The FCA's Discussion Paper 21/5: Compensation Framework Review

https://www.fca.org.uk/publications/discussion-papers/dp21-5-compensation-framework-review

Response by the Transparency Task Force, March 4th 2022

About the Transparency Task Force

The Transparency Task Force is a Certified Social Enterprise, meaning that we exist to make an impact, not profit.

The mission of the Transparency Task Force is to promote ongoing reform of the financial sector, so that it serves society better. Our vision is to build a large, influential and highly respected international institution that helps to ensure consumers are treated fairly by the financial sector. The primary beneficiaries of our work will be consumers; but the sector itself will also benefit through improved market conduct and increased trust in the services it provides.

Our objective is to carry out a broad range of activities that help to drive positive, progressive and purposeful finance reform, such as:

- Building a collaborative, campaigning community; the larger it is the more influence it can have in driving the change that is needed
- Raising awareness of issues; so that society better understands the problems that exist in the financial sector and how they can be dealt with

- Engaging with people who can make change happen; because through such dialogue we can influence thinking, policy making and market conduct

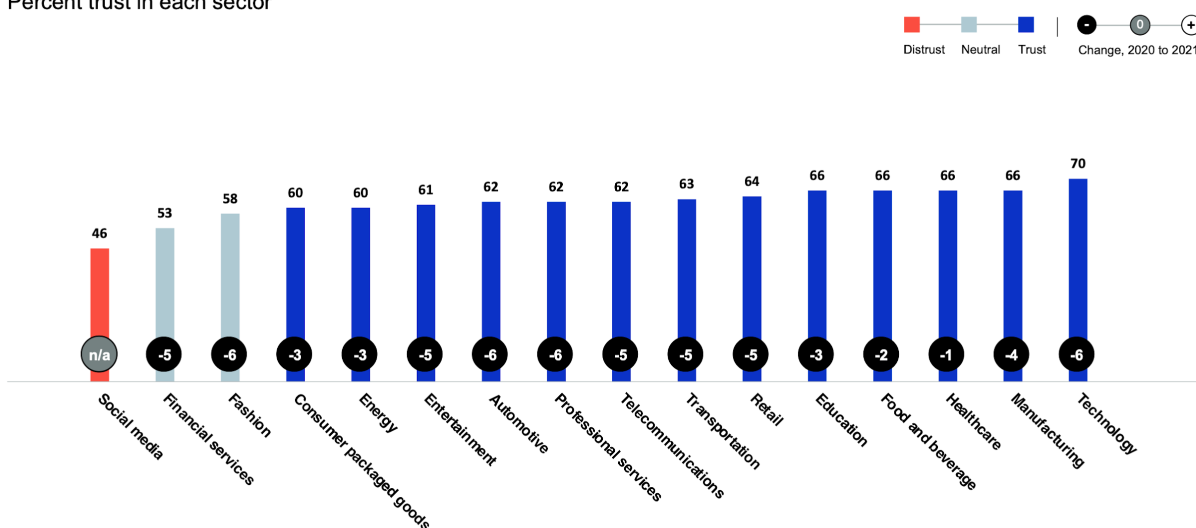
Our response to you has been produced by a highly collaborative group of TTF volunteers, our "Response Squad," working together to build consensus, whilst always remaining true to our "North Star" question: "What is best for the consumer?" For further information about the Transparency Task Force see: http://www.transparencytaskforce.org

This response is all non-confidential. Please note that all comments in this response are part of the response, and should be considered.

Some of this response is contained in answers to FCA's specific questions below, but the parts of the response not shown as direct answers to questions are equally part of this response, and for consideration by HM Treasury.

As always, context is key

We believe that there is cause for concern about the reputational integrity of the financial services sector, in most parts of the world. There is ample evidence to suggest that society is distrusting of financial services. The highly credible 2021 Edelman Trust Barometer in Financial Services shows it to be the second most distrusted industry; second only to social media.



Given the fundamental need for the financial sector to be trusted for it to function successfully, it should be a great concern for the sector's market participants, trade bodies, professional associations and regulators that it is a sector that society does not trust.

It is easy to understand why the financial sector is distrusted; in fact the evidence suggests that people *should* distrust it. Consider for example the overall conduct of the financial industry in the UK compared to other industries when it comes to the level of violations.

The best source for such data is the recently launched Violation Tracker UK. In the interests of transparency we should point out that Transparency Task is very closely connected with Violation Tracker UK; and proudly so. For example, we Chair its UK Advisory Board.

Violation Tracker UK holds data about corporate infringements in 46 sectors. The data shows that the conduct of the sector is so bad that if you add up all the infringements by all the other 45 industries it equates to roughly the same as the financial sector on its own.

That is a truly alarming reality; so much so that repairing the reputational integrity of the sector should be Priority #1 for all stakeholders that truly care for the wellbeing of the sector and the society it is meant to serve.

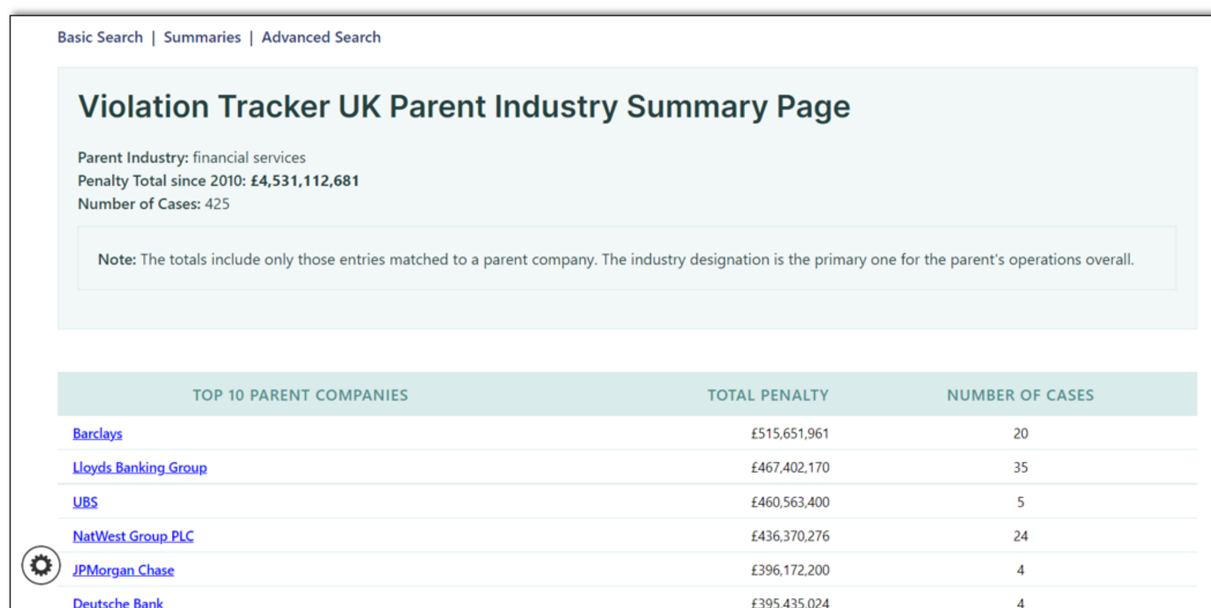
The screenshot below shows the top of a chart that all financial sector stakeholders in the UK should be ashamed that the financial sector is at the top of:

RANK	PARENT MAJOR INDUSTRY	TOTAL PENALTIES	NUMBER OF CASES
1	financial services	£4,531,112,681	425
2	aerospace and military contracting	£1,563,848,550	72
3	telecommunications	£1,222,571,005	65
4	utilities and power generation	£648,048,895	962
5	diversified	£606,182,473	160
6	pharmaceuticals	£336,859,373	24

To view the chart in full, click here.

Furthermore, it is impossible to ignore the obvious question: how can it be, that despite the UK's financial sector being such a systemically important part of our economy and our international reputation, that we are tolerating such poor stewardship of it by its conduct regulator?

That question becomes even more poignant when you look deeper into the data held within Violation Tracker UK and consider the obvious pattern of recidivism that exists within the sector. The screenshot below gives a feel for the scale and nature of recidivism within financial services.



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Violation Tracker UK Parent Industry Summary Page

Parent Industry: financial services
Penalty Total since 2010: **£4,531,112,681**
Number of Cases: 425

Note: The totals include only those entries matched to a parent company. The industry designation is the primary one for the parent's operations overall.

TOP 10 PARENT COMPANIES	TOTAL PENALTY	NUMBER OF CASES
Barclays	£515,651,961	20
Lloyds Banking Group	£467,402,170	35
UBS	£460,563,400	5
NatWest Group PLC	£436,370,276	24
JPMorgan Chase	£396,172,200	4
Deutsche Bank	£395,435,024	4

To see that data in full, click here and when viewing it, scroll down and see the obvious pattern of the same organisations committing the same offences over and over again. Perhaps this suggests that there is a culture within the sector that sees the fines imposed on it as a cost of doing business. Perhaps this hard evidence also calls into question the grotesque lack of effectiveness of the FCA in ensuring the sector behaves properly and that it succeeds in its objective to maintain the integrity of the sector and provide an appropriate level of consumer protection.

The validity of that line of thought becomes even more obvious when you drill down to the next level of infringement data, and look at the violations of particular organisations. For example, examine the infringements by Barclays, Lloyds Banking Group and Nat West; and ask yourself if it would be prudent to do anything that might encourage even more misconduct; or to miss any opportunities to raise the standards of ethics and integrity in the sector.

For the avoidance of any doubt the answer is "No"!

All this makes it perfectly clear that any notion of reforms that might lead to even worse conduct by the sector should be distinguished immediately as a reckless line of thought; and that applies also to failing to introduce reforms that would have a positive impact. The reputation of the financial sector and wealth it generates matter far too much for any reforms to be allowed to gamble with it, or for meaningful reform opportunities to be missed.

Rather, we would respectfully suggest that resource and energy would be better spent examining what needs to happen for the FCA, and thus the delivery of financial regulation in the UK, to become fit for purpose. We believe that turning the UK's financial services industry into the world's best-regulated is the best way to restore consumer confidence in it and the UK, and to persuade governments and regulators overseas that the ghosts of the Global Financial Crisis have finally been laid to rest and that the City can be trusted to trade freely across borders.

We are so concerned by the poor performance of the FCA that we are having to spend a huge proportion of our very limited resources on helping to try to fix it, as these slides about our Plans and Priorities for 2022 show - look in particular at the section about the evidence published thus far from the APPG on Personal Banking and Fairer Financial Services' Call for Evidence about the FCA - see here.

Please therefore be mindful of these well-founded concerns when reading the rest of this response as we believe very strongly that this consultation suggests the FCA may once again miss an opportunity to introduce a meaningful reform that would be a major step forward in helping to achieve its objectives to ensure the market operates with integrity and provides consumers with an appropriate degree of protection.

Response to Questions

Q1: Do you consider that proposed principles 1 and 2 are the appropriate principles to underpin the design of the compensation framework (in relation to the aspects of the framework that the FCA is responsible for)?

Principle 1

We agree with the observation that 'polluter pays' is the optimum principle on which to base a compensation framework. Currently, firms responsible for reckless behaviour and wrongdoing

seldom pay for the negative externalities caused by their conduct. However, simply changing the rules of the FSCS will not alter this. The reason polluters do not pay is not that the FSCS is ahead of them in the queue to do so, but because the polluters either lack the financial means to pay redress (in the case of small firms) or are seemingly protected by the regulators (in the case of large firms, especially banks). A firm must be in default before its liabilities to consumers pass to the Scheme, so the polluters who concern us in this document are the small firms, not the large ones.

The first uncomfortable truth to be faced by the FCA in considering changes to the compensation framework is that the start point must therefore be its own threshold conditions - both the content of the rules and the application thereof. If we want polluters to pay a higher proportion of misconduct costs, we must require authorised firms to have stronger balance sheets, better professional indemnity insurance, or both. There have been countless examples of firms declaring faults with liabilities that massively exceed the combined value of their net assets and insurance cover, as set out in paragraph 2.8 of the consultation paper. On any level, the growth in the number and value of claims passing to the FSCS points to systemic shortcomings in setting and upholding threshold conditions, by both Authorisations and Supervision.

Likewise, difficult questions must be confronted about whether the FCA's Authorisations team is sufficiently 'streetwise' and proactive in identifying bad actors *ex ante* and preventing them from achieving authorised status and, likewise, whether Supervision and Enforcement are up to the job of anticipating, identifying and curtailing wrongdoing before liabilities are created that exceed the perpetrator's financial capacity to remediate.

A number of cases have recently come to light, including these, in which firms have been authorised by the FCA that would never have achieved that status had even the most dilatory diligence been exercised. We question the wisdom of Nikhil Rathi's decision not to employ a full-time successor for Megan Butler following the announcement that she is to step down from the role of Executive Director for Transformation, instead adding the change remit to the duties of Authorisations head Emily Sheppard. We believe that Authorisations is one of the teams most in need of remediation at the FCA. Sheppard is relatively new to the position and has yet to demonstrate her ability to turn around her own department, let alone combine that task with a wider remit. We suspect that Rathi is reluctant to engage a full-time replacement for Butler because he knows the Treasury Committee would expect him (page 3) to look externally for candidates and anticipates that such a search would turn up capable executives who would expect to execute genuine changes, some of which might be unpalatable to existing executives, and to the industry. This thinking has to change.

Putting together these observations brings us to the second uncomfortable truth: if the FCA truly believes that the polluter should pay, there must be a discussion about where the FCA itself sits in the liability stack. Currently, it and its officers, employees and agents enjoy exemption from civil liability, except in cases of proven bad faith or human rights breach. Where the regulator fails to act reasonably in pursuit of its statutory objectives, resulting in otherwise avoidable consumer detriment, but where bad faith cannot be proven or human rights breach either did not take place or, due to the shortcomings in the legislation or the courts' application thereof[1], may not lend themselves to successful litigation, the FCA is unlikely to be held liable by a court. Moreover, as we explain in our response to the regulators' consultation on changes to their Complaints Scheme, we believe that the FCA is currently in breach of the purpose of the Scheme as intended by Parliament, namely that the Scheme would be unconstrained as to the circumstances under which it should award redress or the maximum quantum of such compensation.

The industry describes the FSCS levy as the 'regulatory failure tax' ('RFT'), rightly concluding that while the immediate cause of the misconduct costs that the levy socialises among good actors is the behaviour of their less honest peers, the underlying problem that makes possible that wrongdoing is, in the main, regulatory failure. And yet, as things stand, the FCA is exempt from the RFT. We believe this must be reversed.

We therefore propose that the FSCS should be the fund of *penultimate*, rather than *last*, resort. It should pay out on cases where a firm becomes insolvent in circumstances other than regulatory failure - for instance, when an unforeseen circumstance causes a firm to fall into default. Instead, the FCA should be the *fund of final resort*, paying out where there has been regulatory failure, such as:

- Authorising a firm or individual that does not pass an appropriate fit and proper test;
- Allowing a firm or individual to remain on the register with permissions intact long after the regulator has become, or should have become, aware of grounds for doubting their suitability;
- Failing to prevent or curtail reckless or wrongful behaviour by an authorised firm;
- Failing to prevent an unauthorised firm from conducting or appearing to conduct regulated activities;
- Failing to impose and ensure compliance with the threshold conditions, such that a firm has been unable to remedy the costs imposed on consumers by its actions because its balance sheet and insurance cover are together inadequate to meet its liabilities;

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[1] In particular, the weight of case law indicating that claims brought as soon as a few months after discovery may be time-barred

- Failing to close, or successfully police, holes in the regulatory perimeter, such as the Authorised Representatives provisions, the right of authorised persons to approve financial promotions to be used by the unauthorised, and phoenixing

We make the case for the FCA's exemption from civil liability being removed so it is unambiguously the expected payer of the RFT, and for a fair and transparent process to be initiated to remediate legacy cases, in our response to CP20/11, our response to HM Treasury's Future Regulatory Framework Review and our response to the subsequent FRF proposals for reform consultation.

We are alert to arguments that transferring much of the RFT from the FSCS component of firms' levy contributions to the FCA element would not in fact reduce their overall liabilities, and that adding to the FCA levy the RFT relating to defective policing of the regulatory perimeter and claims ineligible or partly ineligible (for instance, because they exceed the upper limit of the FSCS) would actually increase them. This is true, in the short term. However, we believe it is the right thing to do, for the following reasons:

- The move would, for the first time, create transparency about both the quantum and the direction of the RFT by separating it from genuine, no-fault, 'black-swan' insolvency events of authorised firms and by bringing together the consumer detriments caused by all types of failure in financial services regulation. For many years, politicians and other stakeholders have sought a measure by which they can determine the effectiveness of the FCA. We believe that the RFT, expressed as a separate line within the levy, is an excellent (negative) indicator of the regulator's success in preventing consumer detriment;
- Unequivocally charging the RFT to firms, through the FCA levy, would for the first time unambiguously align their economic interests with consumer representatives in arguing for more effective and accountable financial regulation. The industry has greater lobbying power than consumers, through its influence with both the FCA and the Treasury. Placing it on the same side of the debate as consumers would therefore result in the swift and effective implementation of long-overdue measures needed to fix the FCA and thus reduce the prevalence of consumer harms, over time reducing the quantum of the RFT;
- As the FCA itself admits, some consumers are scared away from mainstream financial products, instead holding a recklessly prudent proportion of their wealth in cash or property, because they distrust the industry and are alert to the risk of unremedied loss. Others transact on or beyond the regulatory perimeter, either because they've been misled or because they've concluded that doing so is not materially more risky than interacting with the industry's mainstream providers. Positioning the FCA as a more

generous and broader-based fund of final resort would eliminate the vast majority of cases in which consumers are mistreated and denied compensation. The industry would therefore enjoy a boost as consumer confidence in mainstream providers and products is rebuilt, as we explain here, translating into additional transactions and revenue, combined with a falling levy as regulatory improvements feed through to a declining RFT

Principle 2

As explained above, we see the FSCS as the fund of *penultimate* resort, paying out in cases where firms have become insolvent due to genuine black swan events, and not as a result of recklessness or misconduct that the FCA failed to prevent or curtail.

We reject the premise that consumer protection should exist only where and to the extent that it is commensurate with the benefits to financial services market participants. We believe that the right to perform regulated activities in a large and affluent financial market such as the UK's is intrinsically valuable and that it is inherently appropriate that doing so should entail certain obligations, among them the requirement to contribute to the cost of remedying consumer losses where these are caused by either unforeseen and unforeseeable events or regulatory failure (costs to be borne by FSCS and FCA respectively, under our proposed model).

We further believe that the FCA's suggestion that the above observation is not true, and that consumer protection should exist only where beneficial to financial markets, is itself a tin-eared observation suggestive of regulatory capture, and one that undermines much of the rhetoric in its recent public statements and consultation papers. We also detect a difference in tone between some of the *caveat emptor* rhetoric in the FSCS consultation paper and the expectations the FCA claims to be setting for firms in its Consumer Duty documents. This leads us to question whether the FCA will enforce against the proposed Duty as proactively as consumers deserve, and believe that this can best be remedied by ensuring that consumers are given a Private Right of Action (PRoA), which would enable them to bypass the regulator and seek redress via the courts if they suffer loss as a result of breach of the Duty. We set out our grounds for this position in our first and second responses to the FCA consultations on this subject.

Q2: What incentives, whether positive or negative, does the FSCS as a 'fund of last resort' create for market participants and what are the consequences of those incentives?

We question some of the consultation document's assumptions about incentives. For example:

- Firms ('bad actors'): the existence of the FSCS as a payer of last (or penultimate) resort does not create a moral hazard, in that firms that are inclined to mistreat clients then declare default will do so just as readily if the Scheme is not there to pick up the liability as they would if it is. The way to prevent the creation of the negative externality is not to shift it from the industry's good actors to consumers but, rather, to police the regulatory perimeter rigorously and to ensure that wrongdoers are punished and are sufficiently solvent to meet their liabilities, and to ensure that the FCA, rather than the FSCS, compensates consumers when these regulatory fundamentals are not achieved and consumer detriment results;
- Firms ('good actors'): the status quo, in which bad actors are seldom prevented from entering the industry nor their activities curtailed and they are seldom punished, but good actors are expected to pick up a proportion of the consequent losses via the FSCS, could be seen to create a moral hazard: rational players may be tempted to turn to crime. Again, the solution is not to alleviate the cost burden placed on good actors but, rather, to shift the RFT part of the cost to the FCA so the shortfall in regulatory performance is laid bare and the industry becomes directly incentivised to argue for assertive and capable regulation, since that is the best route to reducing its own liabilities;
- Consumers: we question the FCA's suggestion that consumers may indulge in risk-accepting behaviours because they believe that the FSCS will pick up the bill should things go wrong. We wonder how many consumers understand the role of the FSCS *ex ante*; and those who do may well be aware of cases in which there have been substantial delays or difficulties in consumers receiving redress, not least because they typically have to pass through the Financial Ombudsman, investigation by the FCA or even both before the Scheme considers paying out, a process that can in itself take some time. There have also been cases in which consequential loss has not been dealt with to the satisfaction of consumers. Generally, we note the gap in attitude between the *caveat emptor* rhetoric of this consultation and the FCA's professed commitment to holding authorised persons to a higher standard of conduct contained in its Consumer Duty proposals. Given the latter's reluctance to grant consumers the Private Right of Action that would enable them to bypass the regulator and impose on the industry the liabilities created by any breaches of the proposed Duty, we question the sincerity of the FCA's position in the latter paper;

- The FCA: we believe that including it in the liability stack will for the first time create a tangible measure of its effectiveness in performing one of its three operational objectives, namely consumer protection: the higher the RFT, the worse it is doing. The RFT could be used as a measure in determining the size of the senior- or whole-team bonus pool or, *in extremis*, in triggering a Treasury-mandated external review of the regulator's performance. This would provide powerful incentives for the regulator to improve its performance

Q3: Do you have any further suggestions on how to ensure the FSCS is not over relied on and represents a true 'fund of last resort'?

Our response to this consultation has so far focused on (i) reducing the totality of the RFT by creating the conditions for improving the standards of regulation and (ii) cutting the FSCS's share of it by ensuring that the FCA pays the tax when the cause of loss is regulatory failure, as opposed to genuine, unforeseeable, good-faith insolvency.

A detailed analysis of how to achieve the former is beyond the scope of this consultation, touching as it does on issues such as transparency and governance of the FCA, the incentives that influence its executives' behaviour and cultural factors in the organisation. The Transparency Task Force provides the Secretariat to the APPG on Personal Banking and Fairer Financial Services, which at the time of writing is operating a Call for Evidence about the FCA. This exercise has enabled us to build up a detailed understanding of these factors and develop detailed proposals on how the organisation might be rendered fit for purpose. The evidence that has been published so far gives great cause for concern about the efficacy of the FCA. We are happy to engage with politicians and regulators on these matters with a view to encouraging the organisational change that is needed.

Q4: Do you consider that a change in the scope of FSCS protection could be justified, whilst remaining in line with the proposed principles for protection at paragraph 2.2? If yes, please outline how and why you consider protection should be changed.

Q5: If you consider a change in the scope of FSCS protection could be justified, please set out the positive and negative implications of such a change in protection, for both consumers and the financial services sector more generally.

HM Treasury has been considering adding a remit to regulators' duties requiring them to have regard to growth and international competitiveness. As we set out in our response, the best way to grow financial services domestically is to raise the dire level of confidence consumers have in the sector's behaviour, and the best way to promote it internationally is to overcome concerns that our regulatory standards cannot be deemed to be equivalent to those that exist in the European Union. These goals, with which we sympathise, are at odds with any suggestion that the scope of the FSCS should be diminished or brought into line with the protections available in lesser jurisdictions; on the contrary, if our wish is to grow the sector, we should want to do the opposite.

A lack of clarity about the meaning or otherwise of FCA authorisation of a firm and of when products are or are not covered by the FSCS was among the shortcomings of the current regulatory environment identified by Dame Elizabeth Gloster in her review of the FCA's handling of that case. We are not convinced that these shortcomings have satisfactorily been addressed since her report was published.

A key component of rebuilding consumer trust is to create a simple and unambiguous regulatory environment that enables them to understand what their rights are in any given situation. Our start point is simple: 'if the firm is FCA-authorised, consumers should be safe to presume that its products are regulated, unless unambiguously marked otherwise and subject to restricted marketing and distribution[2]; and if it's regulated, it's protected.' Thus, the FCA logo should not appear on any promotional material or otherwise in connection with unregulated products and activities, which should not be offered to non-sophisticated clients; and if the product is regulated, FSCS protections should apply - as should civil liability of the FCA if consumer harm occurs that the firm lacks the means to remedy, in circumstances in which regulatory failure made possible the underlying negligence or misconduct.

Conversely, if the firm is not FCA authorised, or if an FCA-authorised firm offers some unregulated products, the products in question should not be offered to non-sophisticated consumers - indeed, doing so should constitute a criminal offence. FSCS protection would *not* apply, though civil liability of the FCA could exist if it could be demonstrated that consumer detriment arose because it failed to perform its statutory duties to a reasonable standard, for

[2] To sophisticated, professional and high net worth investors, the definitions of which may require revision

instance by failing to identify instances of or choosing not to take action against a firm wrongfully displaying the FCA logo despite not being authorised or, despite being authorised, offering unregulated products to unsophisticated consumers.

If the FCA shares our view that our start point is broadly the right one, then the question of which products should be protected is actually a debate about which should be regulated. We believe that this discussion needs to take place, especially with regard to crypto assets, but we have chosen not to engage with it in this response document because we believe that a standalone consultation is required to do justice to the issues raised.

Q6: Following the UK's withdrawal from the European Union, is the narrower territorial scope previously decided on for AIF and UCITS managers and CIS operators still appropriate? If not, what alternative options should we consider?

If the FCA decides to remove FSCS protection from non-UK products, and if it is broadly supportive of the approach we set out in our answer to Q5, then logically those products should be unregulated and therefore restricted in distribution to sophisticated clients. And even if it disagrees with us over Q5, it is surely imperative that any products subject to reduced or no protection should be clearly labelled and marketed as such. Any warnings should be designed to be meaningful to the consumers to whom they are likely to be marketed and not merely to protect the issuers.

Q7: How can we make sure that consumers are provided with clear information about the availability of FSCS protection that equips the consumer to make effective and properly informed decisions about financial products and services, including those where FSCS protection is not available?

Q8: When distributing non-UK funds to retail investors in the UK, should firms be required to inform customers when FSCS protection is not available? If yes, how could firms ensure customers are aware of the lack of protection, through the fund's marketing materials or otherwise?

The current situation, in which firms are largely not required to notify consumers before they enter into transactions not protected by the FSCS, is clearly injurious to consumers' interests and also presents a moral hazard to firms. There have been too many cases in which, for example, SIPP platform providers and authorised representatives have encouraged consumers to invest in unregulated or offshore investment schemes, not covered by FSCS, that were either high-risk or, more often, intrinsically fraudulent; in the latter case, undisclosed commissions, some as high as 30 percent of the principal, both render the expected/promised returns unachievable and represent an unambiguous signal to financially literate advisers that the scheme in question cannot possibly be legitimate. In such circumstances, the victims are forced to prove that the advice to invest in the product was itself negligent or dishonest, a task often complicated by the presence of an investment memorandum or other marketing collateral approved by an authorised firm but issued by an unregulated one - as with the authorised

representatives' regime, a popular catflap enabling the dishonest to circumvent a poorly defined and complacently policed regulatory perimeter.

Likewise, as expressed in our answer to Q6, if the decision is taken to withdraw FSCS compensation from non-UK funds, we believe the optimum option - and the one consistent with the view that regulated should mean protected - is that those products should be unregulated and their marketing and distribution consequently restricted. But if the FCA disagrees and chooses to allow them to continue to be marketed to mainstream consumers, there must be very specific rules on how the absence of protection should be communicated, combined with assertive *ex ante* policing of those regulations and *ex post* action against those who breach them, combined with civil liability of the FCA when it fails to achieve these reasonable expectations.

We accept there's an argument that offshore firms would be competing at a disadvantage relative to UK ones if their products were FSCS-excluded and clearly marked as such. There's an obvious remedy to this problem: they should establish FCA-regulated onshore subsidiaries, whose activities would be covered by the Compensation Scheme. At a time when the Treasury is consulting on whether regulators should be obliged to promote or have regard to the growth and competitiveness of the UK's financial services industry (our response is here), we think it is a small ask that it should first eliminate a regulatory lacuna that enables non-UK firms to offer FSCS protection without being fully onshore and paying their fair share of the consequent costs.

Q9: Do you consider that 'high-net-worth' and/or 'sophisticated' individuals should be excluded from being able to claim from the FSCS in certain circumstances? If so, should the exclusion(s) apply to all types of claim or just certain categories of claim?

We challenge (Q19) the appropriateness of the current sophisticated and high net worth tests, and dispute the assumption that they are better able to absorb losses and hence less in need of FSCS protection. Some may have the means to pursue private litigation against firms, but many do not; also, as we explain in our response to the FCA's second-stage consultation on the proposed Consumer Duty, unless the FCA introduces a genuine Duty of Care, or yields to consumer representatives' demands to give consumers a Private Right of Action (PRoA) to accompany the Consumer Duty, in many cases consumers will not have a right to litigate against authorised persons who cause them to suffer loss. And finally, given the FCA's persistent shortcomings in policing its threshold conditions relating to the need for authorised firms to

have sufficient assets or insurance cover to meet the liabilities that might be expected to arise as a result of their activities, in many cases when things go wrong, there is insufficient money left in the firm for litigation to result in redress. So, FSCS protection is required.

Q10: Do you consider any other amendments should be made to the current eligible claimant criteria?

We strongly oppose any suggestion that there should be any further reductions in the range of eligible claimants.

Q11: Does the CIS look-through remain appropriate from a consumer protection perspective? If not, what alternatives should be considered to protect investors in CISs?

We believe the look-through principle is essential, and should be retained. One of the many challenges in securing partial redress for investors in The Connaught Income Fund Series 1 is that a key authorised party, the Fund's Operator, Capita Financial Managers Limited ('CFML'), whose conduct was egregiously deficient, was not a counterparty in a direct contractual relationship with investors in the Fund. In the absence of a Duty of Care (or a Consumer Duty with Private Right of Action) there were therefore obstacles to successful litigation. Against this background, investors - and liquidators acting in their interests - were limited in their ability to secure redress through litigation, settling for just £18.5m. To complicate matters further, by the time the FCA got round to launching and concluding an Enforcement investigation that might have led to restitution order imposed under Sections 382 or 384 of FSMA, parent company Capita plc had suffered a series of profit warnings and was at risk of breaching its banking covenants. Against that background, the FCA negotiated a voluntary, partial redress scheme incorporating generous time to pay provisions and the sale of the firm's financial services division in order to fund the compensatory payments.

Had the CIS look-through provisions existed prior to April 2018 (we suspect they were introduced to remedy the problems described above), the FCA might have been able to impose a restitution order for the full extent of investors' losses, tip CFML into an insolvency procedure and then pass the liability to the FSCS. Alternatively, the FCA could have accepted Capita's offer of partial redress then issued a restitution order for the shortfall against CFML's replacement as Operator, Blue Gate Capital ('BGC'). BGC was a micro-business with less than £2m in combined

net assets and professional indemnity cover that would have gone into default, transferring liability for the restitution order to the FSCS. Without the look-through (we assume it cannot be applied retrospectively) the FCA instead imposed an order under S384 for a derisory £203,007, we suspect because it knew that the FSCS would not stand behind a material one.

The FCA's decision to leave CFML in the marketplace, solvent and with permissions intact, in order that it could be sold to Link Group to raise capital to honour the negotiated redress scheme, enabled the troubled authorised firm to become the Authorised Corporate Director ('ACD') of the ill-fated Woodford Equity Income Fund ('WEIF'). In this role, CFML stands accused of having failed to intervene to prevent asset allocation decisions that breached the Fund's investment mandate, were not in clients' best interests (including some with connected parties) or both, and of failing to replace the investment manager, Woodford Investment Management Limited ('WIM'), when it became clear that there were acute problems with performance and governance.

We support the argument raised in paragraph 4.16 of the consultation document, namely that while fund manager, operator, ACD and depositary failure rates are low, the consequences of such events can be very serious in both absolute scale (given the size of some funds, and of the largest firms in the sector) and for individual clients. In particular, we are aware of litigation on foot against WIM and Link Fund Solutions (formerly CFML) in respect of WEIF. If it succeeds, the firm is likely to go into default, so the FSCS will be needed to deliver at least part of the redress. Given that this is a known, indeed high-profile, case, we think it is misleading (par 4.15) to suggest that the probability of an insolvency in the sector is low - a different point than the *low failure rate* argument in the subsequent paragraph - because there are two high-profile ones that are eminently foreseeable. Nothing must be done *ex post* to restrict the victims' right to redress through the FSCS.

Q12: Do you consider changes should be made to the level of compensation that is payable by the FSCS? Please provide justification for any changes you propose.

Q13: Would you be in favour of the introduction of set periodic reviews of the compensation limits to ensure that they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?

Given that our remit is to make the case for the best possible outturn for consumers, you will not be surprised that we believe a higher compensation limit is called for. We do so on the basis that there are many sectors in financial services in which *ad valorem* charging is either commonplace or might become so. A person with twice as much money invested in, say, an investment product, may typically be paying almost double the fees of a neighbour with half as much at stake. The provider is therefore in a position to make a commensurately larger contribution to the FSCS levy in respect of the former; it seems appropriate that he or she should therefore receive more redress should things go wrong.

In particular, the concept of a compensation limit made more sense when a high proportion of FSCS' potential liabilities related to general insurance or cash accounts in which very few prospective claims were likely to exceed the thresholds. The decline of defined benefit pensions, followed by the 2015 pensions freedoms legislation, have increased the proportion of people who hold assets materially more valuable than the current £85,000 cap in both pension- and non-pension investments that are far more likely to fall victim to misconduct or provider default.

We can therefore see the case for a significantly higher limit for the investment, pensions and perhaps life insurance categories of business. These are sectors in which the failure of a product or firm can have life-changing consequences for clients, both because of the quantum of money affected and because losses very often crystallise at a life stage at which the victim has little or no opportunity to remedy them, and may also be vulnerable.

However our preference is for a higher limit across the board. In particular, in keeping with our argument throughout this response document that it is in the interests of wider society and of the honest majority in the industry to raise consumers' levels of confidence and trust in the sector and its products and services, we observe that a bigger safety net makes people more confident about taking the plunge. There is also much to be said for simplifying the suite of consumer protections and redress options. In this respect, it seems anomalous and unjust that the FSCS limit should be lower than the FOS one. Surely if the FOS recommends that a firm pays a consumer a sum of money and the firm is unable to do so because it goes into default, all that liability, and not just £85,000, should be paid out by the FSCS.

Periodic reviews would be useful. They should take into account changes in the financial services landscape, such as those we mentioned above, the distribution of FSCS claims by sector and value and of course inflation - both historic and that projected for the period between the review and the next one.

Finally, whatever happens about the FSCS cap, if the Government - or indeed the FCA - accepts that the FCA's statutory immunity from civil liability should be removed, we believe there should be no limit to its liability to any one consumer, or to consumers in aggregate. *If the FCA screws up, it should pay up. Enshrining this simple statement in law is in our view the single biggest step that could be taken to rebuild trust and hence boost business for the UK financial services industry. The 'polluter pays' principle must apply to all.*

Q14: Do you consider that proposed principles 3 and 4 in relation to FSCS funding are the appropriate principles to underpin the design of the funding arrangements (in relation to the classes which the FCA is responsible for)? If not, what principles would be preferable?

We consider those principles broadly fair, subject to the observation that the quantum of the FSCS levy - which is predominantly a Regulatory Failure Tax ('RFT') - should, as we've explained previously in this document, be reduced by shifting the RFT to the FCA and hence to the proportion of firms' levy payments that go to that entity. While the overall scale of the levy will not change in the short term, there may be some distributional effects; and, crucially, there will be a huge long-term reduction, as there will for the first time be transparency about the scale of the RFT and hence pressure from the honest majority in the industry for reform and accountability to be imposed on the FCA.

Q15: How do you consider the current funding model (for the classes that the FCA is responsible for) could be improved, to ensure that costs are appropriately distributed and the impact on firms is proportionate? Please explain how your proposed changes represent an improvement on the current arrangements.

Q16: Are there any alternative metrics to annual eligible income that would help to ensure that compensation costs in the Investment Provision class are distributed more fairly between firms in the class?

Q17: Would you be in favour of the introduction of set periodic reviews of the funding class levy limits to ensure they remain at an appropriate level? If so, what criteria would FCA need to account for in such a review?

Q18: Do you consider that any alternative funding model would be preferable to the current funding model? Please describe the alternative model that you consider to be preferable and the benefits over the current arrangements.

Given that our remit is the interests of consumers, we believe it is not for us to answer these questions. Provided the FSCS is able to meet its liabilities, the detail of the funding model is not something on which we intend to comment, except to say that we believe that the 'polluter pays' principle requires the liability to be apportioned broadly in line with the parties' share of causation (there are some who believe that the burden currently falls too heavily on those who distribute products and too lightly on those who create them. For this reason, we choose not to answer questions 15-17 inclusive. However, Q18 is on brief for us, since it may impact the ability of the FSCS to meet its liabilities, and could also affect the range of products and quality of advice available to consumers.

Risk-based levies sound like a good idea in theory: they are a form of *ex ante* polluter-pays policy, in that the firms engaging in the higher-risk activities would pay more than those taking less risk. However, the approach is subject to all the drawbacks identified in paragraph 6.23, plus one more that in our view is larger than the others combined: the difficulty of correctly identifying and pricing risk.

If the FCA were good at identifying risk *ex ante*, its supervisors would identify firms engaging in risky activities at an early stage and work with them to either reduce such risk or ensure they had sufficient resources (whether through their own balance sheets or professional indemnity insurance) to meet any liabilities that arise. It is precisely because doing this is difficult, and the FCA is bad at it, that the FSCS is needed. Also, in regulators' defence, 'black swan' events can occur, external economic shocks (such as the Covid-19 pandemic) that nobody could predict nor reasonably be expected to plan for.
Pre-fund is a bad idea for the reasons identified. In particular, any requirement for new market entrants to contribute their share of a 'float' would act as a barrier to competition, and hence consumer choice and value. Also, tensions would be created between the requirement for a new firm to have sufficient resources on its own balance sheet in order to be and remain authorised and an obligation to contribute to the pre-funded FSCS balance sheet.

Product levy is in our view a flawed idea, not only for the reasons identified in paragraph 6.25 but for a much more fundamental reason. The cost of many products - for instance, a life insurance policy or fixed-rate mortgage - is set at inception. The expected FSCS liabilities for that category of business will vary hugely during the life of an individual policy, the duration of which cannot possibly be known when the price is set (even with a notionally fixed-duration product such as life insurance or a mortgage, it may be redeemed early). It is therefore impossible to set the levy at a price that gets anywhere close to being an accurate reflection of the risk it is required to cover.

Insurance is a superficially tempting idea, but it too is flawed. If one insurer covers the entirety of the FSCS' liabilities and a black swan event occurs, there may be a risk that it may not be able to meet the full quantum of claims. This problem could be intensified if that insurer is one that also insures (or reinsures) some of the risks covered by insurance policies that are themselves FSCS-eligible. In other words, if an extreme event occurs that results in a huge spike in FSCS claims from the insurance sector, there is a risk that the FSCS' insurer would be unable to pay up, in part because it might be exposed to the same event as an insurer or reinsurer of consumer policies, perhaps even ones in default and hence passed to the FSCS…

In short, the current model is imperfect but it represents a relatively secure way of meeting the expected liabilities of the FSCS. We are not convinced that an alternative funding model has yet been proposed that would do so more successfully.

Q19: Do you have any overarching comments on the proposed principles for the compensation framework, or do you have any further principles that we should account for?

Throughout this response document we have made such observations where we've considered them appropriate, but here we set them out again in one place, in the context of the four Principles:

Principle 1: We believe the FSCS should be a fund of *penultimate*, rather than *last*, resort. We believe it should be there to cover authorised firms' liabilities to consumers following 'black swan' events. Firms should be the payers of *first* resort, compensating consumers for the losses they suffer through firms' negligence or dishonesty. The FCA should be the fund of *last* resort, compensating consumers where there has been regulatory failure (which can include a failure to uphold the threshold conditions, as a result of which a firm lacks the resources to meet its

liabilities as payer of *first* resort). The RFT should therefore be paid by the FCA, not the FSCS; we see this as a necessary first step toward reducing it.

Principle 2: We agree, and have argued for improving, rather than reducing, the protections available, precisely because we are mindful of the Treasury's ambition to promote the growth and competitiveness of the UK financial services industry, a goal that we believe cannot be achieved without concrete measures to rebuild domestic consumers' confidence in transacting with the industry and overseas regulators' and governments' confidence in our regulatory regime.

Principles 3 and 4: We agree; and we think the current arrangements are broadly the least bad option.

Q20: Are there further opportunities to improve the aspects of the compensation framework that the FCA is responsible for? Please describe the further changes which you consider should be made.

Yes. The FCA and its fellow regulators have repeatedly delayed publication of the findings of their summer 2020 consultation to changes to the Complaints Scheme. We believe that the current iteration falls short of Parliamentarians' intentions in that the regulators have largely ruled out the payment of material levels of redress, especially in cases where there has been regulatory failure, and that the proposed one is even worse.

If there is to be genuine reform, especially at the FCA where it is most obviously and urgently needed, we believe this must change, and that there must be an equitable and transparent forum by which the victims of historic cases of negligent or dishonest regulation can receive full and fair redress and there can be transparency about what went wrong. Until that happens, any purported transformation projects are doomed to fail, since it is impossible to solve a problem while simultaneously denying its existence, and impossible to admit to a problem while desperately trying to evade financial liability for it.

We hope the FCA will work constructively with us and other consumer groups to agree a fit for purpose Complaints Scheme for new cases and a fair forum for remedying historic ones.