Treasury Committee

Oral evidence: Financial Conduct Authority, HC 635

Tuesday 9 September 2014

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Watch the meeting

Members present: Mr Andrew Tyrie (Chair), Steve Baker, Mark Garnier, Mr Andrew Love, Mr Pat McFadden, John Mann, Mr George Mudie, Jesse Norman, Teresa Pearce, Mr David Ruffley, John Thurso.

Questions 1-172

Witnesses: **John Griffith-Jones**, Chairman of the Financial Conduct Authority; and **Martin Wheatley**, Chief Executive and FCA Board Member, gave evidence

Q1 Chair: Thank you both very much for coming to give evidence to us this morning.

Mr Griffith-Jones, what contingency planning have you put in place for the Scottish referendum?

John Griffith-Jones: We have done some basic contingency planning, although it is fair to say that we think the conduct issues are likely to emerge over time once we know what the Scottish Parliament, if the vote was yes, wants to put in place, but such things as making sure that our phone lines are properly manned if people ring us is obviously in our control, and making sure we have a position around what advice would be appropriate to be given on day one were consumers to ask, "What should I do?"

Q2 Chair: Is a new regulator going to need to be put together and what steps would that involve?

John Griffith-Jones: It will be the responsibility of the Scottish Parliament to decide how it wants to do regulation. It will clearly need a regulator.

Q3 Chair: Is that a straightforward job?

John Griffith-Jones: I think it will turn out to be complicated to work out the detail, but first there is vote and then, secondly, we have a discussion as to what it wants. Obviously there are simple ways for them to do it and more complicated ways, but there is a certain amount of segregation required.

Q4 Chair: Is what you are doing consistent with what the Bank of England is doing?

John Griffith-Jones: I can't speak to exactly what the Bank of England is doing, but I think the detailed work on how a new regulator would work needs to be started once you know what the Scots want.

Q5 Chair: The key point I am just trying to get to is whether we are going to arrive at a situation that is as relatively straightforward as we have it now and whether that is achievable, or whether we are going to find ourselves in a more complex—

John Griffith-Jones: I think we are going to find ourselves with a lot of work to do. Genuinely, I think we will find ourselves with a lot of work to do in the process of setting up a new regulatory regime.

Q6 Jesse Norman: Mr Wheatley, obviously the value of fines that you have imposed over the past three years has gone up very significantly, as has the number of new enforcement cases. Do you have any evidence that this policy of credible deterrence, if that is what it is, is working?

Martin Wheatley: I think there are probably two fronts. First, the anecdotal evidence, which is how the organisations that are fined have responded to that. I am sure you will have had conversations with them. I know it involves significant reputational damage to a firm. They do not want to be fined. They would typically put in place some significant remedial actions to deal with the issues that led to the fine. I know, from all the discussions I have had with the firms, that they do take it very seriously.

In terms of data, the one clearest data component we have is that we publish a market cleanliness statistic that tracks the number of price movements that predate the publication of sensitive information. Therefore, it is a proxy indicator of market abuse and insider trading, and that statistic has halved over the past five years since we have been taking a much tougher line on insider trading and market abuse. There are lots of other factors involved, so we hesitate to claim it is all down to that, but it is one of the clearest indicators we have as to the effect of fines and enforcement action on the market.

Q7 Jesse Norman: You are clearly fining a lot more than you were and in much higher numbers. What about going after people who are responsible individually? What is happening with that? Are you commenting on your very widespread idea that some of the banks have got off scot free and when they pay fines it is ultimately the corporations who pay them, not the people who did the misdeed?

Martin Wheatley: Yes, I think that is a fair point. There is a significant widespread desire to see individuals—not just corporates—censured and fined. We have had this debate before in the context of the Banking Commission. The complication is very often the offences. Obviously if they are fraud, that is something the SFO can take forward, but if they fall short of fraud, there has to be a specific rule that has been breached. We found in a number of cases there was no a specific rule that would have applied to the individual who was below the level of the senior person's regime. That has been the construct. We are hoping that our proposals under the senior managers' regime will give us greater ability to take action against individuals.

Q8 Jesse Norman: You want to drive towards the situation where named individuals are responsible for business lines of activity, and if things occur in those business lines for which they should have exercised, or had, some nominal responsibility, they themselves could potentially be culpable.

Martin Wheatley: We want to move to situations where, as you say, the responsible manager will be held to have failed if he has not executed sufficient control and the individual will be fined as well. That would be a structure that we hope we will be delivering as part of our current consultation.

Q9 Jesse Norman: In other words, it is still the FCA's policy to shoot first and ask questions later?
Martin Wheatley: No. Our policy is very much that we are evidence-based. When we see something awry in the market, we will gather the information that we need to gather. We will take appropriate actions on that, which range from supervisory actions right through to enforcement actions.

Q10 Jesse Norman: Right. But, for example, your LIBOR sanctions did not seem to make much difference to the forex calls that you had?
Martin Wheatley: I think it has made a lot of difference. Obviously it is unfortunate that the forex has come along. Again, I cannot say too much about it, because it's an investigation, but it is reported in the press as having been collusive actions by a group of traders across a number of banks. I think all the banks are struggling as to how they stamp out that activity. I know all of them are deeply embarrassed by what has happened and want to see that changed. I know that they put in place remedial actions. It is very unfortunate that we have had what appears to be abuse in another sector of the market follow on relatively quickly from the LIBOR fines.

Q11 Jesse Norman: We have had another regulator, Andrew Bailey, who said that these fines were making a significant dent in bank capital. The effect of it by not targeting individuals, in a bizarre way, is you do not penalise the shareholders. You damage the bank, with regard to the regulator, on precisely the area in which we want them to grow: bank capitalisation, and stability and solidity.
Martin Wheatley: I think that is right. Obviously we need to take account of what the impact would be on the prudential soundness of a bank, so any action we take is part of a consultation with the PRA. Under the structure that we have created, we would consult first as to whether it would have too detrimental an impact on a bank's capital but, clearly, each fine does take capital and those banks have to replenish that capital in some way.

Q12 Jesse Norman: Do you measure how far the costs of misconduct are being passed on to shareholders and customers?
Martin Wheatley: The answer is no, we do not measure that. I think it is quite hard to measure other than in a very qualitative way. In a quantitive way, clearly those fines, when it leads to a shortfall in capital, have to be met. Sometimes that is met through retained profit, sometimes it is met through a reduction of bonuses and pay within the organisation, and sometimes it is met through capital raising.

Q13 Jesse Norman: But presumably it is a pretty numerical matter: "We have a £10 billion fine. We have this much. We will fund this much out of retained earnings, this much out of bonus pool, and this much out of dividend," or whatever it might be?
Martin Wheatley: The amount that can be taken out of a bonus pool is a defined amount and you can look through to that and see that. It is very much harder to see the other things, because there are so many different moving parts in a bank and, frankly, our fines will be one aspect of a whole—

Q14 Jesse Norman: Would you give some consideration to and possibly write to us about the possibility of requiring banks to make a calculation as to how far the cost of their conduct has been absorbed by these different sources of potential funding—retained earnings, loss of dividend, bonus pool—because I think that would give a much clearer

sense of the extent to which the people responsible were, directly or indirectly, bearing the cost, since many of these institutions are being run on the interest of their employees?
Martin Wheatley: I will come back to it. There is a direct relationship in conduct fines to what is then subsequently taken back through claw-back, so that is a much more direct relationship, albeit it is typically not public. On the elements of how it hits either the pricing of products or capital, I think even the banks would find it extremely difficult to follow through the maths of that and come up with an answer.

Q15 Jesse Norman: Yes. I do not think you need to go as far as the pricing of products, although you could. You could start with the first step of just looking at the impacts on dividends, retained earnings and capital, as well as on bonuses, just as a first thought.
Martin Wheatley: Okay.

Q16 Jesse Norman: Do you think that the reputational damage that is being done by enforcement action makes a difference if we do not already have effective competition? The point should be, surely, that it is competition that channels customers, suppliers and so on away from a bank that has been reputationally damaged and towards another institution?
Martin Wheatley: In an ideal model, there would be a market-based discipline and a customer-based discipline that would say that when banks have clearly fallen short of normal customer service standards or ethical standards, the customers ought to take a view—"I will operate in a different way." It appears that there are all sorts of reasons why that does not happen in financial services. We have, as you know, a competition objective. We have been working quite hard as to how that objective will play through with a view to increasing competition within the market, lowering barriers of entry and allowing greater choice. A lot of the work we have been doing is looking at how we provide people greater ability to move when they see a service or bank that falls short of ethical standards.

Q17 Jesse Norman: The PRA has never vetoed any of your enforcement actions, has it, or attempted to?
Martin Wheatley: We are required to consult with them, and if they use the veto power, that would be public, so it would need to be a public action.

Q18 John Mann: You have not answered that last question, so let me ask it in a different way: how much does financial stability play a role in the level of the fine that you set?
Martin Wheatley: It is always part of the equation that is taken into account. We have a discussion. We have a debate and, under the structure we have created, that is a good debate. It is a healthy debate. The level of our fines, though large, are not at a level where they represent systemic risk to any of the institutions. The levels of fines that you have seen in the US and some of the class actions could represent risk to the institutions, but that is a completely different ballgame to our fines. Even in the largest of rates from £100 million to £150 million, that is different to the multiple billion dollar fines that we have seen in the US and the subsequent class action. Here in the UK, I do not think it has yet become an issue, but it is always a discussion that we have.

Q19 John Mann: It could be an issue for consumers if you are not setting high enough fines.

Martin Wheatley: It could be and, again, coming back to Mr Norman's comments, how high do fines need to be to change behaviour? Honestly, my view is that the banks are changing behaviour. They are responding to the signals that we are giving them. I think the fines that we have are at about the right level, and obviously it is proportionate to the offence, but I do not think they are in the ballpark of either creating systemic risk or being too small to have an impact.

Q20 John Mann: In terms of behaviour, are there any powers that Parliament has not given you that you need?
Martin Wheatley: We are still working through some aspects of our work on the senior manager regime. That will bring in different aspects that allow us to act against relevant individuals, as we spoke about earlier. I think that will get us to a point where we can act. There are certain areas that are not part of the UK regime that are part of the US regime: the use of wire-tapping and covert intelligence to obtain evidence. That is a big question, but that is something that clearly we do not have as part of the UK structure. If we had that, we would have probably a slightly different approach to insider trading, as the SEC does in the US.

Q21 John Mann: Why are you much weaker in money laundering than the Americans?
Martin Wheatley: When you say "weaker", we act and we take actions against firms. What we have not done is taken the very large sanctions that the US has taken on both money laundering and sanctions busting. I do not think we are weaker. We have a dedicated team that is out there doing the work of checking money laundering within banks and acting accordingly.

Q22 John Mann: You do not have those big fines but, at the same time, if you are a perfectly honest, law-abiding Syrian, let us say, in this country, you can suddenly have your bank account shut down.
Martin Wheatley: It is a complex issue. The banks are trying to de-risk their operations by doing more to check accounts. Clearly they have to create a system as to how to do that and when you create a system, there will almost certainly be unfortunates that are caught in the system that perhaps should not have been. That is the nature of getting tougher on Know Your Client-type rules, AML-type rules.

Q23 John Mann: Why is it complex? If it is a blanket power on all Syrians with bank accounts in the country, that is broad brush—it is not complex. Why are individuals who have done nothing wrong being targeted when at the same time, we are applying such small fines compared with the Americans when it comes to money laundering?
Martin Wheatley: Again, if I can come on to the specific, each bank will have to create a model as to how it vets individuals who want to open accounts or who have suspicious transactions going through their accounts. They will all adopt a different model. That has to be an intelligence-driven model, not one that simply takes a blanket approach that means, as you said, that perfectly innocent people who should have access to banking are denied it. They are working through that process at the moment. I would not say that any of them have it perfect yet, but that is what is being developed and, in part, it is being developed because they realise that the cost of getting it wrong is very high, whether that be in terms of reputational damage in the UK, if we take action, or in terms of the financial damage in the US if the various US regulators take action.

Q24 John Mann: When it is an unintelligent approach, as we have seen not just with, but including, various people of Syrian descent having their bank accounts closed when they have done absolutely nothing wrong, is it not your role to intervene to get the banks acting properly and reasonably, and why are you not doing that?
Martin Wheatley: The truth is that we are doing that. We would not do it on an individual case. If there is an individual complainant, the proper route is for that individual to raise that complaint with the bank. If they are not satisfied with how the complaint is handled, they have a route through the FOS. From our point of view, if there are issues with particular institutions that rise above the individual, we absolutely would have that discussion with the bank and ask it to review its controls, or we may require some measures to be taken to change things. That is absolutely what we do.

Q25 John Mann: If we take this Syrian situation as an exemplar when a bank such as HSBC has targeted lots of individuals who have done absolutely nothing wrong ever and could never be claimed to have done anything wrong ever, that is not an individual. That is lots of individuals, so there is a systemised approach there. Why are you not intervening in terms of the processes being followed by that bank or others in similar examples?
Martin Wheatley: Again, you ask why we are not intervening. We have a regular programme of AML controls and checking with all of the major banks.

Q26 John Mann: Why are we not intervening effectively then?
Martin Wheatley: When you say "effectively", clearly those banks want to get to a position where they are not disadvantaging people who have perfectly reasonable access to banking and are making sure that they do not provide services to people who are using banking for criminal measures. That is their job. I would not say they get it right all the time and whether we are effective or not, I would not judge it just based on one individual instance.

Q27 Chair: Have you done a cost-benefit analysis of money laundering regulations?
Martin Wheatley: No.

Q28 Chair: Do you think that might be a good idea?
Martin Wheatley: I think it would be extremely complex to do.

Q29 Chair: That is not a reason for not doing it. It might be that areas that have a good deal of complexity are ones that merit the clarity that might come with a cost-benefit analysis about the merits of what is being done.
Martin Wheatley: Of course, one of the difficulties is that this is a global rule and, even if we were to do a cost-benefit analysis, the ability to, first of all, identify the benefit against cost is, as I say, complex. It is not a reason not to do it, but we still have to think about whether you can come up with a credible answer. Even with a credible answer, the authority that would take responsibility is the Financial Action Task Force. That is a global body that would ultimately have responsibility for that change.

Q30 Chair: There are two main players. There is Britain and there is America.
Martin Wheatley: Primarily, yes.

Q31 Chair: This is not quite as multifaceted as you are suggesting. If they give a lead, we will get somewhere. Have you discussed it with the Americans?
Martin Wheatley: Not in the terms that you are now pointing—

Q32 Chair: Do you think that might be a good idea?
Martin Wheatley: I think it would, yes.

Chair: Perhaps you could get ahead with that and report back to us on progress.

Martin Wheatley: Right.

Q33 Chair: This is not just a case of a few unfortunate individuals, although I am sure John Mann is correct in those that he has alluded to. We are talking about many thousands of perfectly respectable, ordinary people trying to go about their banking business and finding it is suddenly very difficult, perhaps because they have taken a job abroad or in an unusual market. Is that not the case? Is not the de-risking leading to the de-banking of a large number of people, and vastly increased and unreasonably increased costs for many thousands more—tens or perhaps even hundreds of thousands more?
Martin Wheatley: I think that is right. I think that is what is happening and, in part, that is happening because the costs of getting it wrong are so high that all the banks want to take themselves out of that risk. Delivering an intelligent solution is quite complex and takes time and I think, exactly as you say, it has made access to banking for anybody more difficult to get through the Know Your Client rules. They are more extensive. It is more difficult for certain people who would come from, as the banks would see it, riskier regimes or with riskier profiles to get access.

Q34 Chair: The regulators have to start exercising judgment so that they are led by the British and the Americans to make sure that we do not end up closing down activities and banking services for individuals unreasonably, do they not?
Martin Wheatley: Absolutely. I think your point is right that the UK and the US can take the lead with this, but it is a global body and that global body has put in place a set of rules and we are obliged to follow those rules until that policy changes. If the policy changes, clearly British banks can take a different approach.

Q35 Chair: But until I suggested a cost-benefit analysis, it sounded as if you were not doing much of a challenge.
Martin Wheatley: We have had discussions. I am still sceptical as to the real ability to do a cost-benefit analysis on something as complex as this, but we can certainly have the discussion. I think the points you have raised are valid.

Q36 Chair: Whether it is formalised wholly in numerical terms, judgment has to be exercised, has it not, about whether the rules that have been put in place and enforced are delivering something that is worth the candle or whether, as you were implying a moment ago, we might more sensibly go down the road of more intelligence-based money laundering regulation, rather than blanket imposition of quite tough rules that, in the end, the banks decide to de-risk from, leaving many people unbanked?
Martin Wheatley: I think the banks would argue that they are trying to develop the intelligence-driven approach that does target the people who are genuinely—

Q37 Chair: It is the regulators that need to give the signal that they are encouraging the system rather than penalising it.
Martin Wheatley: We encourage them to have proper AML controls and proper Know Your Client checks. It is the job of the banks to design what "proper" means.

Chair: You have agreed to take a look at it and to discuss it with your key sister regulators in the United States.

Martin Wheatley: Yes.

Q38 John Thurso: The money laundering regulations as passed by Parliament are clearly based on the principles of measuring low-risk situations. I was recently approached by the chair of Castletown Community Council, which finds the due diligence that has to be done on its bank account for the village hall is greater than that for many PLCs. Is that a proper risk-based assessment?
Martin Wheatley: It sounds odd but, again, I cannot comment on the specific circumstances.

Q39 John Thurso: Let me help you a little bit further. I have been contacted by a great number of voluntary groups, village halls and community associations, all pointing out the immense difficulty if the treasurer retires in changing the treasurer or whatever.
Chair: It might be quicker to go round this table and find anybody who has not.

John Thurso: Is it really the intention of the money laundering regulations to make voluntary life and associations almost unbankable, or is it to catch genuine criminals? Is it not for you to be talking seriously to the banks about getting their priorities right?

Martin Wheatley: Yes, it is for us to do that, and it is exactly what we do. Unfortunately, the banks—you will have seen this through some of the high-profile cases—have consistently failed to spot the very high-risk people that they should not be banking and our challenge to them has been, "You need to develop procedures, practices and controls that stop you banking people who are using the banking system to launder money or for other criminal means".

Q40 John Thurso: You might suggest to them that if they stopped scrutinising community associations quite so strongly and had a go at some international criminals, they might find it more fruitful.
Martin Wheatley: Yes.

Q41 Chair: They also need the confidence that if they had taken all reasonable steps, they would not be hammered anyway by the regulator, do they not?
Martin Wheatley: Yes.

Q42 Chair: Do you think they have that confidence now?
Martin Wheatley: Again, when you say "hammered by the regulator", obviously we have responsibility for AML, but so do the many other regulators. I think if you ask the banks, they would say that their concerns are about the proportionality of the US system. I do not know that you would get the same response on the UK system.

Q43 Chair: The de-globalisation of banking that is taking place with respect to this is being driven from the United States, not the UK?

Martin Wheatley: I think the serious de-risking the banks are going through is a response to some of the things that have happened in the US. We absolutely do want them to have proper controls in place. It is not that we do not, but I think they would argue that some of the sanctions appear to be disproportionate.

Q44 Chair: When we were in the United States, we found that you had good relations with a number of regulators. It sounds as if there is a piece of work for those good relations to be of benefit for.
Martin Wheatley: Yes.

Q45 Teresa Pearce: Martin, you mentioned earlier about wanting increased competition, and this is something we have heard for a very long time. It is what we all want, but what about the communities where there is no bank at all—no competition; no branch? As you know, my constituency has 50,000 people with no bank anywhere in sight. Barclays has just announced the closure of another branch. What happens to those communities? There is a move to look possibly at shared banking facilities—to have branches with more than one bank in there. Is there anything that you can think of that would be a barrier to that? Is it just that the banks do not want to do it?
Martin Wheatley: I do not think there would be a barrier. Clearly the ATM system itself, if there is one in the area, is a shared facility. You can, at no cost, access cash through an ATM, regardless of who provides that ATM and who your bank is. That is part of a shared facility. I am not aware of any particular regulatory hurdle that would exist. One of the interesting innovations is—it is still relatively early stages—that we are seeing significant growth in mobile banking, where people are seeing services come forward. They can access banking on their devices and phones, which is making banking less dependent on the physical presence of a bank in a particular area. I think there are a number of things happening already that are changing the landscape in terms of access to services.

Q46 Teresa Pearce: I can see from the point of view of a bank why they may want to close branches, because it cuts costs, but the consumer wants somewhere that they can go where, if they need to, they can talk to somebody. I only ever go to a branch normally if I need to cash a cheque or submit a cheque, but in my area there are small cash businesses that find it difficult to bank their cash because the nearest branch is closed. It is affecting their insurance because they are holding more cash on premises. It is affecting their security. The police are warning them against this, but if they have to make a journey in a car quite a distance to bank cash, that is a problem. There needs to be a physical presence. As a body, what pressure can you put on banks to fulfil what the consumer wants, which is local branches?
Martin Wheatley: In terms of provision of services, I think there is a public policy question about that which is broader than simply our objectives. Our objectives are obviously about competition. They are about protection and they are about integrity, but requiring banks to keep open branches is much more a public policy question. We can implement what the powers are that we have, but I do not think we would have a power to do that.

Q47 Teresa Pearce: But your objective of competition.
Martin Wheatley: Yes. Sorry, this is a point I was going to come on to. We do try very hard to encourage people to be able to provide services. We look at whether we are a barrier and whether any of our processes are barriers. We know that increasingly there are

banks coming along with a lower cost model that is not dependent on the physical presence, but that is quite different from having a conversation with a bank that says, “Don’t close that branch.” I think that is quite a difficult conversation for us to have.

Q48 Teresa Pearce: But there are communities where there is no branch at all. I think there were 2,010 branch closures in the last 10 years and there was a voluntary pledge where three of the big four said they would not close the last branch in town, but that has since dropped, and I think RBS has now walked away from that pledge. Surely, if you have the role to look at what the consumer wants, there should be some criteria by which banks deliver what the consumer is asking for, and the consumer is asking for a presence in the community. Often the local branch will close and we will say, “Oh, it is okay, the post office is still there,” but the post office is not the same thing and the post office current account is not the same thing as banking.

I am just interested about this whole idea of competition. We talk about it and all agree it would be a great thing, and it does not seem to move any further forward. In fact, the consumer choice is going further away as well because if you do not have a branch at all, you will go to the nearest branch and probably that could be a bus ride away.

Martin Wheatley: You saying it does not seem to move it further forward. There is quite a lot we have done in competition. One of them was to look at our own processes and the PRA as to how far we were stopping new entrants coming in, and we have found a few things that we should have changed a long time ago that do enable banks to get up and run quicker. We can encourage competition or we can remove the barriers to competition, but I think the intervention that says you cannot close a branch in a particular area is more of a public policy question.

Q49 Teresa Pearce: I agree, but could there be anything that as a body you could do to encourage banks to look at the idea of shared facilities?

Martin Wheatley: I would be very happy to look at that and have the discussion, so we can carry that part of the debate forward. As I say, the ATM is effectively a precursor to that, if you have an ATM in the area.

Q50 Teresa Pearce: Maybe we would need an increased use of ATMs. Maybe ATMs do more things.

Martin Wheatley: Possibly. The one thing I would say is that, under our payment system regulator remit, one of the things that we are seeing already and expect to see is quite a lot of innovation in banking, and that innovation will not necessarily just be about the bricks and mortar presence of banking. There will be a lot of different ways that new banks will offer their services.

Q51 Chair: The switching reform—has that achieved much?

Martin Wheatley: It has given people the ability to switch. It is successful within the confines of what it achieves. I think the percentages of switching has met all the targets in terms of those who choose to switch and their ability to switch, but the actual number of people who are choosing to switch is still relatively low in the overall scheme of things.

Chair: So not much.

Martin Wheatley: I think it has increased by about 15% since it was introduced.

Q52 Mr Ruffley: The pension changes that George Osborne announced and the guidance guarantee—could you just explain why those parties giving the guidance are not subject to your current FCA authorisation and why there will be a new separate regime?
Martin Wheatley: I suspect I am not the best person to ask. The Treasury has designed the regime. The Chancellor gave the commitment that there would be this free face-to-face guidance. I think the desire is to design a regime that is cost-effective and that delivers benefits to the 400,000 people a year who have an annuity and need to do something, but does that in a cost-effective way that is not over-regulated. The Treasury design, therefore, is to choose a couple of organisations to deliver that service. Our role will be setting, maintaining and monitoring compliance with the principles, but not to authorise or regulate. I think that is just a decision about proportionality, and I think it is largely based on the fact that the organisations delivering this service will not have the potential conflict of interest that many financial services firms do when they are delivering advice.

Q53 Mr Ruffley: Do you not think that regime that you have outlined might give rise to mis-selling?
Martin Wheatley: That is always a risk, but the selling part of this regime will be done through either the IFAs or the providers of product, and that part of it is covered by our regulation. The part that is not is the first front—

Mr Ruffley: No, I understood that.

Martin Wheatley: The advisory part will still be fully regulated and fully authorised as it is today.

Q54 Mr Ruffley: One respected analyst, Tom McPhail at Hargreaves Lansdown, believes, as many experts believe—as you know, Mr Wheatley—that it could be superficial and it obviously would not be personalised advice. Are you responsible for commenting on or doing anything about advice that ends up being superficial and very non-personalised? What happens if that prediction by industry experts comes true?
Martin Wheatley: First and foremost, it is not advice in the regulated sense. It is guidance, and that guidance is a generic guidance that will point people to: “This is where, given your circumstances, you should go next.” In some cases, where you should go next will be relatively simple. It will be, “Take a cash sum out and buy an ISA; buy something very straightforward.” If it is more complex, our expectation is that the guidance would not be able to deliver the level of advice needed and would say, “You now need to talk to an IFA,” or, “You need to talk to a regulated person.” This guidance is very much a signalling as to where you might need to go, given your circumstances.

Q55 Mr Ruffley: You think it might be something as basic as, “You need to go to an IFA”? That could be the guidance, could it?
Martin Wheatley: In many cases, yes.

Q56 Mr Ruffley: In which case it is not a very useful guide.
Martin Wheatley: You say not very useful. Every year there are 400,000 people who face this situation. For a large number of those people, the guidance may be perfectly adequate for some people as, “Take a cash sale and invest it in an ISA and here are a range of ISAs.” For anybody with slightly more complex requirements, it is almost certainly going to be, “You need to talk to somebody who is authorised.”

Q57 Mr Ruffley: Fairly basic guidance is what you are envisaging?
Martin Wheatley: Yes.

Q58 Mr Ruffley: What role will the Money Advice Service have in any of this in the run up to D-Day next April 2015?
Martin Wheatley: That is still being determined, and I think it is for Treasury to set out in precise terms the roles of the Money Advice Service and The Pensions Regulator.

Q59 Mr Ruffley: You will be aware that this Committee's Sub-Committee has had a hearing on the Money Advice Service. Over a period of well over a year, some of the evidence we have had as to the performance of the Money Advice Service has been fairly damning. Do you have confidence in the Money Advice Service to play any meaningful role in the run-up to next April?
Martin Wheatley: I think the questions of the historical role have been whether its marketing budget has been well spent. Up until now, the money advice it does is obviously the money advice, and the debt advice or debt servicing, parts of their business. I think the questioning has been about whether the large marketing budget it spends has been well spent. I think that is a completely different question from the one that it is being asked to do now. What I do have is confidence—maybe John will comment as well—in the board and the management of Money Advice as a competent organisation.

Q60 Mr Ruffley: You think that is a question that should be posed—whether or not the board is competent?
Martin Wheatley: No. I think the question to be posed is, operationally, how would it gear up to dealing with what could become tens of thousands, and possibly hundreds of thousands, of individuals. It is an operational challenge as to how you get to scale to be able to deal with that level.

Q61 Mr Ruffley: On the products that might be emerging in the run-up to April 2015, you have been given powers to intervene early if you do not like the design of certain of them. How are you going to determine detriment, given that you probably have an early sight of the kind of new products that are being manufactured or are about to be manufactured? What things do you not like the look of so far that might lead you to intervene?
Martin Wheatley: It is early days to say what we might not like the look of because, frankly, people—

Mr Ruffley: Are you aware of anything you do not like the look of—things that are kicking around in the market?

Martin Wheatley: Nothing specific. In general terms, the things we always ask a lot of questions about are those that appear to have disproportionate costs baked in or levels of complexity that are very hard to unravel. They are typically the things that we would be concerned about. Honestly, we are not at the stage yet where we have seen anything where we have been able to get into that debate. The other point I would make is that, while we have been given the power to intervene, we are not a product approval organisation. The products will be available and out there in the market, and we will have to review those products as and when we see products or we see complaints or we see potential detriment.

Q62 Mr Ruffley: There has been quite a lot of comment, particularly in last weekend's financial press, about exit penalties for those who want to exit existing pension schemes next April—that there might be a real shock for pension holders where their contracts are silent on the issue of exit penalties. Where exit penalties are clearly on the face of a contract, the consumer cannot complain if those exit penalties are levied when they depart from the scheme, if they choose to do this next April. Is that something you are worried about? Commentators seem to think that this could be something that has not been thought through. What do you think about that?
Martin Wheatley: We would certainly look very carefully at what appeared to be disproportionate exit penalties that were not part of the original contract. If an individual has entered into a contract, clearly there will be some administration costs that would come at the end, and we would look at what those costs are, but if there are disproportionate exit penalties and they were not part of what was entered into, we would look at that either under our unfair terms and conditions procedure, or under our principles of being clear, fair and not misleading with consumers. This is absolutely something that we will be looking at.

Mr Ruffley: You have those two levers you have just described?

Martin Wheatley: Yes.

Q63 Mr Ruffley: Has this been flagged up as a potential problem by those in the industry?
Martin Wheatley: We have had a number of discussions where people are concerned about it, so yes.

Q64 Mr McFadden: Mr Wheatley, can I return you to the subject of fair markets and pricing that was asked earlier? Interest in this started with the exposure of LIBOR fixing a couple of years ago. If you pardon the pun in this, have we fixed the situation? Have we sorted it?
Martin Wheatley: In truth, no, I do not think we have, and you have seen the stories about FX and we have confirmed that we have had an investigation under way and we have had subsequent events to LIBOR. The Chancellor this year in the Mansion House speech announced a piece of work that was about fair and effective markets, which is being managed under the auspices of the Bank of England, the Treasury and the FCA, which is looking at how much further the regulatory umbrella needs to go to give us confidence in wholesale markets. That piece of work is asking questions about: is the UK system adequate or does it need to go further? Does the European system that is coming along, which is MiFID and market abuse regulation, extend far enough? There are quite a number of questions about the regulatory perimeter, but the answer is no, we have not solved it yet. It is still a work in progress.

Q65 Mr McFadden: It has not yet been fixed. We know that a number of banks have been fined and we have seen quite a lot of news about that. How many individuals involved in LIBOR fixing have had action taken against them?
Martin Wheatley: There are quite a number of individuals who the SFO has now announced that it is taking action against. I do not know the precise figures. I am sure I can write to you.

Mr McFadden: Ballpark: 10, 20, 50?

Martin Wheatley: I think it is in the region of 20 to 30.

Q66 Mr McFadden: What kind of action is being taken against those individuals?
Martin Wheatley: This comes back to your question of whether we have fixed it. The complexity is that very often the wholesale market space is not regulated activity and, therefore, we have no rules that we can apply to take against individuals. The SFO is looking at whether the activities meet the test of being fraudulent and, therefore, that they are criminal activities. The test would be if it can prove they are criminal activities, it can take action. There was not a rule set—this is one of the gaps that we have closed on LIBOR—that was a breach on which we could therefore take action against individuals.

Q67 Mr McFadden: In simple terms, are you saying sometimes price fixing is not a matter for the regulator, but might be a crime?
Martin Wheatley: Historically, yes, that has been the case. The question we are now asking with the combination of the fair and effective markets review is to whether the rule set needs to extend further so that it could become misconduct that the regulator, therefore, would have traction over.

Q68 Mr McFadden: When is this fair and effective markets review going to finish?
Martin Wheatley: I think next June is the current timetable. The timetable is that the consultation paper will be published in the next couple of months and a final report next June. There is likely to be some legislative change, which I am sure will come back to being debated by this Committee at some point.

Q69 Mr McFadden: Do you understand the fundamental importance of this to the public? It is probably a fact of life that people moan about the price of things. We all do that, but it is one thing to moan about the price of something if you think the price of that thing has been set honestly in a competitive supply-and-demand situation, but it is another thing entirely, is it not, if the price of that thing has been fixed artificially by a small group of people who are going to benefit personally from the actions they pursue? This is a fundamental breach of what a market economy should be, is it not? A cartel is not a market.
Martin Wheatley: No, and you ask if I understand the importance of this. Absolutely, and this is why it is such a priority for us to clean up these markets and to give people that confidence back.

Q70 Mr McFadden: Mr Griffith-Jones, you look though you want to come in.
John Griffith-Jones: Only to say that, if you step back and look at what we have achieved in the first year, I do think we have made quite an impact on the consumer space, but we internally have talked about the need to get to a similar position in the wholesale space, and at roughly the same moment the Chancellor decided to set up the fair and effective markets review whose work, if I can just agree with you, is absolutely seminal to sorting this out.

Q71 Mr McFadden: Apart from the impact on consumers, is the reputation of the City of London as a place for fair and honest dealing at stake here?
John Griffith-Jones: Yes. Not only is it at stake on the downside, but it has an upside that if we could sort this out, so that it got a reputation for no longer behaving in this sort of

way, it would be world leader. This is quite a big piece of work. I can see you are nervous about June, but there are quite a lot of component parts to fixing this on a sustainable basis.

Q72 Chair: Mr Griffith-Jones, have you tried to write down the criteria that might be of use to establish whether a benchmark should be regulated?
Martin Wheatley: Perhaps it would be best if I answer that.

John Griffith-Jones: Martin has been working on this for six months.

Martin Wheatley: The answer is yes, absolutely. We have set that out and that would be one of the first deliverables of this project.

Q73 Chair: Have you published that?
Martin Wheatley: That will be published.

Chair: Could you give us an interim look at that? We would be grateful if we could see the criteria you are intending to use?

Martin Wheatley: I will have to discuss it with the Bank of England and the Treasury because it is a tripartite, so I do not think I can commit unilaterally. I will have to discuss that.

Q74 Chair: I am not asking about what you will do as a consequence of whatever you may have drawn up as criteria. I am asking only for the factual information that relates to those criteria.
Martin Wheatley: Okay.

Chair: Thank you.

Martin Wheatley: I am sure we can.

Chair: We will come back to it outside this hearing, probably along with a number of other issues that we also have outstanding.

Q75 Mark Garnier: Thank you. We have talked about benchmarking, but there are also other prices that are important, referring back to the equity prices, which are not benchmarked in the same sort of way, but are obviously very important given valuations. I have raised this in this Committee before—that it is common knowledge that, certainly by the time you get outside the FTSE 350 shares, there quite a lot of jiggery-pokery going on with opening and closing to get preferential prices, depending on what your interest is. Have you done any work on this?
Martin Wheatley: Yes, we are constantly. It is one of the key parts of the work we do on market surveillance. Our market surveillance system monitors—whether it is FTSE 100 or 350—constantly through the day and certainly at the close, and especially at certain closes. Quarter closes tend to be a little bit higher profile. When we see unusual movements, we investigate those movements, and when we are uncomfortable with the actions people have taken, we act against them. We have done that in the past and we will continue to do that.

Q76 Mark Garnier: How frequently do you do it?
Martin Wheatley: We assess them all the time.

Q77 Mark Garnier: This is a computer algorithm that is looking for—
Martin Wheatley: Yes, we have a computer that takes in a very large amount of data of what is going in—trade by trade, all the data as to what is happening in the market. We would look at outlier information, spike information—anything that looks unusual. We would try to track down whether there were explicable reasons as to why a price moved in a particular way. If there are not, we will ask firms to provide more information to us. We also get suspicious transaction reports. We get an increasing number of reports and we investigate them all. All of them are investigated to the point where we decide—

Q78 Mark Garnier: How many suspicious transactions do you get? If I were to talk to an equity trader, they would be having a look through the market and saying, "There are 20 or 30 suspicious transactions per stock per day". I do not intend to exaggerate.
Martin Wheatley: We get thousands.

Q79 Mark Garnier: You investigate every single one?
Martin Wheatley: We look at patterns and with many of them there is a perfectly reasonable reason as to why the price would have moved—a company has put some sort of news or a piece of research has been written. A lot of them are relatively easy to explain, but the ones that are not we pursue, and we go and we ask the brokers and demand explanations from firms. The answer is yes, we do.

Q80 Mark Garnier: I have spoken to one or two brokers informally and they have told me that they put in complaints to the Stock Exchange and the FCA and they have had absolutely no response whatsoever.
Martin Wheatley: In terms of response, what you have to realise is sometimes those reports do not go any further because we have a rational explanation as to why. Sometimes they do and we start to investigate, but we typically would not inform a firm that we had started an investigation into another firm. With the level of information that goes back, people may be frustrated, but we have to be quite careful about how we treat the information.

Q81 Mark Garnier: I appreciate that. Were you surprised when this came up a few months ago as a big problem that had been as yet undisclosed?
Martin Wheatley: It is a fact that has always been there, let us be honest. People wanting and having an incentive to mark the close typically is something that has existed in markets when there were floor-based markets, so it has always been there. Under today's environment we are able to detect that much more quickly because basically—

Q82 Mark Garnier: I will tell you what is bothering me about this. You have a huge amount of confidence the systems you have in place are right and yet when I talk to people in the markets they do not have that confidence. What is going on? Why is there such a gap?
Martin Wheatley: Maybe there is a good degree of cynicism, I am not sure, but I am confident that we have a system in place that will detect unusual movements and we will follow up those unusual movements where we do not think there is an obvious explanation for them. The other point is there is an obligation on all firms to make a suspicious transaction report to us when they see something unusual. Firms have an obligation as well to tell us if they have seen something, or a client has done something that they think should be investigated.

Q83 Mark Garnier: I just want to ask a couple of questions, if I may, on a completely unrelated subject, and that is to do with gifts to regulated firms. As I understand it, if you are, for example, in a bank and somebody gives you a gift such as a day at the Grand Prix or something, you have to put that on a register in order to have full transparency—as, indeed, we do here in Parliament. Is that the case?
Martin Wheatley: I think that is the case. You might be stretching my knowledge but I think that is the case.

Q84 Mark Garnier: Do you know what the case is with banks that take on secondees from advisers?
Martin Wheatley: No.

Q85 Mark Garnier: It has been suggested to me that the gift registers—again thinking about the case of Members of Parliament—is a perfectly reasonable thing and that we have full transparency. For example, if a bank manager who presumably allocates businesses is given a day at the Grand Prix, it is absolutely right that it is registered so that there is full transparency, so that happens. However, it seems there is a number of occasions when banks will take on secondees from advisers—accountants, insolvency practitioners and that type of thing—which apparently is reasonably common practice, that will effectively be a gift by the accountancy firm of anything between £50,000 to £100,000, depending on the length of secondment, and yet that is not declared.
Martin Wheatley: I can only commit to going and looking into that. I am not aware of that.

Q86 Mark Garnier: Would you agree that it is an area you need to look into? Clearly, if a day at the Grand Prix or a day at the races is something that can affect the outcome of business decisions, which is what it is all about, the case of having advisory firms giving secondees—as I say, that would be very expensive—can be done only for the simple reason that the firm wants to develop a better relationship with the business giver, so the bank in the case, and that it is something that can distort outcomes and therefore should involve much more transparency?
Martin Wheatley: Can I take that away and have a look at it? Clearly, it would have to be that there is a conflict of interest that is abused as well and clearly we have rules about conflicts of interest and proper process, but I am not aware that this is a prevalent activity. I will have to take that away.

Mark Garnier: I am told it is more prevalent than perhaps one could imagine.

Q87 Mr Mudie: Mr Wheatley, I am grateful for your briefing that you sent the Chair, but you are aware that I asked the Governor of the Bank of England and the Director of the PRA how many dark pools there were operating in the UK and what major banks ran their own dark pools. The Governor did not know and Andrew Bailey did not know, and they suggested I ask you. I was after reassurance and now that I have you in front of me I am hoping I will end this session reassured. How many?
Martin Wheatley: There are 12 dark pools that are owned and operating in the UK at the moment. Most of the big major global banks will operate their own dark pool and obviously they have different sizes and a different market share, but Credit Suisse, Deutsche Bank, Goldman's and UBS all run dark pools in the UK.

Mr Mudie: Twelve, did you say?

Martin Wheatley: Yes.

Q88 Mr Mudie: Does that include the major banks?
Martin Wheatley: Yes.

Q89 Mr Mudie: What proportion of trading do those do in UK trading in equity and fixed income markets? What proportion? The Governor seemed to think it was predominant and extensive. I do not think he used the word "extensive"—it was a better word than that—but is this so? Twelve seems to be a small number.
Martin Wheatley: That is the number of dark pools operating. There are different numbers in equity as opposed to debt markets as opposed to forex markets. Some of them specialise in different markets. In the equity market, the proportion of trading in dark pools is very low because, frankly, you have the exchange and you have open markets—lit markets—that are predominant. They are more prevalent in debt markets, but the definitions are slightly different as well, because in debt markets, most brokers would always have had what would be called an internalisation engine where they, frankly, just try to cross business from two clients. That is slightly different from the concept of a dark pool, which is largely about the technology as to how it is delivered. Yes, in debt markets and in forex markets, the large players try to internalise as much flow as they can because there is not a public market for business to go into.

Q90 Mr Mudie: When you say the 12, just to be clear, those are the ones that are regulated.
Martin Wheatley: Yes.

Q91 Mr Mudie: Some are not regulated?
Martin Wheatley: Again in debt markets and equity markets you have to be regulated to offer that process. In forex markets you do not.

Q92 Mr Mudie: I do not know whether you picked up on Brad Katsuyama being in front of the House of Lords Economic Affairs. Did you read the verbatim report?
Martin Wheatley: Yes.

Q93 Mr Mudie: How worried are you with the evidence he put? For example, he said, "Billions of shares are traded every day in markets with little to no public documentation." That should be a very scary thing for people to hear. Lord Carrington asked, "Are the markets rigged?" "The way that the markets have been designed means that certain players in them are definitively disadvantaged, so rigged is probably one of the many words that can be used to describe that situation." He then went on to describe how Knights Capital had gone down, which raises financial stability questions. Were you at all concerned when you read his evidence?
Martin Wheatley: Yes, concerned because the statements he and a number of others have made—there have been a number of commentators on this over the last two years—are suggesting that in particular US equity markets are systematically failing to deliver the benefits to end consumers. So, yes, concerned because many of the same players that operate in US equity markets will operate in UK markets and European markets. For that reason, for a long time and before this evidence, and before the various books have come out, we have been talking to the people who operate these pools and we have a supervisory regime for the people who are running the algorithmic trading against those dark pools.

We have satisfied ourselves about the commonality—which features are common in the UK to the US and which are different—and that we do not have the same systemic abuse that seems to exist based on these allegations. I say "seems to exist" because there are lots of cases that are now running as to whether those allegations stand up or not. The UK and Europe in general is very different and so the opportunities to run some of the more exploitative strategies are much more difficult to do in the UK market.

Q94 Mr Mudie: Much more difficult? Then you can reassure me that this behaviour that Brad outlined is a US phenomenon and is not present in the UK.
Martin Wheatley: I think I would struggle to say it is not present in the UK. There are concerns we have and we have taken enforcement action against people who are running strategies that are abusive in the market.

Chair: Is that the Barclays case?

Q95 Mr Mudie: No, it is not. It is one individual.
You specifically mentioned in your annual report that you have dealt with one person and fined one person—a considerable fine, but one individual person, and no one else. I am asking whether, concerning the 12 leading dark pool plus high-frequency traders that operate, you can reassure us that what we read about and what Brad gave evidence about, with his experience as an ex-head of trading in Royal Bank of Canada and an operator of an ethical dark pool, the behaviour he describes cannot and is not happening in the UK.

Martin Wheatley: That would be a heroic statement to make because the behaviour he described is very broad. There were a lot of different trading strategies being adopted, and some of those cannot operate in the UK.

Mr Mudie: You cannot give us this reassurance?

Martin Wheatley: No.

Q96 Mr Mudie: For example, three of the operators—this adds to my worries—operate in the UK. One is a British bank, Barclays. You have Barclays charged with a number of serious offences operating within its dark pool. You have Goldman Sachs already being fined by the authorities in America. It did not accept guilt, but they paid the half-billion fine, and you have Deutsche having a class action and also being brought into answer questions on the operation of high-frequency trading in a dark pool. They are here in the UK. Are you relaxed that somebody like Barclays can operate this way and, in particular, regarding what Pat McFadden said over LIBOR? The regulators here only started taking it seriously—and we had the evidence and we went through it—when the USA authorities took action and gave the public the information, and it was inevitable that the regulators here had to do something. To us LIBOR was fine; it was only when America blew the whistle. Now, America is blowing the whistle. We see how Barclays, Goldman Sachs and Deutsche are acting in the States. Does that not raise any concerns with you that you should go through all those organisations like a dose of salts? Every aspect of high-frequency trading and the operation of the dark pool should be scrutinised to the last detail. Has it been done?
Martin Wheatley: I was answering your question, which was can I give you a guarantee that this does not exist here. When I said "no", that was not out of complacency. It was out of the knowledge of the work we are doing.

Q97 Mr Mudie: No, I accept you cannot. I accept nobody could say that. It would be a very dangerous thing to say, but the reassurance I seek is that I question you and I am then satisfied that with the vast resources and the seriousness of the events, you can assure us that you have put people in and they have gone through it thoroughly and come back to you. I see from your method of working that they should have a named, nominated supervisor. Has that supervisor put on your desk that they have gone through this bank and nothing untoward is happening in this area?
Martin Wheatley: We are spending a lot of time—

Mr Mudie: No, answer the question.

Martin Wheatley: I will answer the question, but you are characterising us as responding to either the hearing in front of the Lords or the publication of this book. We have been spending much on this for much longer than has become popular recently. I am very well aware of—

Q98 Mr Mudie: It is not popular; it is worrying.
Martin Wheatley: It has become popular in the media and it has become a high-profile story.

Q99 Mr Mudie: We should have more in the media. We might get some action then.
Martin Wheatley: We are taking action. On the question about LIBOR, we did not just respond to the US on LIBOR. Our investigations were well advanced and we were co-operating with the US all along.

Q100 Mr Mudie: Go to the specific question I asked you. Have supervisors in the knowledge, as you have just accepted, that this has been going on for some considerable years, put on your desk an all-clear on those three institutions as to how they operate their dark pool and high-frequency trading in that dark pool—absolutely straightforward, no problems? Do you have that assurance from your people?
Martin Wheatley: No, I do not have that assurance and I would be very suspicious if I did get that assurance because the nature of these firms is that the strategies change every day. The algorithms change every day.

Mr Mudie: And?

Martin Wheatley: Therefore you constantly have to keep doing it. If assurances say that a firm is clear and we could not worry, it would worry me more. I do not want somebody to say, “We do not have to worry about that firm any more,” because we have to monitor them on an ongoing basis.

Q101 Mr Mudie: No, you could, at a given moment in time, get that assurance and you could make it clear to the firm concerned that if it changed its algorithms or order basis, you are notified of the changes. If you are saying as the chief regulator that you cannot reassure me that those steps have been taken, it is a very nice reassurance to the banks, but it is not to the ordinary investor.
Martin Wheatley: I think you are phrasing the question in a slightly strange way.

Mr Mudie: I think you are answering it in a strange way.

Martin Wheatley: I would feel uncomfortable with somebody that gave me a reassurance that we do not have to worry, because I want us to worry and I want us to continue to worry. These firms change their algorithms every day. That is the nature of high-frequency trading. It constantly evolves.

Mr Mudie: No, I accept that. I have just accepted—

Martin Wheatley: The one thing I can give you assurance on is that we worry about this and we care about it, and we spend a lot of time looking at it.

Q102 Mr Mudie: I am happy that you worry about it. I am more concerned that you do anything about it. I am saying at a given moment in time the specific nominated supervisor has told you they are fine but, as you say, that is good. You can tell me when you last had that put on your desk about those three institutions. You can give me a date. Then I would ask you, "What steps have you taken to give me reassurance that, in an evolving market and an evolving business, any changes are logged with you and looked at by your people as a matter of course?" That is all I am after.
Martin Wheatley: What I would say to you is that, in proportionality terms, the business evolves so rapidly that that is not a sensible thing to do—to ask them each day what parameters of their algorithm they have changed.

Q103 Mr Mudie: So we just trust them?
Martin Wheatley: No, we do not just trust them. We rely on the monitoring which, as I have just explained to Mr Garnier, we do on a regular basis in the market. We rely on suspicious transaction reporting, which is the market telling us something that has happened, and we rely on our own intelligence. This is something that we do constantly. It is not a one-off and you forget about it.

Q104 Mr Mudie: Martin, you sound suspiciously like the executive director of markets who came before us on 11 March 2014 and was asked by Andrea Leadsom, "In view of LIBOR, have you looked at your records in other markets?" She was saying you saw what happened in LIBOR and you were behind the curve. This was on foreign exchanges. You were still behind the curve. She said, "Look at you, you are behind the curve. Did you look at it?" The answer we got was, "We have gone through a process recently of asking people whether they knew of any other issues in the market. It is not our job to go off hunting for rigging of markets." Do you stand by that? Is that your approach—that it is not our job to go looking for it? He went on to say, "If somebody tells us, we will have a look at it".
Martin Wheatley: Again, the point I made earlier is that there is a regulatory perimeter as to what is covered. Neither LIBOR nor forex are in the regulatory perimeter. Where it is clearly our job, we do it all the time every day—equity markets, debt markets; all the time, every day. Where it is not our job, we still say to banks, "Look, you need to make sure that you are not falling foul of what we consider to be a reasonable standard in markets," even though they are not regulated by us. If we do then see something, as we have with LIBOR—and we are not behind the curve, and we are not behind the curve on forex; we have reacted very quickly to intelligence that said there are problems in these markets, but we cannot go looking for things that are not our job.

Q105 Mr Mudie: Is it not your job when you are responsible for the conduct and supervision of the equity markets?

Martin Wheatley: No, sorry, I am just talking about other markets that were not.

Mr Mudie: I am talking about the mainstream markets. It is your job.

Martin Wheatley: Mainstream markets, absolutely, but LIBOR and forex I was characterising as outside of that. They are different to that.

Q106 Mr Love: Can you focus on high-frequency trading? According to research carried out in 2011, high-frequency trading accounted for 77% of transactions. Can you give us a more up-to-date figure on what you think the domination of the market is by high-frequency traders?
Martin Wheatley: That was the figure for the US markets. The UK markets have never been as concentrated as that. About one third of the UK equity market is high frequency as of today; slightly higher than Europe, and lower than the US.

Q107 Mr Love: I will then come on to the concerns that have been expressed in relation to high-frequency trading, and this is not just Michael Lewis. I think this is widely shared in the media particularly. They relate to concerns about competition, market resilience issues, and indeed the potential for market abuse. Do you share those concerns? Are those things that you are focusing on?
Martin Wheatley: Yes.

Q108 Mr Love: Let me come to competition. There is a very costly infrastructure to high-frequency trading. A lot of people are suggesting that is making it very difficult for competition in the marketplace to take place. Are you aware of those concerns and what action are you talking to ensure that we have competitive markets?
Martin Wheatley: Clearly the firms that adopt high-frequency strategies spend a lot. They have developed very sophisticated algorithms. They invest a lot in the speed of their communications and the speed of their processing. They are bearing the cost of setting that up, but clearly the exchanges that are on the receiving end also have to build an engine that could cope with that volume and those exchanges make their charges and recover their money from all the users of the market. Given that high frequency are very large users of the market in terms of volume, they pay a disproportionately large amount in terms of their contribution to the overall costs. What is not the case is that those high-frequency firms have an inbuilt cost advantage or an anti-competitive cost advantage. That is one of the allegations in the US—that they had been given some specific commercial advantages by the trading platforms. That model does not exist in the UK.

Q109 Mr Love: You are not concerned? We have reports of further investment on technology. Undersea cables are being talked about, microwave links, lasers and so on. Are we reaching a situation where it will be prohibitive for new market entrants of high-frequency trading?
Martin Wheatley: I think we are reaching a situation where the cost of running those operations is going higher and higher. That is absolutely true, but for an average investor who wants to buy Marks & Spencer's because they believe in the long-term success of Marks & Spencer's, not because they believe in the next microsecond there will be a three basis point change in the price, they still have very cheap access to markets. It is simply that high-frequency traders have a particular strategy that is about scalping very small amounts of value in very, very short periods. For an average investor who takes the view,

"I like the company for the next 10years", they do not need that infrastructure and they are not prohibitively costed or expended out of the market by the investment costs.

Q110 Mr Love: Let me go on to market resilience. We obviously had the flash crash some time ago in the United States. I would not ask you whether you are concerned that something similar might happen in the United Kingdom, but we continually hear reports of many flash crashes localised. There was a report in the newspapers of someone who had turned a new algorithm on and lost £3.1 million in 29 seconds, and if it had lasted several minutes, it might have disrupted the whole marketplace. Is this a concern and what are you doing to address it?
Martin Wheatley: There are two separate concerns. The flash crash phenomenon, as you say, which happened more than three years ago in the US but has been repeated several times since, is a function of the market structure in the US where you have very fragmented platforms and multiple different platforms, and you have a national market system that means there is very predictable logic as to how those platforms interact with each other.

Q111 Mr Love: Are you saying to us that it could not happen here?
Martin Wheatley: I am quite careful in separating it out from the other instance you gave. That particular instance is very unlikely in the UK market, but the situation of somebody losing a large amount of money in 29 seconds or a rogue algorithm is absolutely as likely here as anywhere else. We regularly look at firms and talk to them about their systems and controls, and how they build in failsafe mechanisms to stop the sticky finger or the rogue algorithm existing. That absolutely can exist here and you could see the same.

Q112 Mr Love: What confidence do you have in those measures? All those measures will slow down the high-frequency trading and the whole competitive basis currently is to speed it up. How do you ensure that they carry out those checks and balances when they know that it is going to affect their competitive position?
Martin Wheatley: We make it a requirement that they have them and if we go and see them and they do not have it, we will remove their access to the market. We have very strict rules about the levels of validation that firms need to put in place before they send orders into the market. If people develop a system without those rules and it creates a rogue impact on the market, we will require that that firm ceases to trade in the market until it fixes the problem.

Q113 Mr Love: When high-frequency trading firms do not handle clients' money, they are not required to be regulated. Do you know the size of this unregulated marketplace and what contacts do you have with them to ensure that they are not getting up to issues of market abuse?
Martin Wheatley: Again, in terms of the size of the market, as I have said, it is about one third of the UK equity market in terms of total volume. We do talk to the firms, we do supervise them, and we do go out and find out what controls and validation they put in place, even though they are not handling client money. Typically they are handling their own money, but they are still required to be authorised and, therefore, we do supervise them.

Q114 Mr Love: Can I just be clear, because I understood that where they were not dealing in client's money—in other words they were trading on their own account—

they were not required to be regulated. Are you telling us that everyone is required? We know MiFID II is coming in, but prior to that?
Martin Wheatley: There are two separate models. Some of them have become direct members of the exchange and, therefore, are interacting directly and they are. Some of them are using brokers' services and, therefore, they are a client who sits behind the broker. We do not have the same controls on them. We have put the controls on the broker. Increasingly they are moving to want direct access to exchanges and are using less and less of what we call sponsored access. What you have described is much more the sponsored model that existed probably until two or three years ago, but most of them have now become direct players in the market.

Q115 Mr Love: Can you reassure this Committee that you are on top of the risks involved in this unregulated part of the marketplace, recognising some of the concerns that have been expressed more generally about high-frequency trading?
Martin Wheatley: Yes, I can. I think from the answers I have given that you will realise that this is something we do take very seriously and we spend a lot of time on it, but, coming back to Mr Mudie's question, I cannot give you guarantees, though, because we know how fluid this market is and how fast it moves.

Q116 Mr Love: You have drawn distinctions between the UK market and the US market. Are we moving in a direction towards that of the United States where there are these arrangements between the exchanges and the high-frequency traders, where there is an armed war going on to invest to speed up the process, and where the challenges of flash crashes are very evident? Is that a concern of yours and would you consider taking action before MiFID II comes in to regulate the whole of this market?
Martin Wheatley: The answer to the question is: yes, we are moving in that direction, but it is not as fragmented. As of today, the London Stock Exchange still has 60% market share of UK equities. The New York Exchange has less than 20% market share of big-board shares. It is not as fragmented, which is one important difference, but it has been moving in that direction. There are more competitors to the exchange.

The second key point is we do not have what is called the Reg NMS system in the US, which is the logic that forces all orders to be handled in a different way. Our best execution rules are more complex and, therefore, more difficult to systematise through an algorithm. Those two things are the two big differences. The third one is the exchanges and the platforms here have not created specific order types that favour high frequency. A big part of the allegation, certainly in one of the books, was that those order types systematically favoured high frequency. That has not been the case in the UK.

Q117 Chair: Just a point of clarification. I think you said earlier that high-frequency trading is about one third of UK markets, I think the Tab Group, a consultancy, estimates that it is in fact 77%. That was a UK figure, not a US figure.
Martin Wheatley: I would be very surprised; I do not believe it has ever been that high. I am aware that the suggestions were that the US market was around 70%. I have never seen a figure that said 77% for the UK.

Q118 Chair: That is its estimate.
Mr Love: Can we ask them to clarify that?

Chair: If the Tab Group has it wrong for any reason, you will come back to us and let us know.

Martin Wheatley: I will certainly talk to them.

Steve Baker: Volume or value?

Chair: I do not have it in front of me so I cannot be sure.

Martin Wheatley: I would expect it would be volume of trades.

Q119 Chair: Mr Griffith-Jones, have you taken a look at this whole issue of dark pools and high-frequency trading from the position of a chairman looking down on it with a bit of perspective?
John Griffith-Jones: I have frequently asked Mr Wheatley and his colleagues what we are doing, rather in the same way as he has just been cross-examined by your colleagues.

Chair: You have?

John Griffith-Jones: I have.

Q120 Chair: I do not want to ask you questions if you have not given thought to that area because it is my questions of a more general nature that I want to put that are more suitable for a chairman. All this derives from MiFID, does it not? MiFID ended the platform monopoly on the grounds that competition was good between platforms. Is that correct?
John Griffith-Jones: That and the continued advance of technology making it possible.

Q121 Chair: The fact that that possibility arose provided the opportunity for MiFID to take that approach. Have you seen any estimates for the benefits that have flown from this?
John Griffith-Jones: Not quantified, but it is, as I am sure you are aware, generally recognised that there is more liquidity in the market and the spreads have narrowed as a result of the automated trading systems. I do not have figures to hand, but I believe it is the case that spreads have indeed narrowed.

Q122 Chair: I think Goldman Sachs has estimated that the benefits from competition are of the order of about £300 million, but I do not have that research to hand either to be sure. Has anybody tried to take a look at the research that has been done on the costs—the increase in transactions cost that has come with the creation of dark pools and the associated high-frequency trading? The two are closely interlinked.
John Griffith-Jones: I do not know.

Q123 Chair: I think this might be worth a look. I have in front of me here one piece of research suggesting that that figure is of the order of £3 billion, which is 10 times larger than the benefit estimate. I have seen estimates of larger than that. I am wondering whether all this has been worth the candle and whether we have entered the business of creating competition in the wrong part of the market—that is at the platform end—when perhaps we might have considered trying to generate competition elsewhere. This is a complex and multifaceted question that I do not think we can explore much further now, but I am a little concerned that the regulator does not have a firm view about it, given that

this whole problem has in a sense been created by a regulator decision, MiFID I, the unforeseen consequences of which we are now trying to remedy with MiFID II. Could you take a look at this and come back to us with your best estimate of the research that has been done in this field, and whether you agree with that research?
John Griffith-Jones: Can I just make one general point? I think as regulators we have to chase down these individual markets and phenomena as they arise and keep on top of them, but the history of regulators keeping ahead of innovative technicians is not, shall we say, 100% at the very least. There is this rival alternative, which is getting the conduct agenda firmly into the traders on these platforms. This is where the work of the fair and effective markets review that we were talking to Mr McFadden about comes together with the sort of chasing down the technical issues, but I believe we have to attack it from both ends.

If we just say, "Let's go and look at forex this morning, dark pools this afternoon and high-frequency trading the next day," we will always be behind the curve because people are trying to make money and very clever people are using technology to gain technical advantage over someone else. There has to be some sort of conduct overview of what the rules of the road are and it is part of fair and effective markets—I will come back with that.

Q124 Chair: That is an interesting remark. In the first instance, I would just be grateful for an overview with the regulator's best assessment of the costs and benefits on the basis of published research of these very considerable regulatory innovations that have taken place with MiFID and now shortly with MiFID II.
John Griffith-Jones: Yes, we will do that.

Q125 Steve Baker: Retail investment advice. Earlier in an answer, Mr Wheatley, you said to Mr Ruffley that the advice could well be taught to someone and authorised. Would you agree that we are moving into a world where it is increasingly important that authorised persons are available to give advice?
Martin Wheatley: Yes, I absolutely agree with that and, as you know, one of the main thrusts of the RDR was to ensure that the level of qualification of people giving that advice was raised.

Q126 Steve Baker: Could we just turn to the consultation the FCA recently undertook subtitled "Clarifying the boundaries and exploring the barriers to market development"? It was variously described by investment advisers, rather unflatteringly, as raising as many questions as it answered, and adding nothing and solving nothing. Are you disappointed by the reaction to this consultation?
Martin Wheatley: No, quite the contrary. Inevitably everything we put out will get a few critics, but most of the reaction to the consultation was a lot of people coming forward saying, "At last, a regulator that is prepared to listen to us when we say we cannot quite fit into your regulations, or you are a barrier to the way we want to operate". We have run a number of roundtables since. We have had a lot of engagement with the industry, both small start-ups and established firms, who are very keen to engage with us about how we move things forward. I agree with the comment that it did not answer questions; it was not intended to. It was a chance to raise the question of what more we need to do.

Q127 Steve Baker: Both the consultation and the thematic review noted that this uncertainty about the regulatory framework is inhibiting innovation in the advice market,

leading firms to exclude useful product information. Are you concerned that consumers will suffer from an advice gap as long as the FCA is unable to give the industry that regulatory certainty?
Martin Wheatley: I am concerned if people cannot get access to services they need, and clearly the maze of complexity that exists around finance is something that people do need advice on. Since the RDR has come in, I am also concerned that the old model, which was not in our view servicing the vast proportion of everybody as well as it could have been, has meant that some people are less well serviced now. Part of the reason for this project was to try to kick-start that ability to get advice into all segments of the market.

Q128 Steve Baker: My constituent, Gary Heath, has been agitating on this subject—and fairly successfully. He went through FCA figures and indeed your own interview with *Money Marketing*. The numbers he has given me is that with IFAs exiting the market, that leaves 3.8 million people, he believes, without advice. With banks reducing the advice they give, he adds another 4.2 million people. He also goes through to think that by the time advisers have top-sliced those people able to pay fees, he estimates that about 15 million people will be without advice. Do you consider this a serious problem?
Martin Wheatley: I do not recognise the numbers; I have not seen that analysis. Clearly, if that were true then, yes, it would be a serious problem, but markets are dynamic places and they evolve. I do know that all the major investment banks are looking at how they offer their model. I do know that we have a number of smaller organisations looking to launch into the market. There was a big feature in the press yesterday about one such company that says, "It is nonsense to say that people below £50,000 should not get advice. We can provide that advice to those sorts of people".

I think we are seeing a wave of innovation coming through the market. There is a lot of investment going into financial technology innovation. We are trying to tap into that hub and make sure that we can encourage it and not become a barrier to that innovation, and that we will fill the gaps. I do not think the numbers are as large as you have suggested, but whatever they are, people will innovate and they will fill those gaps.

Steve Baker: I will make sure that you see his final report.

Martin Wheatley: Please.

Q129 Steve Baker: I will be very glad to write to you and put the numbers to you. How will you be keeping a close eye on this advice gap? How will you make sure that people are able to access the advice they need? What will you do if it turns out that the advice gap has grown very large? How will you close it?
Martin Wheatley: The primary concern we have at the moment is making sure we understand it, and that was the purpose of publishing that document—to get people talking to us about it. We have run six roundtables that have been absolutely packed out with people wanting to talk about how they want to offer their services. We are asking them whether there are any aspects of our regulation—our authorisation process—that is a barrier to them. For many people, engaging with the regulator for the first time is a scary process. They find us opaque and difficult to understand, and the rule book difficult to understand. We have set out our own innovation hub to provide the ability to handhold them through that process and get them through our complex processes quicker.

Q130 Steve Baker: On this point about information and complex processes, you have drawn a distinction between information, guidance and advice. Are those distinctions too complex to be useful to consumers and do you think it matters?
Martin Wheatley: It matters. It is a key one for the industry. It matters because the obligations that sit with the person providing that differ. If you are giving advice, you have a suitability obligation to make sure that advice is suitable. If you are just giving information, it is for the individual to worry about whether it is suitable or not. That is quite an important distinction, and it is part of what holds the market together. If we have qualified advisers giving advice, we expect them to be giving advice that is suitable for the individual, which is a lot of what RDR was about in the first place.

Q131 Steve Baker: You are satisfied that professional advisers will be able to navigate these rules so that the number of advisers in the marketplace increases? It does seem to me it needs to increase.
Martin Wheatley: It needs to increase. I got in trouble last time when I talked about advisor numbers, so I will be very careful on this. There was a drop-off in advisor numbers prior to RDR coming in, but what we have not seen is a continued drop off. The numbers since RDR has come in have been growing, and I think the IFA community has been healthier since that period.

Q132 Steve Baker: Could we just turn to cyber-security? How many specialists, broadly, does the FCA employ to look at cyber-security?
Martin Wheatley: I will have to come back to you on that. I do not have a number.

Q133 Steve Baker: Is it more than none? Do you employ any?
Martin Wheatley: Yes, we have a number of specialists that are looking at cyber-security, but that is a shared responsibility between us, the Bank, the Treasury and the security services. We spend our time looking at this as an issue across the industry with a number of other bodies.

Q134 Steve Baker: Did you struggle to hire people when you were in competition with those bodies you have mentioned, and also the other banks?
Martin Wheatley: Again, I am not aware that we did, but I could have to come back specifically on that.

Q135 Steve Baker: The other question you could perhaps come back to me on is whether you employ any of what the technical community tend to call ex-black-hatters, who perhaps might have been ex-criminals or ex-hackers who have probably demonstrated their ability to understand the problem by being on the wrong side of it. Perhaps you might let us know if you employ anybody who has been in that position.
Mark Garnier: Everyone needs a chance.

Steve Baker: Yes, everyone needs a chance. I am grateful.

Are you confident about the nature and extent of the co-operation between the FCA, the Bank of England, the intelligence services and others?

Martin Wheatley: Yes, I am. It became a priority of the FPC about a year or so ago and that has brought together those agencies in a much more cohesive way. Yes, I think that works well.

Q136 Steve Baker: Mr Griffith-Jones, how do you perceive the Government's arrangements there in terms of where lines of responsibility are drawn for this particular problem?
John Griffith-Jones: I am not absolutely close to it, but I have heard enough to know that it requires co-operation of these four bodies, and they do need to work with each other. Therefore you can have as much technical governance as you like, but what you need is a joined-up solution and protection for them.

Q137 Steve Baker: I am going to come on to some more IT-related questions, but as chairman of the FCA, would you agree that the FCA is increasingly dependent on highly sophisticated IT?
John Griffith-Jones: Yes.

Q138 Steve Baker: Therefore would you think that cyber-security was likely to be increasingly important?
John Griffith-Jones: Yes.

Q139 Steve Baker: Good. I think we can safely expect the FCA to be doing more—and more actively—on onsite security in future.
John Griffith-Jones: Both on that and on other aspects of IT, in particular the whole question of how much we invest in our surveillance operation. You would have to match IT with IT. Then there is a whole question of the European reporting requirements, which largely relate to MiFID II, which will require more IT again. Yes, we have no choice but to become more IT-enabled as we go forward.

Q140 Steve Baker: The Bank of England seems to have taken the lead in this area by citing financial stability, but the FCA has the responsibility for ensuring integrity, as of course you know, and for consumer protection. Where does the FCA's responsibility end and the Bank's begin? Where does the consumer's responsibility for cyber-security begin and end?
Martin Wheatley: In terms of consumers, certainly the banks now when they provide online access are increasingly using three levels of protection. They are using passwords, difficult physical devices, and PINs or codes. The consumer clearly has a responsibility to protect the integrity of those lines of defence and not write their PIN on the back of the card that is the physical device. There clearly is a set of things that are down to the individual.

From the banks' point of view, clearly there is a systemic threat and there have been increasing denial of service attacks on not just the major branded commercial operations, but the infrastructure provided as well. That is a major concern—if one of the infrastructure providers was to be threatened. Therefore, the responsibility is constantly to make sure that knowledge is being shared among those different bodies as to the type of service attacks that are occurring, where those attacks are coming from and what the features of them are—so sharing information, and for those organisations to test their firewalls, and test them to quite a high standard.

Q141 Steve Baker: You have talked quite authoritatively about that area, but it sounds like you consider that particular issue of, say, denial of service attacks on infrastructure to be a responsibility of the Bank of England?
Martin Wheatley: Yes, that is very much in FPC territory.

Q142 Steve Baker: Where is your responsibility specifically in relation to protecting consumers?
Martin Wheatley: That was the third part I was going to come on to. Part of each firm's authorisation threshold condition is that it has adequate systems and controls. Part of having adequate systems and controls is the ability to make those available—if it is a 24/7 service then 24/7; and if it is a batch service to provide it through the window that they have contracted to—and to test it against resilient firewall breaches. Part of the supervisory calendar is that we require firms to demonstration to us that they have done adequate testing of that on a periodic basis.

Q143 Steve Baker: Did the FCA contribute to the CBEST system, and how do you plan to contribute both to that system and to future testing? CBEST is the cyber-resilience testing system that the Bank of England is operating.
Martin Wheatley: Our supervisors would have spent time. I cannot give you specific examples as to how we contributed, but between us, the PRA and the Bank of England, we spend a lot of time working out what it is that we should be requiring firms to do.

Q144 Steve Baker: I am conscious of the time, so perhaps if we just skip forward to some issues about the amount of data in particular. I think you know from a previous meeting that I am a software engineer, with City experience, and I am slightly concerned from things I have heard that you are now collecting so much data that it is extremely challenging for you to handle it. I have specifically heard that it is difficult for you to attract and retain the right software engineers to get this task done. Could you comment on that particular problem—your capacity to meet regulatory objectives through building the right software?
Martin Wheatley: You are right in terms of data. We collect today around 9 million transaction reports a day. Under MiFID II, that will more than treble. The amount of data coming in to us is vast. We have invested in our diagnostic capability, particularly for the equity market and the debt market, so that we can profile that data and analyse it, and basically come through to the suggestions Mr Garnier was making about the marking at the close. We have not built that for forex markets or for some of the other derivatives markets that could come in scope as part of MiFID II. That is a piece of work that we have to go through.

In terms of attracting software engineers, it is very difficult. Everybody has exactly the same problem, and these skills are in high demand and are very difficult to attract. Therefore we use a combination of our own in-house staff, where we have a core team. Some of the billed services we outsource. We have a long-standing outsourcing arrangement with Fujitsu, and we will use other outsource partners as appropriate. Some of it is we will bring in consultants or contractors to work specifically within our teams. A challenge that everybody has is finding good-quality software engineers you can hold on to.

Q145 Steve Baker: Could you characterise the degree to which you consider a risk to your ability to meet your objectives?
Martin Wheatley: I think the risk is effective implementation of European directives. Each time a new directive comes in, what has typically been happening is the level 2 rules, and then the level 3 detail, come very late in the process to meet the deadlines that the European Union has been setting. The risk of the objectives is that for a period after a

directive is implemented, we will be struggling, and firms themselves would be struggling to have had enough time to build the software and the capability in there.

Q146 Steve Baker: To be very specific, does software engineering capability appear on a risk register anywhere?
Martin Wheatley: Yes, it does.

Q147 Steve Baker: Turning to the data itself, do you believe everything that you are collecting is strictly necessary to meet the FCA legal objectives?
Martin Wheatley: It is like that quip about marketing, isn't it? You know that 50% of it is a waste of time, but you just do not know which 50%. If we didn't collect all of it, we would not have the ability to dive in and find the things that are problems. By necessity, 90% of the data—or 99% hopefully—is perfectly legitimate trading that is operating within the market, but unless you collect it all, you cannot find the 1% that is problematic.

Q148 Steve Baker: It feels like you are fishing—you are collecting the maximum amount of data to ensure that, should a problem emerge later, you have the data.
Martin Wheatley: When you say "the maximum", we are collecting the defined data that we are required to collect.

Q149 Steve Baker: I am asking: do you think that this is the right definition of data?
Martin Wheatley: Typically, the definition is about an ID, a price, a time, a quantity, and a security, and that is the set of data. There are essentially five data components and we collect that about a lot of things that move.

Q150 Steve Baker: I just have to go back to my notes. It looks like there is rather more than that, but perhaps we will save the data transactions to another day. How well prepared do you think firms are to meet their obligations to provide you with this information?
***Martin Wheatley*:** I do not think they are yet. The level to design has not been completed yet, so we will have a huge challenge between early next year when those final design principles are established and the live day. I am talking about MiFID particularly now, which will be 1 January 2017. I think there's going to be a massive challenge for the industry to be ready in time to be fully compliant with MiFID on that date.

Q151 Steve Baker: Do you specifically supervise their ability to meet that challenge?
Martin Wheatley: I think we are practical in that sense. If it is clear that firms are working towards building the software in all good faith, we just have to take a practical view. If they are not, we take a different view to them. Our supervisory approach has to be a very pragmatic one. Partly the deadlines that have been set at a European level make it very difficult for firms to be completely compliant.

Q152 Steve Baker: Thinking about the range and scope of the things we have just been discussing about cyber-security and IT capacity and so on, could you reassure me that you are fully confident yourselves that the City's IT capacity is equal to the task of delivering stable, functioning markets in the context of the cyber-security threat that we face?

Martin Wheatley: I do think the City's capacity is equal to the task. The challenge, as I said earlier, is that this is a very rapidly evolving space, and it is creating the bandwidth to meet the regulatory requirements that are being imposed on firms, their own service and product developments—clearly everybody wants to have a better service—and the threats that come from cyber-attacks. I think the capacity exists there but, nonetheless, it is a challenge just keeping pace with the amount of change that is coming through.

Q153 Steve Baker: Finally, what assessment have you made of the compliance costs in this area?
Martin Wheatley: Again, we have not specifically done a cost-benefit analysis of the benefits of the data collection against the cost of building that, in large part because it is not optional for us. If it is a European directive and it is implemented as a European directive, it doesn't matter what the answer to our cost-benefit analysis is. We would be acting outside our authority if we did not implement it.

Chair: We would like to know the costs of compliance and we are in conversation with the firms to try to obtain this.

Q154 John Thurso: I will come to you first, Mr Griffith-Jones. All my questions are about the relationship between yourselves and this Committee—the co-operation with the Committee. There are three areas where we have asked for papers or asked to see things recently where, for one reason or another, you felt unable to comply. The first was over a request to see internal audit reports, the second was on some legal advice, and the third was relating to deals with banks. I will take you to those in turn and start with the internal audit reports: if we were to insist on seeing those, on what grounds would you resist us?
John Griffith-Jones: My understanding is that if you insist, you insist. As I said—I think in real time at the last hearing, and as I wrote to your Chairman subsequently—I beg you to consider the arguments about giving us a protected space in which to do our work, of which receiving reports about things that are not quite right, frankly, and putting it right is a wholly necessary part of every organisation's function. If you shed a spotlight into that in real time, you alter the behaviour of the people in the protected space and make my job more difficult to do regulation work. That is my only reason. I completely understand that if something goes wrong, you hold us to account afterwards, and if you say, "Was there an internal audit report on this, and did you act on it?" that is completely for the public domain.

Q155 John Thurso: Part of this is timing. Just as a matter of interest, do you believe that these reports are FOI-able?
John Griffith-Jones: I have not a complete legal answer to that question.

Q156 John Thurso: Can I help you?
John Griffith-Jones: Yes.

Q157 John Thurso: Unless you have an exemption, they are, because the Nuclear Decommissioning Authority has had legal advice that its audit reports are. I sit on the House of Commons' audit Committee, and I can tell you that our audit reports are, with exemptions and so on, but I think you will find, unless you have a specific exemption, that they are FOI-able. My suggestion to you is that the Committee either insisting or FOI-ing or whatever is not part of a good relationship. What the Committee is looking for is not to

know what the discussions are. One of the exemptions I can tell you relating to any publication request against the House of Commons is details of a controlled weakness not yet dealt with, which could be exploited if made public. There are some obvious exemptions.
Obviously, you are now audited by the NAO, so all this matter comes before the PAC after the event. The suggestion we are making is that, if we could, as a Committee, Chairman, come to a reasonable arrangement about what we might see, this would enable our scrutiny, and, if we co-operate on it, we can do it in a manner that does not come up with the negative consequences that you foresaw in your letter. Would you accept that that is a reasonable thing for the Committee to try to do?

John Griffith-Jones: I am extremely nervous of the practicalities of it, as is obvious. I would not have written a letter and I am certainly not relying on some sort of legal protection on this. I genuinely believe if we can find a way—I think I suggested, from memory, in my letter that the chairman of the audit committee should come and see you, whether it is with me or without me, and tell you what we have done and give you a summary. That does not seem to have fallen—

John Thurso: Perhaps to save time, because I think what we have established is that if we insist you probably cannot resist, but we would like to be reasonable scrutineers and you have some points to make, we should say that this dialogue go back to the Chairman and the Clerk to have further dialogue further, and we look at it again next time. Would that be —

Chair: Let us move on to the next one.

Q158 John Thurso: I will move on to the next one. Can I come to the question of legal advice? You will be aware that this is particularly with regard to the embedded loans and whether the FCA has a role in regulating those. The FCA has had internal and external legal advice that basically, as described to us, says it does not have a locus in regulating these. This is clearly something the Committee is extremely concerned about and is looking into in other inquiries. There are two points here. The first is for us to know and understand what the factual basis and consequence of the opinion is and, to do that, we need to have a reasonable understanding of opinion rather more than a letter from general counsel.
The second point is the impact of that on policy. It is my understanding that the Chair, through the Clerk, has been discussing the possibility of somebody, under proper terms of security or confidentiality, reading the opinion and reassuring the Committee in broad terms, and this has been resisted. Can you explain why, when this is something that we have done before in other circumstances, and something that the Banking Commission did very successfully—we appointed people who were agreeable to both sides and could look at something in the actual draft or piece of paper, and then come back and say, “We can satisfy you on this point”— you are resisting so hard on this one?

Chair: This is the chairman’s matter.

John Griffith-Jones: Let me try to give you an answer to this, and it may be that we disagree. I think, in the case of the specific piece of legal advice, we need to get on record that Sean Martin, our counsel, wrote you a synopsis of the arguments, which you were, I presume, concerned might not be complete and accurate. He then went and got counsel, Mr Flint, who gave the opinion to confirm that the synopsis was both accurate and complete. It seems to me that you are questioning whether Mr Flint and Mr Martin have given you the answer. I would suggest that if you want to go and see Mr Flint yourselves, that would be an alternative way out. It is not for me to have an inference or objection, but it does seem to me that this is a live case. There is a lot of real money at stake here. There are people, as you know, who believe we have drawn the boundaries in the wrong place who would like us to take action. We are mid-flight with a lot of money at stake, and for us to put into the public domain the basis of our decision making I find a difficult position.

Q159 John Thurso: We understand that. We are not asking to put that in to the public domain. We are asking you to allow the Committee to be assured in exactly the same way the Banking Commission was assured when, for example, Mark Garnier and I did not see first-hand documents, but an appointee of the Committee, usually an external expert, was asked to go away and look at this and give us an assurance as to, "Does it do X, Y, Z?" They came back and gave us that assurance or not, as the case may be. I am not asking for you to put it in the public domain, but for us to be able to scrutinise the impact of that opinion, we have to be able to understand it in more detail than the helpful but rather general letter we have had from general counsel—*[Interruption.]*

Chair: Can we stick with the question for the chairman? It is entirely the chairman's matter; it is not a matter for the Executive. It is for the board, led by the chairman.

John Griffith-Jones: The board has had a discussion on this, and I am not wishing, Mr Thurso, in any way to be difficult about this. I just, from all my background, think that there is a protected space around getting a legal opinion and it seems to me that that has to be acknowledged.

John Thurso: Let me tell you why I have a problem—

John Griffith-Jones: Allow me to ask a question back. Obviously, if you were to be satisfied that the opinion was indeed as you expected or at least as I expected, that would be perfect, but what happens if you disagree? What happens if you disagree?

Q160 John Thurso: There are three areas, we submit, in the last 10 years of very highly contentious public policy where some of the most eminent QCs in the land have given opinions. In each of those cases they ended up being tested in court and were found to be wrong, because that is one of the things that happens: two eminent QCs give different opinions. It seems to me that there are legal opinions that might be given to the Government, by the Treasury Solicitor or whoever, and what we need to try to establish, without going to court, is, on the policies going forward, the nature and robustness of the opinion. I would like to leave this at that point, if I may, Chairman, but I think this is a matter that should not be considered as closed. We need to get to a point where the policy part, which is an important part, is something that we can look at.

On that, come to the policy on this very quickly. The impact of this legal opinion, as far as you are concerned, is that virtually all financing to small and medium-sized enterprises is unregulated. Is that correct?

John Griffith-Jones: Commercial loans are unregulated, yes.

Q161 John Thurso: The conduct of the lending is unregulated?

John Griffith-Jones: Yes. That is what you said.

Q162 John Thurso: Yet you have only just fined RBS a fairly massive amount. Your press release said, "The firm has failed to ensure that advice given to customers was suitable. Reviews of sales found that in over half the cases their suitability was not clear from the file recording. Issues with the sale process included affordability assessment, failing to consider customers' budgets, failing to advise customers when looking to consolidate debt, not advising customers what mortgage terms were appropriate to them." It is perfectly within the bounds of policy to say an organisation that was doing those sales on a fairly heroic scale and very badly was likely to have the equivalent culture in its selling of other products, bearing in mind that many SMEs are also private customers. It is a reasonable possibility to explore, is it not?
John Griffith-Jones: I think you could reasonably say that some—

Q163 John Thurso: My point is that you are stating that the product is not regulated by virtue of the regulations and, because the product is not regulated, the conduct of selling a product is not regulated either? That is what you said?
John Griffith-Jones: Yes.

Q164 John Thurso: You are putting on public record that virtually no loan to a small or medium-sized enterprise is regulated and, therefore, there is virtually no redress in any of these cases?
John Griffith-Jones: When you come to redress, clearly firms do have complaint-handling processes to follow, which is covered by our rules. I am not defending the regulatory structure as it is, but it is just, as it is, commercial loans are not regulated. Complaint-handling is. Any buyer of those loans who has a concern should have his complaint dealt with according to our rules.

Q165 John Thurso: Would you confirm, as you just basically did—you said that you are not defending the system—that the system we have now is that if you are a very large PLC and you buy a big hedge, you have a vast amount of redress through the FCA? If you are Jones and Jones, the plumber, and you have taken out £50,000 and it turns out to be a TBL, you probably have no redress? Is that an acceptable position for a regulator, given all that we have uncovered over the last five years?
John Griffith-Jones: Again, we administer the will of Parliament and, whether Parliament intended it to be this way, certain things that look anomalous to us now are the way the law is written. If the law was changed and written differently, clearly we would have a different approach.

Q166 John Thurso: Would it be fair to say that you are saying, "It is you, Parliament, who have created the anomaly. It is therefore for you, Parliament, to deal with it"?
John Griffith-Jones: If the rules were changed, such that commercial lending was within scope, we would have a different approach and we would have a completely different approach to this issue.

Q167 John Thurso: Have you discussed that with the Government and made it clear to them that this anomaly exists?
John Griffith-Jones: Yes, and I think I have shared that correspondence with you before.

Q168 John Thurso: The final point—I am sorry to take so long, but I do think these are very important. I think this probably comes back to the chairman. The FCA has

undertaken a number of arrangements with banks in respect of activities—deals as it were. You have basically written to us saying that you do not wish to disclose those because it would make your job extraordinarily difficult if people knew what the deals were in public. That is a similar argument, obviously, to that which was made by HMRC in relation to arrangements it has come to. People's tax affairs are private and, basically, sometimes a deal is the fastest and most economical way to arrive at the objective. I understand that argument. The consequence of that was that HMRC got banks all around the park in the PAC over what they had done with Starbucks and others—or Goldman's was it? I cannot remember now. How can we, as the people who are scrutinising you, make sure that you are not doing deals that are inappropriate but, at the same time, without cutting across the boundaries that you have put forward? How can we be reassured, without having some knowledge of this issue?
John Griffith-Jones: Can I take this in parts? I think that if we, as a regulator, are to do mass redress schemes, of which this is classically one, we have two ways of doing it. Either we go through the law courts, which takes a very great length of time and costs a very great deal of money, or, as a proactive regulator, we go out on the front foot and say, "This is how we are going to do it", and the necessary part of "this is how we are going to do it" is coming to an arrangement with the banks that is "voluntary", or at least contractually voluntary, to do it that way. If they refuse, we end up in the law court and we get into a PPI-type situation.

I know for a fact, although I was not part of the detail, that very early in the FCA's life—in fact I cannot remember whether it was before or after cut-over when the interest rate thing happened—that, on the back of the knowledge of the PPI unsatisfactory outcome, Martin and his team took the proactive decision to do it on an arranged basis. The upside to that was that people would get their money quicker and it would be much cheaper for the consumers who we were trying to protect. The downside would be that it was potentially subject to legal challenge thereafter, which would unravel the scheme because we are subject to judicial review, and we could be unravelled. If you say we want to inspect each of these schemes as we go along, and with respect that is not whether it is you or anyone else, we would be back in the—

Q169 John Thurso: That is not the question I am asking. I am not asking to second-guess your decisions; I am asking how we, as a Committee, can scrutinise properly and I am asking for your help with this.
John Griffith-Jones: Ex-post, I have no problem with this at all. We must be accountable. You have given us enormous powers and we are affecting literally billions of redress here. For me to say you cannot ever see it is ridiculous, but to say, "We want to see it real-time," has the inevitable consequence that if you do not like it, you, with respect, will intervene. Or you may intervene—could you give me some comfort you won't?

John Thurso: Time is pressing, and I am last, and you want out as much as I do, I am sure.

John Griffith-Jones: I want to solve all these three issues. It is a very unhappy state of affairs.

Q170 John Thurso: In relation to both my first point and my third point, it seems to me that, on both occasions, you have used the phrase "in real time". There is a complete acceptance that we are not there to do the regulation and, therefore, we will not receive

stuff in real time. What we are seeking is the ability to scrutinise you and that means doing it not 10 years afterwards, but at a time scale after you have dealt with something that means it is still relevant for scrutiny. I think this is the area—rather than doing it in public—where the Chairman, the Clerk and yourself need to discuss it.
John Griffith-Jones: I understand that this is not going to be allowed to drift, but if we are talking about time scales, I think I need to be able to talk to my executive about what is practical. In the same way you guys have met and are clearly not happy about this, my board is unhappy, not because we do not want to co-operate, but with the state of the relationship. We are very keen to solve this, but, as you can tell from my strongly held view that you are affecting our ability to do that—

John Thurso: The final point I just want to make before we end is--

John Griffith-Jones: So may we continue our—

Q171 John Thurso: The impetus behind this is not to catch you out, but to give you the authority of scrutiny so that the markets, the players and the public all have enhanced confidence in you. That is the sole objective that I have and the Committee has in seeking to bottom these things out. I will hand it back to the Chairman.
Chair: Do you want to say something?

John Griffith-Jones: I appreciate the exchange of views. We need to get this fixed. Hearing that is helpful. I will commit, as I am sure you are requiring me to, to continue to try to get to a better place than where we are at the moment, which we need to do.

Q172 Chair: To be frank, it is likely to be the last softball hearing on this. We are fed up and there is deep disquiet about the slow and apparently obstructive approach that we have had on a number of issues that we have raised, and it is not confined to these three, with the FCA. Rather than pursue this now, I think it would be better if we try to get these fully sorted out outside this hearing. Today we have tried to think of a way of enabling you fully to put on the record your view on these issues without coming back to you in substance on each of them. Let us hope we do not need to do that. We do need to get to a better place quickly now and, for that, we need a good deal of co-operation that we have not always seen in recent months on a number of variable issues. I am sorry to have to make that statement, but I think it has to be put on the record.
John Griffith-Jones: Could I ask that you let me know, because I am obviously aware of the three, but I am not aware—

Chair: Let us take this forward outside this meeting. I think that the concerns that you have expressed—I am not going to go through each one individually—can readily be addressed. Indeed, we have already proposed perfectly reasonable approaches to dealing with all of them, which we understand, as I think you also heard. Thank you very much for coming to give evidence this morning. It is now this afternoon—only just—and it has been very helpful. It is a discussion we will be taking forward in due course and, no doubt, you will be coming before us in six months, if not before.