in the front office.²³ Proper management information, such as records of trading, which enables problems to be identified is an essential requirement.²⁴ Firms are obliged to keep patterns of trading under review as a method of identifying problems.²⁵ It follows that complaints data should be subject to a 'root cause analysis' as part of the firm's quality enhancement²⁶ and that a lack of 'suspicious activity reports' may indicate that poor anti-money laundering procedures are in place.²⁷

The wording of Principle 3 emphasises that management structures need to be risk focused. Systems need to be tailored to the activities of the particular firm and the risks that they create. The FCA has criticised firms for not having systems specific to their major areas of activity. The Principle thus requires detailed, as opposed to general, internal rules. For example, the FSA held that the Royal Bank of Scotland²⁸ had breached Principle 3 by seating its derivatives traders in close proximity to staff who were making LIBOR submissions and placing no restrictions on their ability to communicate. On occasions, the bank had allowed some derivatives traders to act as substitute LIBOR submitters. These practices created an obvious risk that submissions would be influenced by trading positions. The principal reason given for the finding that Deutsche Bank had broken Principle 3 was that it had no 'IBOR-specific systems and controls in place' and that 'minimising the risk of Trader misconduct was not at the forefront of the priorities.'²⁹ Similar findings were made against Barclays Bank in the foreign exchange decision. The policies which it had:

'were very broad and not tailored to the FX business. (T)here were more specific policies covering a range of risks, including confidential information, conflicts of interest, external communications and electronic communications. These policies were not sufficiently clear or specific in their application to the FX business nor did they address adequately the key behaviours...'³⁰

Remuneration and bonus schemes are another area which creates risks. The Wells Fargo mis-selling scandal which was caused by a remuneration scheme which created incentives for sales staff to open accounts fraudulently has its equivalent in the UK. In 2013 Lloyds TSB Bank plc, Bank of Scotland plc.³¹ was fined £28 million as a result of a remuneration scheme which increased the pay of staff who exceeded sales quotas on investment products and reduced that of those who failed to meet them.

²³ FSA, Final Notice, *UBS AG*, 25th November 2012.

²⁴ FCA, Final Notices, *Lloyds TSB Bank plc, Bank of Scotland plc*, 10th December 2013 and *Barclays Bank PLC*, 23rd May 2014.

²⁵ FCA, Final Notice, *Martin Brokers*, 15th May 2014.

²⁶ FSA, Final Notice, *Bank of Scotland plc*, 23rd May 2011.

²⁷ FCA, Final Notice, *Sonali Bank UK Ltd*, 12th October 2016.

²⁸ FSA, Final Notice, *The Royal Bank of Scotland plc*, 6th February 2013.

²⁹ FCA, Final Notice, *Deutsche Bank AG*, 23rd April 2015, paras 2.9, 2.11 and 4.53.

³⁰ FCA, Final Notice, *Barclays Bank PLC*, 25th November 2015, para 4.32.

³¹ FCA, Final Notice, *Lloyds TSB Bank plc, Bank of Scotland plc*, 10th December 2013.

This created a high risk of mis-selling and had at times resulted in staff selling products to themselves, colleagues or relatives and then using cooling off periods to escape the transaction once their sales figures had been calculated. Controls existed within the bank but were not focused on the high risks created by the scheme (they focused on the customer rather than on the sales staff). A particular problem was that supervision of sales staff was conducted by sales managers whose own remuneration was dependent on the performance of the staff they were supervising. The moral is clear. Had sufficient challenge been made at the time that the remuneration scheme was devised, the unintended consequences would have been identified and the problems of mis-selling and self-selling would have been avoided. Once the scheme was in operation, it created significant risks which should have been very carefully monitored. The authority, in its decision, emphasised that where a situation creates risks, it is the way in which the firm controls those risks that matters.

Inadequate training and guidance of staff is a common cause of a breach of Principle 3. Compliance policies may be held to have been too general and not specific to the risks created by the work being undertaken.³² Monitoring of sales staff must be conducted in order to ensure that compliance and quality standards are being met, not simply to check sales performance.³³ An expansion in sales may need to be accompanied by an equivalent expansion in compliance monitoring.³⁴ An inadequate number of staff to conduct the required depth of monitoring may result in the principle being broken.³⁵ The decision in Chase de Vere Independent Financial Advisers Limited³⁶ provides a different example. There, liability was established under Principle 3 as a result of the firm having inadequate mechanisms with which to research the characteristics of products which were being recommended to investors.

In the modern world it would be wrong for a firm to ignore the risk of IT failures or cyberattack. In 2007 Norwich Union Life was held to have breached Principle 3 for failing to secure customer data against the risk of fraud.³⁷ The RBS IT failure³⁸ provides an example of a failure to guard against the risk of a systems failure. Employees had removed some software from the banks' system without having tested the consequences of doing this. The result was a failure which crashed the banks' systems and created a systemic risk for the whole banking system as customers who could not access funds could not pay others who did not bank with RBS. FCA held there to have been a breach of Principle 3, based on a failure to have adequate systems in place to control and manage the risk of such an IT failure. Those managing the upgrade did not conduct it properly and, in addition, the bank's defences against the risk of an IT failure were inadequate. The culture which had grown up within the bank concentrated on reaction to specific forms of IT incident rather than identifying and managing the whole range of IT related risks confronting it. Higher levels of management had limited IT skills and insufficient challenge to the views of those doing the job had occurred. The decision shows the need for firms to have an effective and proactive risk assessment policy: one which regularly challenges the views and assumptions of specialists within the firm. It is also of more general

³² FCA, Final Notice, *Barclays Bank PLC*, 23rd May 2014.

³³ FCA, Final Notice, *Bluefin Insurance Services Limited*, 6th December 2017.

³⁴ FCA, Final Notice, *Swinton Group Limited*, 16 July 2013, para 101.

³⁵ FCA, Final Notice, *Porta Verde Financial Services Limited*, 24th October 2013.

³⁶ FCA, Final Notice, *Chase de Vere Independent Financial Advisers Limited*, 5th November 2014.

³⁷ FSA, Final Notice, *Norwich Union Life*, 17th December 2007.

³⁸ FCA, Final Notice, *Royal Bank of Scotland Plc, National Westminster Bank Plc, Ulster Bank Ltd*, 19 November 2014.

importance because of the emphasis which was placed on the fact that the relevant IT staff were comparatively inexperienced and that the departments overseeing their work were understaffed. A failure to resource the management of risk adequately can lead to a breach of Principle 3.

Organisation: being open and cooperative

Principle 11 states that a firm must deal with its regulators in an open and cooperative way and must disclose to the FCA anything relating to the firm of which the regulator would reasonably expect notice. A number of decisions made under this Principle emphasise the Authority's need to be fully apprised of significant developments in firms and that it will take stringent enforcement action against those who withhold information from it. These decisions are examples of the intrusive nature of modern financial regulation. Proactive regulation cannot work unless the regulator is fully apprised of significant developments in the firms being supervised.

The decision to impose a penalty of £792,900 on Achilles Macris³⁹ for a breach of APER 4 (the open and cooperative requirement as applied to individuals under the former approved persons regime) says a lot about the intrusive nature of modern regulation in the sense that Macris's personal liability was based on a failure to disclose to the FCA a serious deterioration in the trading position of the funds he was responsible for at JPMorgan Chase Bank. There are two elements to this case which show the kind of regulation which is now in place. First, there is clearly an obligation on a firm and its managers to inform the regulator of bad news. The regulator has to be involved when matters are occurring which can impact on the wider market. The other element impacts on the responsibilities of individuals. Those leading management need to set an example for those further down in the hierarchy to follow. There is an obligation to be open and cooperative with the regulator and senior management, by acting in this way, can contribute to the development of an open culture within the firm.

A number of enforcement actions taken against major banks emphasises the point that proactive regulation does not work if the regulator does not know what is going on and that the FCA will penalise banks which impede its work by failing to make disclosures. In *The Co-operative Bank plc*⁴⁰ the bank was held to have breached Principle 11 by failing to notify the Authority of intended changes to two senior positions (and the reasons behind those changes). This was regarded as a serious failing: the regulator would expect to be notified of any intended changes to senior positions without delay in order to enable it to properly consider and assess the management of the firm. It was particularly important that this was done in this case, as there were significant issues concerning the health of the bank at that time. Deutsche Bank has been penalised twice for breaching such requirements. In 2015⁴¹ it was held to have broken Principle 11 when it withheld a report made by the German regulator, telling the FCA, untruthfully, that its release had been prohibited. The bank was also found, in that case, to have destroyed tapes in breach of an instruction to preserve them. A penalty of £228.6 million was imposed for this and breaches of Principles 3 and 5. In 2014⁴² the bank was held to have breached SUP 17.1.4 R of the FCA Handbook, which obliged it to accurately report to the regulator all CFD Equity Swaps transactions which it executed. The failure to report the matter accurately had extended over

³⁹ FCA, Final Notice, *Achilles Othon Macris*, 9th February 2016.

⁴⁰ FCA, Final Notice, *The Co-operative Bank plc*, 10th August 2015.

⁴¹ FCA, Final Notice, *Deutsche Bank AG*, 23rd April 2015.

⁴² FCA, Final Notice, *Deutsche Bank AG*, 28th August 2014.

a period of five and a half years. The FCA commented in its Final Notice in the case that ‘Accurate and complete transaction reporting is essential to enable the Authority to meet its operational objective of protecting and enhancing the integrity of the UK financial system. The primary function for which the Authority uses transaction reports is to detect and investigate suspected market abuse, insider trading and market manipulation.’ The bank was subject to a penalty of £4.72 million for this failure.

Customer care

The other main issue which emerges from the data is the importance of customer care. FSMA s 1B(3)(a) and 1C stipulate consumer protection as one of the FCA’s three statutory objectives. This concern is of particular importance at a time when there is a need to build a new culture in the industry. The sales and bonus-oriented approach which gave rise to many problems in the past needs to be replaced by a more customer focused, professional approach.

This theme can be seen underpinning many examples of the FCA’s enforcement work. The survey data does not show a great number of decisions in this area. However, customer related misconduct will often impact on individuals rather than being spread across the whole firm. For example, sales of ‘unsuitable’ products are more likely to result in litigation or claims to the Ombudsman than in enforcement action against a firm.

The Principles for Businesses lay down five specific duties owed by firms to customers which reflect the ‘consumer protection’ objective and the desire for cultural change in the industry. In many cases, fulfilling these duties will cost firms time and money. However, the customer’s interests have to take priority. The ones of greatest importance in terms of developing standards of conduct are: Principle 6 (treating customers fairly); Principle 9 on suitability of advice and Principle 7 on the provision of information to customers.

Customer care: treating customers fairly

Principle 6, which features in 3.21% of cases brought against firms, requires that a firm ‘must pay due regard to the interests of its customers and treat them fairly.’ This is obviously a very general principle which can be breached in many ways. Equally, it is one which is central to the ‘consumer protection’ objective: the public should be able to buy financial products knowing that fair treatment of customers is central to the firm’s culture.⁴³ Giving priority to sales performance at the expense of the interests of customers is a classic way of breaching this Principle⁴⁴ as is selling a product without having adequate grounds for believing it is affordable or appropriate for the customer’s needs.⁴⁵ Customers need to be given a full understanding of the product being offered: they should be directed to the full range of options open to them, not just to the one which is most profitable for the firm or the member of staff making the sale.⁴⁶

The DISP chapter of the FCA Handbook contains detailed rules on the handling of complaints. A breach of these rules is likely to lead to a finding that customers have not been treated fairly. In 2013 the FCA

⁴³ FCA. *The FCA’s approach to advancing its objectives*, (2013), p 11.

⁴⁴ FCA, Final Notice, *Swinton Group Limited*, 16 July 2013.

⁴⁵ FCA, Final Notice, *Quick Purchase Limited t/a Rent My House Back*, 23rd October 2015.

⁴⁶ FCA, Final Notice, *Stonebridge International Insurance Limited*, 7th August 2014, paras 4.23-26.

imposed a penalty of £2.83 million on Policy Administration Services Limited⁴⁷ for a number of failures including a failure to undertake a root cause analysis of customers' complaints in accordance with DISP 1.3.3R. Principle 6 has been invoked in relation to inadequate handling of the PPI complaints process.⁴⁸ These decisions show that customers should be treated as individuals and should not be permitted to fall foul of blanket policies. In the Lloyds Banking Group case the FCA commented that the problems revealed (giving guidance to complaints handlers which effectively created a presumption that the sales process for PPI had been 'compliant and robust' and not notifying the complaints handlers of known defects in the institution's sales processes) meant that: 'a significant number of customers who had already been treated unfairly once were treated unfairly for a second time and denied the redress they were owed.' The problem facing banks in such a matter is one of striking a balance between giving staff a script of responses to work through when dealing with a customer and allowing a level of freedom which runs the risk of statutory requirements not being satisfied. In Clydesdale Bank PLC the bank's policy of not retaining documents beyond a certain date had been used to justify an instruction to complaint handlers not to spend time searching for older documents even though some documents had survived and could have been retrieved. The strategic importance of these findings in terms of rebuilding customer confidence in the banking industry is shown by the Authority's statement in the Final Notice to Lloyds Bank that: 'Ensuring that every customer is treated fairly when they complain is important to the Authority's consumer protection objective and in rebuilding trust in financial institutions particularly following the widespread mis-selling of PPI.'⁴⁹

Principle 6 has also been important in relation to the obligations being placed on firms to deal sympathetically with customers in financial difficulty. In relation to *Yorkshire Building Society* the Authority stated:

'It is important that firms proactively engage with these customers to ascertain the cause of their difficulties and their future financial prospects and to identify swiftly payment solutions appropriate to customers' individual circumstances and which are fair. To do this effectively, staff dealing with customers need to be adequately trained, sufficiently skilled and provided with appropriate guidance.'⁵⁰

As a result of these failures, the Society was found to have delayed achieving appropriate solutions for customers who were in arrears with the result that the sums owed by many customers had increased. The FCA found that it was not realised by the Society that delays in achieving a solution were detrimental to a customer's financial position and thus unfair under Principle 6.⁵¹

Customer Care: suitability of advice

⁴⁷ FCA, Final Notice, *Policy Administration Services Limited*, 1st July 2013.

⁴⁸ FCA, Final Notices, *Clydesdale Bank PLC*, 14th April 2015 and *Lloyds Bank plc, Bank of Scotland plc and Black Horse Limited (together Lloyds Banking Group "LBG")*, 4th June 2015.

⁴⁹ FCA, Final Notice, *Lloyds Bank plc, Bank of Scotland plc and Black Horse Limited (together Lloyds Banking Group "LBG")*, 4th June 2015, para 2.3.

⁵⁰ FCA, Final Notice, *Yorkshire Building Society*, 28th October 2014, para 2.6.

⁵¹ *ibid* para 4.47.

A more specialised consumer protection obligation is that in Principle 9 to take reasonable care to provide advice which is suitable for the customer having regard to their financial circumstances and risk profile. A breach of this Principle features in only 6 (1.28%) of the cases surveyed. One presumes that this is because issues of mis-selling are more likely to result in an individual bringing a case to the Financial Ombudsman Service or a civil claim under FSMA s 138D for breach of the more specialised COBS 9.2.1R rather than in regulatory action.

However, Santander⁵² and The Royal Bank of Scotland plc, National Westminster Bank Plc⁵³ were both held in 2014 to have breached Principle 9 by failing to ensure that their advisers gathered all necessary information from customers to enable suitable recommendations to be made and to ensure there was an adequate process in place for assessing the risk that a customer was willing and able to take. In addition, Santander had failed to ensure that there was an adequate process in place to check that certain investments continued to meet customers' needs or to implement adequate procedures for monitoring the quality of investment advice and remedial action taken where advice had been found to be unsuitable or unclear. In John Joseph Financial Services Limited⁵⁴ a finding of unsuitability was based on a failure to warn of the risk created by a lack of diversification in a portfolio.

Customer care: information needs

The Principle 7 duty is that a 'firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.' This was the basis of a finding of breach in 2.78% of cases against firms. The information provided needs to be balanced, not slanted towards the positive and downplaying the risks.⁵⁵ The FCA has stated, in holding a bank to be in breach of this principle, that: 'providing clear information up front about the service to be provided, what it is going to cost and the main features and risks of a product is essential to delivering fair outcomes for customers.'⁵⁶ In practice, most customers will rely heavily on promotional material when deciding to make an investment. Indeed, it is a feature of the financial services industry that customers know very little about the substance of the product they are buying.

The Yorkshire Building Society⁵⁷ and Credit Suisse⁵⁸ decisions of June 2014 are good examples of misleading promotional literature. The firms were held to have breached Principle 7 because they had marketed a product emphasising a maximum rate of return which it was known would be almost impossible to achieve and had failed to make early exit fees clear to customers. In Invesco Asset Management Limited⁵⁹ the FCA emphasised the importance of proper disclosure of information when investments are being managed as the investor is unlikely to be in a position to monitor the process personally. In that case, there had been a failure to disclose breaches of investment limits in certain

⁵² FCA, Final Notice, *Santander UK plc*, 24th March 2014.

⁵³ FCA, Final Notice, *The Royal Bank of Scotland plc, National Westminster Bank Plc*, 27th August 2014.

⁵⁴ FCA, Final Notice, *John Joseph Financial Services Limited*, 30th September 2015.

⁵⁵ FCA, Final Notice, *Westwood Independent Financial Planners*, 17th December 2013.

⁵⁶ FCA, Final Notice, *Santander UK plc*, 24th March 2014, para 4.25.

⁵⁷ FCA, Final Notice, *Yorkshire Building Society*, 16th June 2014.

⁵⁸ FCA, Final Notice, *Credit Suisse International*, 16th June 2014.

⁵⁹ FCA, Final Notice, *Invesco Asset Management Limited, Invesco Fund Managers Limited*, 24th April 2014.

funds and of the fact that the use of derivatives introduced leverage into the funds which exposed investors to increased levels of risk.

Conclusion

The most important result of this survey is the dominance of principle-based regulation in the FCA's enforcement work. There is also evidence to support the view that modern financial regulation adopts a proactive stance, uses a meta-regulatory approach in emphasising the need for firms to police themselves and concentrates resources on the most significant cases. There is little evidence in enforcement cases of an 'outcomes' focused form of regulation being in operation. Possibly such an approach would involve devolving too great a degree of discretion to those being regulated in a period in which light touch regulation has been discredited.

In detail, there is considerable emphasis placed on active risk management and consumer protection by firms. In itself, this is not surprising. However, this occurs in a context in which the FCA is applying an active form of regulation to those firms which contrasts with the former 'light touch' approach. The modern regulatory system does not accept that major institutions can be trusted to deal with the matters themselves in the absence of active regulation.

A return to 'light touch' regulation seems highly unlikely for a number of reasons. First, the scars from 2008 and the later examples of misconduct, such as the LIBOR manipulation, are still too raw. Second, the need for the banking and finance industry to show that it is reputable as it competes for business remains. To water down the level of regulation would be to send precisely the wrong message. Third, it would require the dismantling of much of the current system which would be very difficult to do politically. The fact that the amount of fines being collected through enforcement has dropped dramatically does not mean that a 'light touch' approach to supervision is being adopted:⁶⁰ it simply shows that a batch of cases featuring really bad conduct have now been disposed of.

The psychology underpinning this area of regulation has changed. Before 2008 the consensus was that risk had been virtually eliminated from the system: it would require events that only occurred once in a thousand years to bring it down. That was wrong and as a result the question now is not 'could it happen again?' but 'when and in what form will it happen again?' As the modern outlook is fundamentally pessimistic, it seems unlikely that there will be much of an appetite for loosening the level of regulation.

In addition, there is the challenger bank/Fintech debate to be taken into account. Anyone who has studied the fall of HBOS will know that the mentality in parts of the bank was that it was a 'challenger' which could outgun older more established banks because it used more modern techniques to handle risk. Hopefully, the lesson has been learned, although the tension, which one sees embedded in the FCA's statutory objectives between encouraging competition and building a robust and safe system remains. What must not happen, and there are already signs of it in the fact that P2P lenders are outside of the deposit protection scheme, is for successful challengers to be allowed a more favourable regulatory regime which permits them to cut corners and to undercut more established businesses. There is a strong argument for saying that financial regulation needs to remain robust.

⁶⁰ FCA, *Enforcement Annual Performance Account*, 2016/17.

Indeed, it is in relation to new business techniques that proactive regulation needs to be at its most vigilant. However, the fact is unavoidable that intrusive regulation is likely to depress bank earnings and to make them vulnerable to disruptive technologies: there is a difficult balance to be struck between safety and success.

However, the form of regulation we have is not unproblematic for a number of reasons. First, it has become fairly prescriptive. One can envisage the industry becoming increasingly critical of the level of controls and the cost of compliance which they create especially given the existence of a government whose ideology tends to favour deregulation. Second, it favours risk avoidance and conservative practices. It tends to concentrate attention on the avoidance of risks rather than on building a new culture in the industry. As such, regulation needs to be seen as an element, albeit an important one, in a wider issue of building a new and better culture in the financial services sector.