Herbert Smith Freehills LLP – Written evidence (EGC0030)

1. INTRODUCTION

1.1 Herbert Smith Freehills LLP ("**HSF**") is grateful for the opportunity to provide written evidence to the House of Lords Financial Services Regulation Committee (the "**HLFSR Committee**") regarding the Financial Conduct Authority's ("**FCA**") Consultation Paper 24/2 "*Our Enforcement Guide and publicising enforcement investigations–a new approach*" ("**CP24/2**") published on 27 February 2024.

1.2 HSF is a global law firm with a leading Financial Services Regulatory practice which is represented across our global network. We have represented a significant number of regulated financial services firms and individuals in the UK. The views expressed in this note are our own.

1.3 We are responding to the HLFSR Committee's call for evidence because we are deeply concerned about the potential impact of the proposed changes set out in CP24/2, as are many of our clients. We submitted our response to the FCA's consultation on 30 April 2024 which included input from clients who may be affected by the proposed changes. We are committed to continue engaging with the FCA's proposal and we consider that the HLFSR Committee has a critical role to play in this regard.

1.4 We set out below a summary of our concerns, and we address the following points that arise from the further information provided by the FCA (in particular to the HLFSR Committee and House of Commons Treasury Committee (the "**Treasury Committee**")) after the publication of CP24/2:

- 1.4.1 The respective scope of the FCA's proposal and its existing approach;
- 1.4.2 International and domestic comparators;
- 1.4.3 The FCA's reliance on previous disclosures made by Investigation Subjects; and
- 1.4.4 Commitments to improving the FCA enforcement process.

2. SUMMARY OF OUR CONCERNS

2.1 We consider that the current proposal to identify the subjects of ongoing FCA investigations ("**Investigation Subjects**") is deeply concerning. We note that the proposal will impact both financial services firms that are regulated by the FCA, and UK-listed companies more generally. The proposal risks causing severe financial and/or reputational damage to Investigation Subjects, ranging from significant impact on share price to calling into question whether a firm can continue as a going concern.

2.2 While we see that it might seem superficially attractive to publicise a significant proportion of investigations for reasons of transparency, we do not believe the proposal to name Investigation Subject(s) is reasonable given that:

2.2.1 The statutory threshold for opening an investigation is very low – all that is required is for the regulator to consider that there are circumstances suggesting that a firm or individual may have breached one or more rules or principles, or that there is good reason for conducting an investigation; an investigation is a fact-finding process which seeks to establish whether there is evidence that may support the taking of action in a particular case, or more generally, facts about the nature, conduct of state of a business, and is not enforcement action per se;

2.2.2 Based on cases closed in 2023/2024, FCA cases currently take 3.5 years to complete on average, leaving Investigation Subjects and the markets in a state of uncertainty, with the result that the markets tend to price in the full adverse impact at the point of earliest announcement, irrespective of likelihood of outcome;[1] and

2.2.3 According to the FCA, 65% of the investigations it opens eventually close without further action. We understand from the FCA that, based on a high-level review of its current portfolio (from the past 9 to 12 months), it has estimated that around two-thirds of its investigations would have been published under these proposals. Therefore at least some publicised investigations are likely to conclude without further action, but having inflicted unwarranted damage from adverse publicity.

2.3 The proposal is misguided for several reasons:

2.3.1 It undermines the statutory protections enshrined in the Financial Services and Markets Act 2000 ("**FSMA**") in respect of publication of, or concerning, statutory notices (e.g., warning notice statements which, we have been led to understand, broadly contain the level of detail the FCA would propose to publish about an investigation) and appears to override the intention of Parliament as reflected in statements made during the legislative passage of the relevant bills;[2]

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1 However, see further 5.1 below.

2 See e.g., the Treasury Select Committee's third report in February 1999 welcomed a bar on the (then) FSA publishing enforcement action until the full enforcement process had been completed; see also 2012 debates of the Joint Committee on the Draft Financial Services Bill regarding proposals for the publication of information about warning notices.

2.3.2 The purported rationale for the change of approach lacks any evidential basis. Given that only 34% of investigations result in enforcement action, the proposal is neither proportionate nor consistent with the FCA's statutory objectives;

2.3.3 In terms of international competitiveness, having regard to the practices of regulators in the vast majority of other jurisdictions that act as financial centres, it risks making the UK an international outlier, and undermining the financial services industry which sits at the heart of the UK economy and is a key driver of growth; and

2.3.4 The proposal may well have unintended consequences that risk undermining, rather than achieving, the FCA's stated aims, including for example diminishing public confidence in the FCA.

2.4 The FCA is seeking a step change in the current policy to only disclose in exceptional circumstances. The change would effectively remove a presumption against the disclosure of investigations. We recognise that publicity may be warranted in the exceptional circumstances envisaged under the FCA's existing policy and note that the regulator has occasionally published details in such circumstances. However, no tweaking of fine details of this proposal can counteract the damage that a policy of routinely publishing investigations is likely to inflict upon Investigation Subjects and the UK market. We welcome recent indications from the FCA that it is listening to the feedback it has received to CP24/2, that it is not going to rush through its proposal, and that it plans to undertake further consultation.[3] ***The FCA needs to be open to fundamentally rethinking its proposal.***

2.5 We consider that the FCA's intended aims can be achieved through better means which would not involve the identification of Investigation Subjects. Its existing tools are extensive, and a more general communication to the market (for example, an "Enforcement Watch" publication akin to the FCA's Market Watch or Primary Market Bulletins, or the publication of anonymised examples of good or bad practices) could take account of the broader spectrum of regulatory interventions in sending a message to educate and deter the industry more widely and at an early stage.

2.6 We welcome the FCA's stated intention to complete its investigations more quickly, and consider that this proposal would, at best, have no impact on this intention, and, at worst, could cause additional delay due to discussions about when and what to disclose

[3] Speech by Therese Chambers on 24 September 2024 at AFME Annual European Compliance and Legal Conference.

and the potential for firms to be less inclined to settle given that the negative publicity of the issue is already in the open.

3. THE RESPECTIVE SCOPE OF THE FCA'S PROPOSAL AND ITS EXISTING APPROACH

3.1 Although not expressly stated in CP24/2, the FCA has clarified in various fora since it was issued that under its proposed approach, there will be no presumption in favour of, or against, disclosure. Since the publication of CP24/2, the FCA has provided further (albeit limited) information on the types of investigation cases (including the identities of the Investigation Subjects) it would consider publishing under its new proposal.

3.2 Nevertheless, there remains a significant lack of clarity as to how the FCA would apply the proposed public interest framework in practice, and what types of investigation cases would be disclosed under the new approach that would not be disclosable under the existing approach.

Information to the Treasury Committee

3.3 The FCA provided information to the Treasury Committee on the types of investigation cases that it would consider publishing under its new proposal. We set out below details of a specific example cited by the FCA, the British Steel Pension Scheme ("**BSPS**").

3.4 In the FCA's letter to the Treasury Committee dated 7 May 2024, it stated as follows:

> *There may be reasons specific to the case in question why it is in the public interest to name firms in a factual and measured way. For example…We may be concerned about potential ongoing and significant consumer detriment. This was the point that the Public Accounts Committee highlighted in their report on the British Steel Pension Scheme (BSPS) in 2022 when they asked us to look into publishing names of firms under investigation that pose serious risks to consumers. BSPS campaigners have made a similar point.*
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> *[Footnote 2] One of the representatives of BSPS pensioners made the following comment on the proposals last week which highlights the delicate choice we have been consulting on. "It might hurt someone who is genuinely innocent but as with BSPS you had a lot of advisers saying to steel workers 'if you heard anything wrong the FCA would have told you'' "A lot of steelworkers contacted the FCA at the end of 2017, and asked 'Can you tell me whether or not the adviser was being investigated'. The FCA was not able to tell them and the steelworkers took their advisers' reassurance at face value. "Many steelworkers would have been saved a great*

deal of financial loss if the FCA had been clear with them in 2017."

3.5 Nikhil Rathi specifically referred to the example of BSPS in his oral evidence to the Treasury Committee on 8 May 2024 when responding to Harriett Baldwin MP (Chair of the Treasury Committee), who pointed out that the FCA already has the power to name firms under exceptional circumstances:

> *The FCA had information about problematic financial advisers who were being investigated.*
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> *The steelworker pensioners were not aware we were investigating and they were calling our contact centre and being told the firm they were asking about was on the FCA register and no further information was disclosed.*
>
> *They then took advice and potentially lost their life savings. And that was the point that the public accounts committee asked us to look into, in this context, whether there was more we could say in those circumstances.*

3.6 He further explained to the Treasury Committee that the FCA was unable to publicise information in those cases under its existing approach because "*sadly investment fraud is not exceptional*."

3.7 While it is correct that, as part of its investigation into the BSPS, the Public Accounts Committee[4] asked the FCA to "*look into whether it would be an option to publish lists of those under investigation, where there are significant grounds to believe they are committing serious harm to consumers*", it is by no means clear whether this would have made any difference in the BSPS case in terms of preventing consumer loss (as Nikhil Rathi appears to suggest):

3.7.1 Although the FCA has not disclosed when it opened the investigations into the relevant firms, it appears that in at least some cases, unsuitable advice had already been provided, and the decision to transfer out of the defined benefit pension scheme had already been taken – this is supported by the Public Accounts Committee's finding that the FCA failed to take swift and effective action at all stages of the BSPS case,[5] that it lacked the relevant market data in order to take decisions,[6] and that there was significant delays in the FCA's response;[7] and

3.7.2 Judging by the fact that a consumer redress scheme was required, it appears likely that the number of firms giving unsuitable advice far exceeded the number that were

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4 Section 1, paragraph 12 of the Fourteenth Report of Session 2022–23.
5 Section 1, paragraph 8 of the Fourteenth Report of Session 2022–23.
6 Section 1, paragraph 9 of the Fourteenth Report of Session 2022–23.
7 Section 1, paragraph 10 of the Fourteenth Report of Session 2022–23.

investigated by the FCA – this could have led to an outcome whereby consumers took assurance from the fact that a firm had not been identified by the FCA but the firm was still giving unsuitable advice.

3.8 Notwithstanding the above points, we consider that the identity of firms in the BSPS case could have been disclosed under the FCA's current approach, and that the FCA's decision not to suggests that it applied an overly narrow interpretation of what constitutes "*exceptional circumstances*". While it is correct that "*investment fraud is not exceptional*", extensive, immediate, and ongoing potential consumer detriment clearly did make the BSPS case exceptional.

Review of the FCA's current portfolio of cases

3.9 The above example, taken in isolation, might suggest that the FCA is only incrementally shifting away from its existing approach.

3.10 However, the FCA's previous statements to the industry about the scope of their intended changes has been different. We understand from clarification provided by the FCA at events held with market participants that the proposed approach would result in a significant number of investigations being announced by the FCA. Based on a high-level review of its current portfolio (from the past 9 to 12 months), the FCA estimated that around two-thirds of its investigations may meet its public interest framework test. We note that the FCA has stated that in its next round of consultation, it will publish more information on the numbers of cases that might be affected.[8] The Committee may wish to ask the FCA to estimate the percentage of past closed investigations it believes would have been made public under these proposals over, say, the last 2 or 5 years.

3.11 We note that the prospect of the FCA adopting a far more expansive approach to disclosure under its new proposals is further evidenced by the additional points it referred to as potential reasons for disclosure in its letter to the Treasury Committee dated 7 May 2024 (see pages 2 to 3, points i, ii, and iv to ix).

3.12 For the reasons set out in our response to CP24/2, we strongly disagree with the proposition that the FCA should adopt a significantly more expansive approach to publication.

Clarifying the FCA's existing approach

3.13 We consider that the types of investigation cases that the FCA has referred to as its most convincing examples of when publication would be warranted under the new proposals would (or should) already be covered by its existing approach.

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[8] Speech by Therese Chambers on 24 September 2024 at AFME Annual European Compliance and Legal Conference.

3.14 If all the FCA requires is to publicise a small number of additional cases for good reasons and that which sit at the edge of its definition of "*exceptional circumstances*" there are much better ways of achieving this aim than the sea change envisaged in CP24/2.

3.15 A possible way forward would be for the FCA to clarify expressly in guidance what "*exceptional circumstances*" means – including investigation cases where:

3.15.1 the subject matter of the investigation is already public or is the subject of rumour or speculation; and/ or

3.15.2 the FCA reasonably considers there to be a material risk of future consumer harm and the disclosure of the Investigation Subject's identity is required to protect consumers.

3.16 As part of the process for publicising ongoing investigations, the FCA should set out in the publication why it considers there to be exceptional circumstances that warrant disclosure.

4. INTERNATIONAL AND DOMESTIC COMPARATORS

International comparators

4.1 CP24/2 refers to the Monetary Authority of Singapore ("**MAS**") and notes that it adopts a similar approach to one being proposed by the FCA. We explain in our response to CP24/2 that this statement is not reflective of MAS practice. While MAS's written guidance broadly aligns with the FCA's proposal, in practice MAS does not ordinarily publicise its investigations. Investigations publicised by MAS have generally concerned cases where the subject matter was already in the public domain and so broadly follows the FCA's existing approach to publicity.

4.2 The HLFSR Committee's question 11 to the FCA in its letter dated 18 April 2024 was, "*How does this proposal compare with the approaches taken by other supervisors internationally (other than the Monetary Authority of Singapore)?*". Annex II of the FCA's response dated 25 April 2024 referred to the Australian Securities and Investments Commission's ("**ASIC**") "*longstanding policy that it may make a statement about an investigation when it is in the public interest to do so*." We explain in our response to CP24/2 why this example does not support the FCA's position. In practice, it is exceptional for ASIC to comment on ongoing investigations. The occasions where public statements have been made are the result of public/media speculation as to the existence of an investigation and ASIC has, in effect, been required to clarify the position by way of statement. ASIC's approach to publicity in respect of ongoing investigations is therefore akin to the FCA's existing approach.

4.3 In light of the above, we are concerned that the references to international comparators is potentially misleading and note that it

has been taken up in the press in the way described by the FCA, which is regrettable.

Domestic comparators

4.4 In responding to the HLFSR Committee's question 11, the FCA provided Annex III (16 pages) that covered the position of domestic regulators. We respectfully submit that the approach adopted by other UK regulators is largely irrelevant to the assessment of the FCA's secondary objective to advance the international competitiveness of the UK economy and its growth in the medium to long-term.

4.5 We further note that for many of the regulators to which the FCA has referred, Parliament has provided express authority in statute for those regulators' power to publicise information about investigations – see for example:

4.5.1 Section 25A of the Competition Act 1998 in respect of the Competition and Markets Authority;

4.5.2 Section 35 of the Gas Act 1986 and section 48 of the Electricity Act 1989 in respect of the Office of Gas and Electricity Markets;

4.5.3 Sections 26 and 393 of the Communications Act 2003 in respect of the Office of Communications; and

4.5.4 Section 201 of the Water Industry Act 1991 in respect of the Water Services Regulation Authority.

4.6 In contrast, FSMA provides no such statutory basis for the FCA to exercise such powers. We explain in our response to CP24/2 why the FCA's proposal effectively undermines the statutory protections in FSMA and appears to override the will of Parliament.

4.7 Finally, we agree with the following statement by the (former) Chancellor of the Exchequer that "*How you stimulate growth is different sector by sector so I think it's completely reasonable to name and shame a failing water company which has outrageous amounts of leaks. But I think in a financial services context it's different.*" The position of the FCA, and the financial services industry, is very different from other regulators and industries - in particular, we note that:

4.7.1 the Competition and Markets Authority and the Serious Fraud Office do not regulate specific industries; and

4.7.2 other regulators that the FCA referred to regulate industries that are natural monopolies or oligopolies that have few participants that take up a significant market share (e.g., the Office of Gas and Electricity Markets, the Water Services Regulation Authority, the Financial Reporting Council, and the Office of Communications).

5. PREVIOUS DISCLOSURES BY INVESTIGATION SUBJECTS

5.1 The FCA's letter to the HLFSR Committee dated 25 April 2024 relies on previous disclosures made by Investigation Subjects regarding FCA investigations to support its assessment that such disclosures do not have a material negative impact on share price. However, this assessment does not compare like-for-like. Disclosures by Investigation Subjects are generally high-level and set out in the contingent liability section of financial statements. This is not comparable with the kind of statements that the FCA appears to have in contemplation.

5.2 First, disclosures by Investigation Subjects are not designed to achieve the FCA's stated objectives – i.e., to educate or deter market participants or reassure the public. CP24/2 appears to envisage the publication of statements containing significantly more detail than is generally disclosed in Investigation Subjects' financial statements. This is supported by statements made by the FCA in its direct engagement with market participants where it indicated that publicised statements would be comparable to a warning notice statement, "purely factual" and about one page in length. We consider that the greater content and the fact it is made by the FCA (and the publicity that will attract) risks a more material financial impact. Even in this scenario, we query whether that would be capable of achieving the FCA's objectives. This is because the statements publicised by the FCA will likely be high-level in order not to engage section 348 FSMA. Such statements are unlikely to provide sufficient detail capable of achieving the FCA's aim of "*education*" or "*deterrence*" for firms or "*trust, reassurance and confidence*" for customers and others, and are more likely to give rise to uncertainty and speculation.

5.3 Secondly, while disclosures by Investigation Subjects are likely considered by their investors, it is generally not the case that they receive significant public attention. In contrast, the whole point of the FCA's proposal is for its publications to receive as much public attention as possible. The greater publicity, and inevitable speculation and uncertainty (even with the content envisaged by the FCA) is more likely to have a negative impact on share price. We further note that there are a lack of safeguards on the content of the FCA disclosures. An analogy can be drawn to the FCA's use of press releases which frequently overstate the findings in a Final Notice, such press releases featuring in the public record of the issue instead of the more sober language of the Final Notice, this would be exacerbated where the fact of an investigation is publicised, as there is no nuanced notice. Indeed, the FCA has been severely criticised for the content of a press release (described as "highly inappropriate" and "disgraceful") by the Upper Tribunal.

6. COMMITMENTS TO IMPROVING THE FCA ENFORCEMENT PROCESS

6.1 The FCA has signalled that it is seeking to change for the better.[9] We welcome the various commitments the FCA has set out in its correspondence with the HLFSR Committee and the Treasury Committee about how it intends to achieve greater efficiency and effectiveness in its enforcement process. Its efforts should continue to focus on increasing the pace of its investigations. There are promising indications from the FCA's most recent enforcement data that things are moving in the right direction.[10] We consider this to be the most effective way for it to achieve its stated goal of impactful deterrence.

6.2 We also welcome the FCA's continued and promised future engagement with the industry and Parliament in relation to CP24/2. We hope that our response to its consultation, and the helpful interventions of the HLFSR Committee and Treasury Committee, will assist the FCA in understanding that its proposed change in approach will not be helpful to the regulator's desire to improve the enforcement process and or indeed to the fulfilment of its statutory objectives.

11 October 2024

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9 Ibid.

10 https://www.fca.org.uk/data/fca-enforcement-data-2023-24#lf-chapter-id-enforcement-operations