

Enforcement Process Shake Up: UK Regulators Announce Significant Changes

The Financial Conduct Authority (the “FCA”) and the Prudential Regulation Authority (the “PRA”) published the changes they will make to their enforcement decision-making processes on 1 February 2017 in policy statements FCA PS17/1 and PRA PS2/17 (the “PS”)¹. These changes will have significant ramifications for all firms that may be subject to FCA and/or PRA investigation. The PS also signals a growing trend towards the regulators being more open about how they will approach enforcement action, which can only be of help to firms.

Why are the regulators publishing the PS?

The changes contained in the PS follow two reviews of enforcement decision making. In December 2014, HM Treasury published its review (the “HMT Review”)², which contained a number of recommendations to both the FCA and PRA in relation to the full life cycle of enforcement cases. This was followed in November 2015 by Andrew Green QC’s Report (the “Green Report”)³ into the FSA’s enforcement actions in the wake of the failure of HBOS which made three more specific recommendations. These recommendations related to i) how best to determine the scope of an investigation as part of the pre-referral decision making process; ii) ensuring that there is ongoing communication between supervisory and enforcement departments during an investigation and iii) discussing the matters under investigation with the subject of the investigation, unless there is a compelling reason not to do so.

The FCA responded to the HMT Review and the Green Report on 14 April 2016 by publishing FCA CP16/10 and PRA CP14/16 (the “CP”) that included the FCA and PRA’s proposed changes to implement the recommendations put forward by both reviews.⁴ The PS incorporate feedback from the CP. Certain recommendations may apply to regulatory market abuse investigations but will be less relevant to criminal investigations and civil litigation.

What are the main changes?

REFERRAL DECISION-MAKING (FCA)

The Green Report recommended that before making decisions as to which individuals to refer to investigation, regulators should consider what regulatory response is appropriate for all those that could be potentially subject to enforcement. In the PS, the FCA said that its Enforcement Referral Document (“ERD”) now includes a table setting out all potential subjects and the reasons why a firm or individual is or is not being referred for investigation. The FCA is also consulting on providing a guiding set of principles that determine the strategic choices the FCA makes, as part of its future mission.⁵

The regulators also stressed the importance of retaining a significant degree of discretion in making a decision to refer a matter for investigation. The PRA will publish a short guide to its enforcement process and the referral framework when it implements the HMT Review’s recommendations during 2017 which will provide more detail on its approach.

¹ FCA and PRA, Policy Statement, “Implementation of the Enforcement Review and the Green Report”.

² HM Treasury “Review of enforcement-decision making at the financial services regulators”.

³ Andrew Green Q.C., “Report into the FSA’s Enforcement actions following the failure of HBOS”.

⁴ FCA/PRA “Proposed implementation of the Enforcement Review and the Green Report”.

⁵ FCA “Our future mission”.

COOPERATION BETWEEN REGULATORS IN ENFORCEMENT INVESTIGATIONS

The FCA and PRA's Memorandum of Understanding allows the regulators to offer each other information of material interest, with updates occurring at least quarterly and including representatives from both enforcement and supervisory teams. Once the PRA has released further details regarding its plans⁶ for a functionally independent Enforcement Decision Making Committee ("EDMC") and once both regulators have had further experience of joint investigations, the regulators say that they will release more guidance on the approach to joint investigations. The FCA will also continue to publish high level information regarding cooperation with the PRA in its Annual Report. When submitting joint information requests, the regulators will also indicate to which investigation the information sought is relevant.

SUBJECTS' UNDERSTANDING AND REPRESENTATIONS IN ENFORCEMENT INVESTIGATIONS

The HMT Review recommended that the regulators provide more information to subjects regarding their referral to enforcement for investigation, for instance setting out a summary of potential breaches and the context in which they have occurred. The FCA has implemented the recommendation in practice by providing extracts from the FCA's internal ERD to subjects of the investigation. The PRA will also ensure that the subject of the investigation is given more information about the investigation.

The HMT Review recommended that a scoping meeting should usually take place once investigators can share plans on the investigation and the timetable. The regulators have agreed with this in principle but have again stressed that they need to remain flexible about the timing of scoping meetings and that some subjects may prefer to have earlier meetings.

Respondents to the CP did not think that the current enforcement process provides sufficient incentive to make early admissions in enforcement investigations as there is often not enough information upon which to base an admission. The regulators have said that any decision to further incentivise early settlement must also take into account that the regulators need to

ensure that the full extent of misconduct is understood and communicate this to the relevant subjects. The FCA intends to explore this issue further in its forthcoming penalty policy review and the PRA will review its settlement policy in early 2017.

The regulators agree that the involvement of supervision departments in an investigation, as recommended in the Green Report, will help to identify and address important issues that arise. Investigators will also provide periodic updates to subjects about the progress of investigations and subjects can request face-to-face meetings if appropriate. The regulators will also consider how to promote early, constructive engagement between investigators and subjects, by, for instance, providing specific training and increasing the involvement of senior staff.

The regulators will also consider setting out the factors that they may consider relevant to an application to extend the period for responding to a Preliminary Investigation Report or warning notice but observed that individuals were more interested in what information is provided rather than in which document it is given.

SETTLEMENT (FCA ONLY)

The HMT Review looked at the effectiveness of the stage 1 period in settlement discussions. The FCA says that it already aims to give subjects 28 days' notice of the start of stage 1 and to offer, where possible, a preliminary without prejudice meeting to explain the FCA's view of misconduct. The FCA has not been prescriptive about how information is given or what documents it seeks to rely on at this stage.

The current director of Enforcement, Mark Steward, has stated that he regards the current system, where virtually all firm cases settle as stage 1 with a negotiated final notice, as lacking transparency. He has also said that the lack of independent oversight from either the Regulatory Decisions Committee ("RDC") or Upper Tribunal does not benefit the industry whereas under the revised system, the agreed statement of facts will be published with a decision notice that contains a reasoned decision of penalty setting out the way in which the penalty has been set, providing guidance for firms.⁷

⁶ PRA, "Establishment of the Enforcement Decision Making Committee".

⁷ Mark Steward, "Tackling the hard questions".

In order to introduce a streamlined procedure to narrow issues between the FCA and the subject in an enforcement action and encourage firms to refer cases to the RDC or Upper Tribunal, the FCA will introduce a major change to the enforcement process: the concept of partly contested cases. These will arise when either the subject agrees all facts relevant to the proposed enforcement action but wishes to contest whether the alleged breached arose from these facts or when the subject agrees one or more (but not all) the issues relevant to the proposed enforcement action and wishes to contest the narrowed down issues. A firm or individual will still be able to obtain up to a 30% discount in partly contested cases if the issue cannot be agreed at stage 1. The level of discount will be determined by the RDC.

The FCA will also allow for subjects to contest only the penalty given in an enforcement case in front of the RDC. Where a case had been fast tracked, the FCA would review on a case-by-case basis whether to issue a warning notice statement. The FCA will also clarify the involvement of FCA senior management in settlement negotiations and increase the visibility of the project sponsor.

One of the major proposals put forward in the PS is that the discount of 30% should remain in fully settled cases agreed during stage 1, including where the subject contests the penalty while the stage 2 and 3 discounts of 20% and 10% will be abolished. The FCA said that in majority of cases, subjects will decide if they are going to settle by reviewing the draft warning notice in stage 1. The partly contested case procedure will mean that a subject under investigation could obtain a 30% discount without settling on all matters.

The regulators will also regularly review the process (but not substance) of a settled case, seeking comments from those who have settled and the RDC will monitor the effectiveness of changes to the settlement process which may lead to further consultation.

CONTESTED DECISION MAKING (FCA ONLY)

The FCA will make it clearer to subjects under investigation that the existing process allows a subject who has received a decision notice and has not previously made any response or representations to the FCA to refer the FCA's decision to the Upper Tribunal.

The FCA will publish an annual review of the RDC's work covering the annual operation review and the review of settled cases. The FCA will also publish a report on the settlement process review. The first RDC Annual Review has already been published as an Annex to the FCA's most recent Annual Report.⁸ The FCA also clarified that usually the same RDC members that decide to issue a warning notice will be the same as those issuing a decision notice although this general rule may not be appropriate in particularly complex cases.

What's next?

The majority of changes in the PS will come into effect on 31 January 2017. The regulators' introduction of partly contested cases and abolition of the 10% and 20% discounts to penalty in settlement will come into force on 1 March 2017. The PRA will issue a policy statement incorporating feedback to its establishment of the EDMC and a short guide to the enforcement processes during 2017.

However this PS is not the end of the road when it comes to changing the enforcement decision making process. In fact, we will have a better idea of how the process may change further over the course of 2017 once, for instance, the PRA publishes its policy statement on the EDMC and has released details of its settlement policy and the FCA has published its penalty policy review. Interested parties will need to prepare themselves to submit responses if required to upcoming consultations.

The PS reaffirms the regulators' commitment to greater transparency and improving communications between regulators and subjects of investigations. How these ideas work in practice will only be determined by how investigations (and particularly joint investigations) are conducted. Those subject, or potentially subject, to enforcement action will benefit from this greater transparency and clarity which has also been visible in a growing trend towards the regulators offering more detailed guidance of lessons to be learned by all firms in enforcement notices.

⁸ FCA "Annual Report and Accounts 2015/16".

The regulators have however stressed the need to retain discretion over a number of important issues in enforcement decision making, emphasising the need to remain flexible and treat each investigation on a case-by-case basis. Although this introduces an element of unpredictability for firms, firms may ultimately benefit from this flexibility, with cases being assessed on their particular circumstances rather than adhering to certain processes for the sake of having a defined set of rules in place.

Ultimately, time will tell whether the FCA's efforts to encourage more firms to refer cases to the RDC or Upper Tribunal will be effective. In our experience, most large firms are concerned primarily with the reputational and knock on effects of enforcement action rather than the size of the penalty itself. Firms' reluctance to refer cases to the RDC or Upper Tribunal is largely driven by the perceived loss of the ability to influence what appears in the final notice rather than concerns about losing the 30% settlement discount. Smaller firms might be more willing to "have a crack" at trying to reduce the penalty before the RDC, but they will generally have to pay unrecoverable legal costs to do so. For smaller firms, the ongoing costs of defending an enforcement action remain a powerful incentive to settle early.

Nevertheless, the PS and anticipated related publications are helpful in giving firms a clearer sense of how the regulator may view certain issues or circumstances within the enforcement process and can be seen as part of a growing shift towards the regulators providing firms with more guidance to aid them in the enforcement process, particularly as case law on the subject grows and the PRA becomes active in terms of enforcement. More importantly, these publications will also help firms identify how they can implement measures and take certain actions that will, in the end, enable them to avoid future enforcement action.

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