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FSA Enforcement Process Review – Issues Paper

The IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

As you will be aware, the IMA was party to the discussions and meetings with the FSA that culminated in the submission by the Financial Services and Markets Legislation City Liaison Group. The following is the IMA's own response to the FSA's Enforcement Review Issues Paper.

The review provides an important opportunity to enhance a system that, for a variety of reasons, has become regarded as unfair. Broadly speaking, the IMA considers the existing decision making framework to be fit for its purpose, although we are of the view that certain changes, as outlined below, are necessary to ensure that the process is made more transparent and ultimately fair. We believe that these changes can be achieved without a need to fundamentally overhaul the current framework and without undue cost. Indeed, firms are unlikely to contest RDC decisions if they are confident in the process, and are likely to reach a settlement at an earlier stage. On this premise, expenditure overall should fall for a given level of cases. Furthermore, any changes that result in a reduction in open dispute between firms and the RDC is likely to enable the public to have greater confidence in the financial system. Such reform would therefore assist the FSA in meeting its objectives.

We agree that the FSA is right to seek to maintain a regime in which firms adhere to high regulatory standards and that the FSA's exercise of its enforcement powers is a necessary part of that framework. However, it is important that the FSA employs

resources in a manner that is proportionate to the seriousness of the matter and the benefit to be derived for investors as a whole. Accordingly, supervisory solutions should be seen as the norm, with enforcement only being used where absolutely essential. This is consistent with the culture of open dialogue and co-operation which exists between the FSA and firms and which has been a feature of the UK self-regulatory environment since the introduction of the Financial Services Act 1986.

We have focussed our considerations on the decision making process in so far as it relates to regulatory decisions taken in the context of disciplinary action, and set out our comments. For ease of reference we have, where possible, used the same headings as set out in your paper, although not necessarily in the same order.

1. Section 3: Other Matters covered by the Terms of Reference

Transparency of Process

A key objective of the regulatory decision making process is that it must be fair and must be seen to be fair. We are of the view that the current lack of transparency is a fundamental flaw in the process. We consider that there is a lack of transparency in respect of the following:

a) Role of Supervision

- Experience has shown that messages conveyed by the FSA as to how it views a particular compliance issue can be contradictory. We believe that Supervisors should adopt a consistent approach when assessing whether FSA rules have been breached.
- There also appears to be a lack of clarity and consistency in the criteria being considered by the FSA when determining whether a particular matter should be referred to Enforcement. It is our view that a consistent internal policy is required to ensure that a common framework is applied when determining an appropriate course of action. Both a firm's Supervision team and senior management within the Supervision department should be involved in this decision making process. A firm's compliance record and supervisory relationship should be considered, so that decisions are not taken in isolation from the FSA's ongoing supervision of that firm. This is particularly pertinent within the context of theme work or other cross-FSA initiatives, where it has been observed that there tends to be a disconnect between those conducting the theme work/cross-FSA initiatives and the firm's regular supervisory manager. A more consistent process established in cases where a supervisory relationship exists should assist the FSA in establishing relevant criteria for referral discussions for smaller firms.
- There are occasions where positive messages received from Supervision staff and/or delay in internal consideration of an issue with Enforcement leads to a firm being lulled into a false sense of security about the FSA's response. It is important that Supervisors maintain an active dialogue with Enforcement (and the firm) during this process. It is also important that it is made clear to the firm whether or not referral to Enforcement is under consideration. If it is subsequently determined that a matter will not be referred to Enforcement, this should be communicated to the firm. The matter should be revisited only if new information comes to light.

b) Notice of Investigation

We are concerned about the general lack of particulars in Notices of Investigation. Reasons for the investigation are generally provided in broad terms and FSA Principles are often cited liberally. This gives rise to the perception that the FSA will pursue wide ranging inquiries until it finds something on which it can found an enforcement action. We suggest that the FSA's reasons for investigation should be more fully particularised in the Notices and that specific rules should be cited in preference to FSA Principles.

c) Investigation Process

- We believe that the quality of the investigation work undertaken by the FSA is the backbone of the entire process. We are concerned that the current process too often leads to the perception that investigators are trying to build a case against a firm or individuals involved. We are further concerned that the FSA's strategic priorities may eclipse other relevant considerations in determining the FSA's response to specific compliance problems within a firm, resulting in an expectation that the case will conclude with some form of enforcement action. The FSA needs to guard against the danger that a results-orientated ethos leads to a pre-judgement of issues that have yet to be fully investigated.
- Furthermore, we understand that Investigation Reports vary significantly in terms of quality and style, with a tendency to 'plead' a case rather than provide a balanced, objective and detailed assessment of all the available evidence. Given that an Investigation Report is a key document upon which future decisions are based, the report should clearly set out the rules being applied, the Enforcement staff's interpretation of those rules and full particulars of any alleged breach. Investigation Reports and underlying evidence should be subject to proper review by experienced lawyers within the FSA, who have not been involved in the conduct of the investigation, to ensure that conclusions in the report are adequately supported by reliable evidence. Investigation Reports should also be subject to a review by senior management within the Enforcement department. Lastly, a firm should, by right, be invited to comment on a draft of the report with an opportunity to make early representations to the RDC.
- Under the current process, the FSA's Enforcement staff are able to provide information or comment to the RDC that a firm does not see or have the opportunity to consider. Such opacity is in our view unfair and should be removed. A firm should be made aware of all information or comment that has been provided to the RDC at all stages of the process, and should be afforded an opportunity to address these by way of representations.

d) Warning Notice and Disclosure

- We are led to believe that Warning Notices and supporting material can tend to be drafted in a manner which simply sets out the FSA's case and do not adequately explain how a firm's representations to date have been dealt with. It is our view that Warning Notices should set out in full the FSA's reasons for the proposed action including an explanation of how the FSA has dealt with representations and evidence provided by the firm to date.

- It is also important that all material that is required to be disclosed to a firm under s.394 is identified and disclosed – including material that is prejudicial to both the firm’s and the FSA’s case. The disclosure of prejudicial material is fundamental to a firm’s ability to properly make representations. Currently, the disclosure exercise is in the hands of the Enforcement staff. Some degree of oversight by the RDC or otherwise staff outside of the Enforcement division is desirable.

Skills of FSA Enforcement Staff

We are led to believe that the quality of the investigation work undertaken by the FSA is variable. Whilst there are a number of extremely skilled people within the Enforcement division, it can be the case that inexperienced staff are required to conduct detailed examinations based on a limited understanding of both the business under investigation and the application of the FSA’s rules to that business. This problem can be compounded by reluctance on the part of investigators to engage in constructive dialogue with a firm during an investigation. As a result, there is a real risk that conclusions are based on a superficial and inadequate understanding of the business context in which decisions were taken.

Faced with the prospect of enforcement action, senior management at a firm are already likely to be reacting cautiously to FSA enquiries. This mood can become negative if it is felt that the investigators do not properly understand the firm’s business operating model, and the environment in which it exists.

We suggest that there should be an increased emphasis on securing and maintaining a consistently high level of forensic investigation skills across the Enforcement division. Consideration should be given as to whether Enforcement “Grey Panther” arrangements could be established. Alternatively, greater or more structured use could be made of supervision personnel who have relevant knowledge either of the firm or of the market in which that firm operates.

In addition senior Enforcement personnel should be involved at an early stage in significant Enforcement cases with a greater level of managerial control over the investigation process in general. Investigators should be more willing to engage in dialogue with a firm at all stages of an investigation. In general firms have a genuine interest in seeing that issues are properly investigated and remedied. Such dialogue can assist in ensuring that the firm and the FSA are focussed on the right issues.

2. Section 1: Regulatory Decisions

The Current Decision Making Body

Generally speaking, we consider the current decision making body to be fit for its purpose. Thus, whilst we would not advocate a complete overhaul of the current system, we would be open to modifications of the process, particularly insofar as they may free up resources for the RDC to use in more cost-efficient ways.

The part-time involvement of practitioners does present a challenge in that they have a limited time to scrutinise the evidence placed before them. However, we believe that the direct involvement of practitioners in decision making is crucial to the

industry's confidence in that process and that these concerns could in part be addressed by improving the transparency of the process and the quality of the Enforcement staff's output, as outlined above. In addition, consideration could be given to increasing the number of RDC members and reducing the size of some of the individual panels so that there is an increased capacity.

There is a concern that the same RDC members that issue a Warning Notice and subsequently hear representations in relation to a matter, also decide on whether to issue a Decision Notice in respect of that matter. This gives rise to a danger of pre-judgement of the issues. Perhaps even more importantly, it can create the perception of unfairness, leading to a lack of confidence in the system. We suggest that there should be a clear separation of function in this respect.

Representations

We consider that recipients of Warning Notices should continue to be given the option of making both oral and written representations direct to the RDC. We do not consider it appropriate to hear witness evidence as this would essentially change the process from being an administrative one to one more judicial in nature. However, as outlined above, a firm should be made aware of all information or comment that has been provided to the RDC by the Enforcement staff and should be afforded an opportunity to address these by way of representations. This is fundamental to a fair process.

Furthermore, as already mentioned above, a firm should as a right have the opportunity to review a draft of the Investigation Report so that appropriate representations to the RDC can be made.

Settlement

The IMA welcomes the FSA's willingness to enter into without prejudice settlement discussions at various stages of the Enforcement process and supports the continuing involvement of the RDC in the approval of settlements. However, there are concerns about the lack of real engagement of the RDC in the process of settlement discussions. As a practical matter it is difficult to run a negotiation if the people participating in it are not themselves empowered with full authority to negotiate and agree a settlement. That said, there is a concern that if the RDC is privy to settlement discussions, which subsequently fail, its objectivity may be compromised if those same individuals are considering subsequent representations.

Accordingly, we suggest that members of an RDC panel should be directly involved in the settlement discussions with full authority to settle the case on behalf of the FSA (Note: where a Warning Notice has already been issued the members of the RDC panel responsible for issuing the Warning Notice should be involved in the settlement discussions). In the event that settlement discussions fail, subsequent representations should be made to a differently constituted RDC panel, which have not been privy to the settlement negotiations.

3. Section 2: Accountability of Decision-makers to the FSA Board

Transparency of Process

The RDC should continue to be accountable to the FSA Board in the current way. We agree that there would be benefits in greater transparency about the FSA Enforcement process and the workings of the RDC. Accordingly, we would encourage the FSA to publish general information on the operation of the decision making process, specifically relating to the following:

- number of cases handled by the RDC;
- proportion of cases in which the RDC decides not to issue any Warning or Decision Notices; and
- proportion of cases in which the RDC gives significant credit for co-operation, or significantly changes the charges or proposed penalty.

Our comments inevitably concentrate on the process for dealing with contentious cases. We recognise that there is a need to ensure that there is not a significant increase in costs for either firms or the FSA in any amendments that are agreed. We also recognise that there is a very substantial workload for the RDC of other less contentious cases. However, we believe that the amendments proposed will not substantially increase the costs or the time for dealing with the majority of those cases. Threshold condition cases, for example, while being of fundamental importance to the firm concerned, are not usually contentious as to the facts.

We have set out our answers to the specific questions raised in the Issues Paper as an attachment to this response.

If you would like to discuss this letter further, please contact me.

Yours sincerely,

Joanne Jefferies
Senior Legal Adviser

Answers to Issues Paper Questions

Section 1 - Regulatory Decisions

Current Decision Making Body

Do you agree that the objectives for the decision making process as set out in CP17 remain valid?

Yes

Have any been superseded?

No

Do developments since December 2001, or when the FSA took on its FSMA powers, suggest that additional considerations are now relevant?

No

Do you see the scope for efficiency gains from a wider range of decisions being taken by Executive Procedures? If so, which types of decisions might be taken by this means?

Whilst this may give scope for efficiency gains, we do not believe that Enforcement decisions should be taken by Executive Procedures. Such a change would risk reinforcing the perceptions of the industry as to the unfairness of the process.

Does a Committee, like the RDC, remain the right model for making the most contentious decisions?

Yes

Are there ways in which the operation of the current model could be improved?

As set out in our cover letter there are a number of ways in which we believe that the current model could be improved to make the process more transparent and fair. Furthermore, we consider that a separation of function between those members of the RDC issuing a Warning Notice and those issuing a subsequent Decision Notice would avoid any danger of pre-judgement of issues.

What are the best ways to involve practitioners in the decision making process?

Current practitioners will have competing demands on their time whilst past practitioners will inevitably find it more difficult to keep abreast of the latest market developments. What is the right balance between practitioners and non-practitioners (assuming that both categories continue to be expected to operate in the public interest)?

We believe that the current approach is the right one. However, consideration could be given to increasing the number of RDC members and reducing the size of some of the individual panels so that there is an increased capacity.

Representations

Should there be changes to the current way that representations are made, including the stages of the process at which they are made?

We are not advocating significant changes to the way or stages that representations are made, but we do suggest changes to the process within which they are heard. Please refer to our cover letter.

Is current practice, with respect to obtaining comments on a draft investigation report, the right approach?

We consider this to be the right approach but we are concerned that the practice of disclosing draft investigation reports is not adopted in each case and that a firm's response to the draft investigation report is not always properly considered.

Settlement

Is this a fair and effective way to conduct settlement negotiations at each stage of the process? In what respects might it be improved?

We support the process of settlement discussions, but we have some concerns about the lack of involvement of the RDC in that process. Please refer to our cover letter.

Section 2 - Accountability of Decision Makers to the FSA Board

What additional information could the FSA publish about the operation of its decision making process which would enable commentators to make a better informed assessment as to whether the process was operating fairly and effectively?

Please refer to our cover letter.