LC&F and Related Matters

Contents

Suggested amendments

We are not lawyers so are not ideally placed to suggest precise wording for a legally watertight piece of legislation. However we would make the following suggestions:

- Change the name of the Bill to Compensation (Financial Services Regulatory Failure and Fraud Compensation Fund) Bill;
- Change item 1 in the contents to Compensation payments to customers of London Capital & Finance plc, The Connaught Income Fund Series 1 and other cases in which consumers lose money through confirmed or accepted regulatory failure in UK financial services;
- Reflect this change where appropriate in the text;
- In paragraph 1 (1), after the word Report, add: *, customers of The Connaught Income Fund Series 1 and customers of other financial services businesses in the UK adversely affected by regulatory failure that is either confirmed by an Independent Review or accepted by the Treasury without the need for such a Review*;
- Add a new paragraph 1 (5) reading something like: *In this section, "regulatory failure" means a failure by the Financial Conduct Authority (or any successor body) to achieve an appropriate degree of protection for consumers as defined in Section 1C of Part 1A Chapter 1 of the Financial Services Act 2012*;
- Add a new paragraph 1 (6) reading something like: *The compensation payments shall be calculated so far as is possible to put customers in the position they might reasonably expect to have been in had they not been affected by the regulatory failure for which the compensation payments are to be made*

Relevant questions and answers

Does Clause 1 of the Bill provide a fair response to matters identified in Dame Elizabeth Gloster's report?

We welcome the fact that the Treasury intends paying some compensation to the affected consumers but believe that the Bill could be improved in two ways:

- First, the method by which compensation is calculated for each investor should be specified, and should be more generous than the Treasury currently intends;
- Second, the Bill should also provide a route to redress for the victims of other regulatory failure cases - both Connaught, where there already is an Independent Review, published on the same day as the LCF one, that demonstrates extensive evidence of regulatory failure, and many others where there is a mountain of evidence suggesting exactly the same kind of catastrophic regulatory failure but there have not yet been independent reviews

Do you agree that the Financial Services Compensation Scheme is the appropriate body to administer the compensation scheme?

Probably. Some would argue the FSCS is conflicted, because of its decision not to pay out from its levy money to most LCF investors and the abysmal standard of some of the evidence on which those decisions were made. But it may be the least bad option. Most campaigners, us included, believe it's the least unfit for purpose of the 'three Fs' regulatory family - the FCA, the FOS and the FSCS - and it's accustomed to distributing redress to consumers, so has the necessary systems.

Its involvement does raise one issue though; we don't know whether this should be dealt with in the wording of the Bill or separately by agreement with that organisation. Will the FSCS seek assignment of rights? Normally when it compensates consumers from its levy monies it requires them to assign to it the full value of their claims against the firm that's in default.

If we're successful in persuading you that the victims should be compensated in full, there's no reason why this should not happen as a condition of accepting the redress. But if we fail in that task, it's likely that the larger creditors will be reluctant to accept, feeling, quite rightly in our view, that the compensation scheme will have short-changed them, therefore and may therefore prefer to see what comes out of the judicial review appeal or attempt to litigate against the FCA.

The Bill waives the requirement for the Financial Conduct Authority to carry out a full public consultation and impact assessment before the proposed LC&F compensation scheme is established. Do you foresee any issues with this?

No, it’s an excellent idea. Such work would incur avoidable expenditure for the Treasury and further delay getting redress to the victims. Dame Gloster’s Report makes it irrefutably clear that there has been catastrophic regulatory failure at the FCA in this case; and we would argue in many others as well.

<u>What wider questions does the Bill raise about other instances where there is evidence of FCA failings in regulation but no compensation is offered, such as for Blackmore bonds etc?</u>

The Bill does nothing to pave the way for the payment of redress to any of the other victims of the great many systemic regulatory failure cases that have piled up on the FCA's watch.

These include:

- Connaught - there is already a finding in Raj Parker's independent review that regulation was 'not appropriate or effective', but the FCA is misleadingly insisting that investors have already been placed in the position they would have been in had they not invested in the Fund, a claim the Treasury has so far accepted;
- Lendy and Funding Secure - the Action Groups have already written an open letter making the case for an inquiry, setting out extensive allegations of regulatory failure;
- Blackmore Bond - the FCA's failure to act on highly credible intelligence that would have allowed it to close down this fraud in 2017 and 2018 was set out very clearly by Peter Grant MP in the second reading debate;
- Exmount and Bentley Global - the FCA let a series of scams carry on for more than two years, even after it raided the boilerroom;
- Collateral - scammers were able to hack the FCA's interim permission register, changing the name of a similar-sounding firm to that of theirs, go on to achieve full authorisation, allowing them to operate a peer to peer lending platform, the majority of loans made by which were allegedly to connected parties or with defective security. When it finally realised what had happened, the FCA allowed the firm to keep trading for several months;
- Store First and Park First - the FCA allowed an allegedly illegal collective investment scheme to continue to trade for at least three years after becoming aware of it;
- PremierFX - an authorised currency exchange and payments firm turned itself into a deposit taker under the FCA's nose. Allegedly it then became a Ponzi scheme with money from one client used to honour a transfer for another, with other sums being misappropriated. Also claimed that employees of a major UK High Street bank either knew what was happening and did nothing or were actively involved. FCA culturally uncomfortable with holding that bank to account;
- Woodford - the big one. Billions of pounds lost, most of it from people's pensions. The FCA's failures in that case are so extensive it would take longer than the time allocated to this session to do justice to them alone;
- And dozens of other cases, some of which may individually be smaller but the impact of which on the lives of the victims is every bit as large

The Minister said that LCF is one of only three cases in 35 years to result in the Treasury paying redress. The other two, Barlow Clowes and Equitable Life, were not instances of authorised firms undertaking only unregulated activities - not even close. So it can't be this authorised/unregulated split that triggers redress. Those three cases have just one thing in common: a statutory regulator failed on a spectacular scale to use the powers available to it to secure an appropriate degree of protection for consumers (one of its three statutory objectives), and hard-working citizens lost substantial sums as a result. That characteristic is shared by all the recent scandals I've mentioned to you today, and more. So surely their victims deserve compensation too. The question is, if not through this Bill, how?

The Bill is needed because the Financial Services Act 2012 gives the FCA broad immunity from civil liability. There are two very narrow exemptions, for acts of bad faith and human rights breaches. We are unaware of any litigation that has successfully benefited from these, and there is also a huge inequality of arms between a statutory body that can use its mandatory levy income to defend itself and citizens who have been deprived of their savings.

Anticipating this problem, Parliament legislated in the same Act for there to be a complaints scheme, with a Complaints Commissioner responsible for investigating any complaints for which the complainants are unhappy with the FCA response. Unfortunately the FCA was entrusted with specifying the scheme, and over the years it has watered it down so that, in effect, it cannot pay material amounts of redress and, worse, it excludes cases in which there has been regulatory failure.

In other words, there is currently no viable route for regulatory failure victims to be compensated. That is why we are asking you to amend the LCF Bill to provide one. We are not suggesting that taxpayers stand behind all financial services products that collapse, just the ones where an independent review has demonstrated, or the Treasury has accepted without the need for a review, that the regulator failed in its statutory duty to secure an appropriate degree of protection for consumers, resulting in them losing money.

That's a pretty high bar, and one that could require consumers to seek judicial reviews of decisions to refuse to conduct reviews or to pay redress. But arguably that's as it should be: taxpayers' money should not be paid out lightly.

Other options could include:

- A Royal Commission into systemic flaws in the financial services industry and its regulation, as happened in Australia, with a remit to provide redress in all legacy cases;
- Amending the Financial Services Act 2012 to remove the FCA's exemption from civil liability, to apply retrospectively;
- The Treasury could order the FCA to work with consumer groups such as ours to fix the complaints scheme;
- Further Bills like this one being brought forward, one for each case - surely not the most efficient use of Parliamentary time and resources

There's no sign of those things happening right now, and amending this Bill to provide a pragmatic pathway to justice for the many victims of the FCA's catastrophic failure is within your gift. Doing so would make a huge difference to their lives, and to the balance of power going forward.

The Economic Secretary has said that investors should not expect the Government to stand behind losses arising from risky investment decisions in future. Does the Bill risk diluting the message to consumers and investors that they bear responsibility?

We believe that consumers, with the exception of the vulnerable, are sovereign adults who should be trusted to make their own decisions and held responsible for the consequences. However, we all make decisions on the basis of the information available to us, and we believe there are two principles at stake, namely that consumers should be able to rely first on financial promotions issued or approved by FCA authorised firms and second on the FCA to take reasonable steps to police the industry to deter and eliminate bad or negligent actors.

There are some suggestions in the Minister's 19 April statement to the House about the reasons for the compensation scheme that LCF investors should have been suspicious and that the level of redress should fall below the entirety of their losses to avoid creating a moral hazard in which consumers might invest in risky products in the expectation that taxpayers would make good any subsequent losses.

For clarity, the LCF victims did not take a risky investment decision; they took a decision they believed, on the basis of the information presented to them, to be low risk. It happens that the undisclosed risk was much higher, because they were not made aware of serious concerns about the product, which were known by the regulator but not shared. Indeed, some were so prudent they even phoned the FCA to check the product was legitimate; they were given no cause for concern by the FCA, and at no stage, seemingly, was the matter escalated by the call centre. They also weren't greedy: the returns offered by LCF, and indeed the other schemes I've mentioned, cluster around eight percent. This is a typical long-run average return of investing in listed equities, which are much more liquid, and is also the base figure used by the Financial Ombudsman when calculating compensation payments.

The consequence of any suggestion of contributory negligence is that we believe it is acceptable to hold private citizens to a higher standard of financial sophistication than the hive mind of 4000 professional financial services regulators in London, many of whom are law graduates from the world's foremost universities and who have statutory powers to demand information from firms and managers and raid premises and who have in practice an unlimited budget for commissioning legal opinions from the nation's top barristers. If we're being asked to believe that the FCA never smelled a rat, what chance a retired primary school teacher from Nuneaton?

Unless we have an effective compensation mechanism to deal with regulatory failure, there will be no good reason for the British public or international investors to have trust and confidence in our financial services sector. At the level of the consumer, this could lead to reckless prudence - people keeping their wealth in unproductive assets such as cash or a larger home than they need, rather than investing it in the productive economy or, worse, them spending it all and seeking to rely on the state in tough times or their later years. That's the perverse incentive I think we should fear every time we see newspaper headlines about decent people who've done the right thing losing their savings to an ill-regulated Wild West financial services sector. And at the macro level, the last thing we need at this time is for the reputation of the UK's finance sector to be at jeopardy, when we have Frankfurt and others snapping at our heels - the economic costs of that would be devastating as we come out of Covid and deal with the adjustments and opportunities that arise from Brexit.

Is there a risk that the compensation scheme under the Bill will discourage the Financial Conduct Authority from improving its regulation of firms, if the Government steps in on occasion to offer compensation?

No. Certainly there's a moral argument that the polluter should pay, that the FCA, and in turn the firms that pay its levy, should pick up the cost, rather than taxpayers. But there's a pragmatic argument against it.

If this Bill does not provide a viable route to redress for the victims of LCF and other regulatory failure cases, it is only a matter of time before the lacunae in the 2012 Act are tested successfully. Once that happens, we predict that litigation funders will pile in behind the victims in other cases, who will take it in turn to take chunks out of the FCA. Each time it loses, it will be forced to raise its levy to honour the claims and pay legal costs. Every hike in the levy will drive some firms out of business, resulting in the burden being shared between fewer survivors, an endlessly repeating cycle. There is thus a non-trivial risk that one of the UK's most successful industries could be irrevocably damaged by a failure by the Treasury to do the right thing now for the victims of legacy regulatory failure cases and work with constructive critics such as ourselves on the solutions.

We believe that the FCA *will* raise its game if the Treasury steps in to compensate in these cases, because the compensation payments will alert politicians to the severity of the regulator's shortcomings, resulting in irresistible pressure for genuine change. Currently, there's no measure of how effectively the FCA performs its most important statutory function, namely consumer protection, because the only reliable criterion - the quantum of loss suffered annually as a result of such failure - is shared between the FSCS and an unknown number of consumers, so nobody's measuring it. If those costs fell to the Treasury, I assume they would appear as a line in each year's Budget, so MPs would have the ability to see what the losses are per year, and track them over time. Transparency leads to accountability, which leads to reform.

Should the way the compensation scheme will work be on the face of the Bill?

We believe that the compensation scheme should be more generous than the Economic Secretary to the Treasury is currently proposing, and that the basis on which redress should be calculated should be included in the wording of the Bill.

The Minister is currently asking most of the victims to bear around half the total losses (some a lot more). If you believe that they were negligent or greedy, that's perhaps acceptable; but if you believe they acted in good faith but were failed spectacularly by a statutory regulator that failed in its statutory duty to provide appropriate consumer protection, it surely isn't.

I should explain why I say that consumers are being asked to bear around half the losses.

LCF collapsed some two and a half years ago. Assuming it will take a further six months to distribute the compensation, someone who invested two years before LCF went under will have forfeit five years' returns on their capital - around 47 percent after compounding. I'll round it up to 50 percent to make the maths simple. The Treasury is proposing to compensate the victims with 80 percent of invested capital, less income received during the scheme's life, and subject to a cap of £68,000 (80 percent of the FSCS's £85,000 limit).

Someone who invested £20,000 two years before LCF collapsed would have forfeit around £10,000 of returns on the principal by the time the compensation is paid, making a total of £30,000. Under Treasury proposals they'll receive £16,000 - just over half the total. And someone who invested £200,000, as some did, and could reasonably expect investment returns of £100,000, a total of £300,000. They'll receive £68,000 - just over 22 percent of the total.

These calculations exclude sizable time costs and expenditure incurred by those of the victims who investigated what happened, worked with the FCA and Dame Elizabeth, briefed the media, lobbied politicians and pursued a judicial review and now an appeal. Their work is the reason any money at all is on the table from the Treasury, and they deserve to be generously recompensed for doing so - if only because it's so vital to signal to others who find themselves in the same situation in the future that it's worth taking up the cudgel. And finally some people have suffered consequential losses and opportunity costs as the LCF collapse has prevented them withdrawing their money to use for other purposes, including in their businesses or for property purchases.

We have prepared a few notes setting out some ideas for revising the wording of the Bill, which we can supply to you. In respect of the quantum of compensation, we suggest adding a new paragraph 1 (6) reading something like: *The compensation payments shall be calculated so far as is possible to put customers in the position they might reasonably expect to have been in had they not been affected by the regulatory failure for which the compensation payments are to be made*.

We recognise that this wording could lead to some negotiation, horsetrading and risk of judicial review if the Treasury and victims cannot reach agreement, but again we think this is appropriate: taxpayers’ money should be distributed only to the extent that a robust case can be made for doing so.

Is there anything you think is missing from the Bill?

The two big things are the ones we've already raised:

- Provision for other regulatory cases, both Connaught where regulatory failure has already been demonstrated by an independent review but the FCA is misleadingly pretending there are no losses, and the many others where regulatory failure has been alleged, supported by mountains of evidence, but there has so far been no acceptance of it by the Treasury or an independent review published; and
- Wording that clarifies how compensation will be calculated, and that it will be assessed in such a way that the victims of regulatory failure are genuinely placed in the financial position they could reasonably expect to have been in had it not occurred, i.e. that they are truly compensated. If it is the case that it is the FCA that has failed and not the consumer then it is clear the consumer must be properly compensated.

We hope that we have made the moral and practical case for these changes during today's session, and thank you for inviting us to give evidence. We stand ready to provide further information if asked.

Other issues

Do you think it is morally right that taxpayers, some of whom don't have any spare money to invest, should compensate the victims of investment scams, who do?

Yes; many of those people don't yet have investable assets because they're relatively young. They may well do so in later life, and they will then have the same right as today's older citizens to expect that the government will put in place a regulatory environment that protects their assets.

It's worth remembering the political decision-making that led to the FCA coming into being in 2013. Its predecessor, the Financial Services Authority, took effect in April 2013 with a brief to provide 'not just light-touch regulation, but minimal regulation.' This laxity was a major causative factor in the global financial crisis.

Government recognised that the FSA was incapable of supervising the stability of systemically important firms - banks and big insurers - so this responsibility was hived off to the Bank of England's new offshoot, the Prudent Regulatory Authority. But the basket case FSA was allowed to rebrand as the Financial Conduct Authority, still responsible for supervising non-systemically important firms and for conduct matters across the sector. And there was no clear-out of personnel. So we ended up with mostly the same people, doing mostly the same thing, in the same building, but with a slightly different name above the door. We should not be surprised that we have got mostly the same standard of regulation, and of outcomes.

At some point, we believe that the FCA will either have to be replaced, or that there must be radical reform to its governance, accountability, leadership, staffing and performance. Creating a legislative means by which the costs created by its failures are socialised, rather than borne by the few, will have two benefits. First, it will spread the burden for what is, ultimately, a political choice; and second, it will create some visibility of at least some of the costs of regulatory failure, at which point political awareness and understanding of the problem will, we hope, grow, leading in time to a consensus about the need for radical change.

The public debt is close to 100 percent of GDP, and we have not yet incurred all the costs of Covid. Can we as a nation afford to create a liability to regulatory failure victims?

We can't afford not to. Creating a path to redress for those who have been let down by the FCA will make those costs visible, leading to irresistible political pressure for change. Until that happens, the FCA will continue to underperform, creating yet more losses, which are borne on the narrow shoulders of ordinary citizens. The economic consequences of that are less easily measured, but every bit as real. It feeds into suppressed demand, because their spending power is diminished, and into bankruptcies, which in turn damage the businesses of which they are creditors. And it transfers wealth from the masses to those who mistreat them, be they outright criminals or financial services firms that mistreat their customers while still extracting fees.

Some economists believe that PPI payouts provided a material, MMT-style stimulus to the UK economy after the global financial crisis. As we pull out of Covid we're experiencing pent-up demand and a release of savings by those whose incomes are secure, leading to a short-run boom. Once that's over, some households and small firms will be bearing additional debts, suppressing demand and growth, and those in less secure jobs may well become more risk-averse than before so will seek to build up additional savings buffers. In these circumstances the distribution of redress by the Treasury to victims of legacy regulatory failure cases - people who otherwise are largely excluded from discretionary spending by their financial circumstances - could be very helpful to the economy, as well as being the right thing to do.

Further evidence of Catastrophic Regulatory Failure

There is evidence of further catastrophic regulatory failure in the testimonies of victims in these video recordings of symposia that we have run. Note that some relate to recent cases, others older ones, but they all speak about regulatory failure that is taking place *now* in terms of the way the FCA is conducting itself *now*:

- The Premier FX Fraud Fiasco:
  https://www.youtube.com/watch?v=NBnklclAQs4&t=7758s

- The Blackmore Bond Scandal:
  https://www.youtube.com/watch?v=jhLnjirfUZQ&t=2149s

- The Essential Ingredients for Effective Financial Regulation:
  https://www.youtube.com/watch?v=wVY_nE1V04w&t=1256s

- Mortgage Prisoners:
  https://www.youtube.com/watch?v=5sELH0PNXKA&t=37s

- Interest Rate Hedging Products Scandal:
  https://www.youtube.com/watch?v=IViXgkW116g&t=2300s

- The RBS Scandal:
  https://www.youtube.com/watch?v=EVz4ZsCvNcQ&t=1472s

Furthermore, we have relevant evidence to support our claim that LC&F-like cases are taking place now i.e. ongoing, live cases causing material consumer detriment. Please advise if you would like that evidence, or not.

I hope our input may prove to be useful in speeding up the rate at which the much-needed reforms take place, for the benefit of all.

Kind regards,

Andy

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