Judging The Financial Conduct Authority 5 Years On

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On April 1 this year, the Financial Conduct Authority turned five years old. Born from and in reaction to the financial crisis, its principal purpose was to protect consumers, through more effective supervision and more aggressive enforcement. Naturally, the FCA, as with any regulator, has not been immune from criticism. However, it has grown up during a period which has seen political and technological change at an eye-watering pace. Under those conditions, and with finite resources, pursuing its enforcement objectives has been a difficult exercise — hard enough for any bureaucratic public agency, let alone one newly created.

Five years on, how should we judge the FCA, and specifically its enforcement and market oversight division, and what will be its principal challenges over the next five years?

Background

On June 16, 2010, George Osborne, fresh in post as Chancellor of the Exchequer, gave his maiden Mansion House speech. The speech focused on the political response to the financial crisis: an overhaul of the banking system which had caused it and a commitment to reduce the nation's deficit. This was to be an early articulation of "Austerity Britain." Acknowledging that the existing system of financial regulation had failed "so spectacularly," the chancellor set out his proposals for radical reform. The Financial Services Authority was to be scrapped, and with it the tripartite system which had been adopted and promoted by the previous government. The dangers of "light touch regulation" had been exposed, at great cost, and only central banks were to be trusted with macroprudential regulation.

As an enforcement agency, the Financial Services Authority was perceived as weak, lacking sufficient independence to hold firms and their managers to account. Osborne announced the establishment of a Consumer Protection and Markets Authority and reaffirmed a commitment to create a single agency to tackle serious economic crime. The second of those ambitions has never been fulfilled, despite numerous attempts. Out of the first, emerged the Financial Conduct Authority. Although the name of the agency changed, its focus did not: one of the FCA's three operational objectives, enshrined in the Financial Services Act 2012, is the protection of consumers. The Financial Services Act, which implemented Osborne's proposals, came into force on April 1, 2013.

Record of Enforcement

When measuring the FCA's enforcement record, financial penalties and Final Notices are inevitably the most frequently cited, albeit crude, metrics. Here, the FCA has fared well. In 2010-2011 and 2011-2012, the FSA imposed financial penalties totalling 98.5 million pounds and 76.4 million pounds respectively. By comparison, last year (2016-2017) the total fines imposed by the FCA amounted to 180 million pounds. Whilst the intervening years saw a stratospheric increase

in penalties levied — reaching 1.4 billion pounds in 2014-2015 — this was largely attributable to sanctions imposed in relation to the benchmark manipulation cases (LIBOR and FX). In its last full financial year (2012-2013) the FSA issued 79 final notices. In 2016-2017, the FCA issued 180.

Yet these are blunt yardsticks, not least because the level of enforcement activity must be factored against the prevalence of misconduct in the market, which is difficult to assess. Arguably, misconduct in retail financial services has decreased — since 2012-2013, the number of new complaints received by the Financial Ombudsman Service dropped steadily, from 2.1 million to 1.4 million last year. But it is perhaps still too early to tell if an increase in the regulator's enforcement activity is having a deterrent effect across the financial services industry.

In reality, the effectiveness of the FCA is more appropriately assessed against those areas in which its predecessor was deficient. Principally, the FSA's enforcement division drew criticism for the paucity of senior executives held accountable for the sins of the financial crisis. The FSA's lack of appetite to pursue senior individuals was born of caution and arguably a lack of confidence. Rather than sanctioning senior individuals, it was evidentially and procedurally easier, to punish them by rejecting any future application for approved person status or variation.

The FCA is armed with wider enforcement powers than its predecessor. For example, it has six years, not three, in which to initiate an action against an individual when seeking to impose a sanction[1] and it has a wider market abuse regime which contains a new criminal offense.[2] More significantly, the Senior Managers and Certification Regime (SMCR) — introduced two years ago — was aimed at lowering the evidential hurdle for holding senior executives to account. Although initial consideration was given to a strict liability standard, the SMCR imposes a 'Duty of Responsibility' under which senior managers are responsible and accountable for the business areas they lead. Under the SMCR, the FCA can take enforcement action against the responsible senior manager where it can show that they did not take reasonable steps to prevent the breach, as committed by the firm, from occurring or continuing.

Aside from the tools at its disposal, the FCA has changed its attitude and philosophy towards initiating an investigation. In the past, being placed under investigation was a clear indication that the regulator had evidence, and was confident of its strength. Essentially, the commencement of an investigation meant that an enforcement action was almost inevitable. This approach was scrutinized by Andrew Green QC, author of a report into the FSA's enforcement response to the failure of HBOS.[3] Green questioned whether the threshold for initiating an investigation — whether there are "circumstances suggesting" misconduct — was being misapplied.

Mark Steward, head of the FCA's enforcement and market oversight division since October 2015, has addressed this criticism. He has stressed that an investigation is genuinely "diagnostic," and should be conducted with an objective, open mind.[4] This recalibration in approach correlates both with the number of new cases taken on by the division and the number of case closures. During the 2015-2016 financial year, 109 new cases were opened; that number rose to 282 the following year. Across the same period the percentage of cases closed with no further action increased from 24 percent to 62 percent.

It is not yet clear whether these changes, in both the FCA's powers and approach, will result in more final notices being secured against individuals. The SMCR has not yet been properly tested, and how the duty of responsibility will apply in practice remains to be seen.

Future Challenges

What then will pose a challenge for the FCA during its next five years? Instinctively, more investigations mean more work, and a resulting need for increased resource. Steward does not necessarily accept this assumption, and has publicly admitted that, in any event, an increase in resource is "not remotely feasible."[5] As a result, the FCA will need to become more dynamic and efficient. It must learn to identify the key issues in any investigation, do so quickly, and have the discipline to avoid investigative creep.

More broadly, political and technical upheaval — the principal challenges faced by the FCA today — are likely to remain. The response to the U.K.'s departure from the European Unioncould take up a significant amount of the FCA's administrative bandwidth. However, despite suggestions that Brexit may prompt a recasting of European legislation (e.g. MIFID II), initial estimates suggest that the regulatory and legislative framework under which the enforcement division operates is unlikely to change much, at least not in the short term.

That said, Brexit could indirectly affect enforcement activity. The competition to retain London's status as the global capital of financial services has arguably had an impact on the FCA and its management in the past. In 2015 Martin Wheatley's contract as Chief Executive Officer was not renewed by George Osbourne because, as reports suggested, Wheatley's approach to regulation had proved too robust.[6] Shortly afterwards, in December 2015, the FCA dropped its review of banking culture, although the Treasury denied having had any influence over that decision.[7] The recurrent pressure to attract and retain financial services firms in the City could be increased, not only by Brexit, but also by a trend towards deregulation in the United States.

Technology will also inevitably continue to shape the work and development of the FCA. The data the FCA now gathers under expansive reporting obligations (through the Market Abuse Regulation and MIFID II) constitutes a potent supervisory tool. The FCA will need to ensure that its technical capabilities are adequate to harness and apply this information quickly and effectively in monitoring market conduct. Furthermore, the FCA, as well as the legislature, needs to foresee and address the risks posed by the suite of products and services based on new technology. The rise of cryptocurrencies and the rapid development of payment service systems are likely to present substantial challenges for regulators globally.

The FCA has clearly changed its approach to enforcement in response to the criticisms aimed at the FSA. In doing so it has had significant success in securing record financial penalties against firms in relation to misconduct exposed by the financial crisis. But it remains to be seen whether it will be able to hold senior individuals to account. As well as avoiding the mistakes of the past, the FCA must ensure that it takes on appropriate cases and conducts them fairly, ever-mindful of the inevitable impact that an investigation will have on individuals. The statistics, as well as empirical evidence, indicate

that the approach preached by Mark Steward is being practiced. However, we may need another five years before we can judge just how effective the FCA is at instilling credible deterrence at the senior executive level.

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[1] This change to the section 66 of the Financial Services and Markets Act 2002 was brought in by the Financial Services (Banking Reform) Act 2013, and came into force on July 25, 2014.

[2] See sections 90 of the Financial Services Act 2012

[3] Report into the FSA's enforcement actions following the failure of HBOS by Andrew Green QC.

[4] See for example Mark Steward's speech, "A Better View", delivered at the AFME European Compliance and Legal Conference on 20 September 2017.

[5] See above.

[6] Fired FCA boss Martin Wheatley hits out at Osborne and big banks, The Times, 23 July 2015

[7] Banking culture review: Treasury defends FCA decision to scrap study, The Guardian, 31 December 2015