Complaints Commissioner

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25th November 2015

Dear Complainant

Complaint against the Financial Conduct Authority
Reference Number: FCA00053

Thank you for your emails of 3rd and 17th March and 2nd October 2015. I apologise for the length of time it has taken to complete my investigation but, it was necessary to undertake considerable further inquiries. I have completed my inquiries of the Financial Conduct Authority (FCA), and am now able to write to you. In finalising this decision, I have also considered the points which you and the FCA made in response to my provisional decision, and made changes where I considered it appropriate.

How the complaints scheme works

Under the complaints scheme, I can review the decisions of the FCA's Complaints Team. If I disagree with their decisions, I can recommend that the FCA should apologise to you, take other action to put things right, or make a payment.

As you can find full details of how I deal with complaints at www.fscc.gov.uk I do not intend to set them out fully below. If you need further information, or information in a special format, please contact my office at complaintscommissioner@fscc.gov.uk, or telephone 020 7562 5530, and we will do our best to help.

What we have done since receiving your complaint

I have now reviewed all the papers you and the regulator have sent us. My decision on your complaint is explained below.

Your complaint

You complained to the FCA, who wrote back to you on the 16th March 2015 with their decision. The FCA recorded your complaints as follows:

> *'Element One*
>
> You state that you are unhappy with the *"FCA's unwillingness to regulate in the matter of Lloyds Bank claiming a Capital Disqualification Event and attempting to renege on its obligations to investors."*

Element Two

> You are also concerned that a letter you received from the FCA on this matter was signed off by Karina McTeague. You believe that owing to Ms McTeague's past employment with Lloyds that she has an obvious conflict of interest and cannot be expected to have an objective view.'

Element one of your complaint – that the FCA had failed to regulate effectively by failing adequately to protect retail investors who held the Enhanced Capital Notes (ECNs) – was excluded from the complaints scheme by the FCA on the following grounds:

> 'We have reviewed your complaint and consider the issues raised to be general in nature with no specific allegation of misconduct……..complaints that amount to no more than dissatisfaction with the regulator's general policies or with the exercise of (or failure to exercise) a discretion will not be investigated.'

This misstates the test set out in the Complaints Scheme. The test is whether the complaint "amounts to no more than dissatisfaction with the regulators' general policies *or* [my emphasis] with the exercise of, or failure to exercise, a discretion *where no unreasonable, unprofessional or other misconduct is alleged* [my emphasis]."

The complaint is clearly not general in nature – it is highly specific; nor does it relate to general policies; and it *does* allege misconduct in the form of an unreasonable decision not to make a regulatory intervention. The FCA has misstated the test, and has wrongly excluded element one of the complaint. For that reason, I have decided to overturn the FCA's decision, and to undertake my own investigation (a Stage 2 investigation under section 7 of the Complaints Scheme).

Element two of your complaint - that Karina McTeague's past involvement with Lloyds and the current matters surrounding Lloyds gives rise to a conflict of interest - was considered but not upheld.

My role

Before I explain the findings of my investigation, I should make it clear that it is not my role to say what I would have decided had I been the regulator. My task is to assess whether or not the decisions were within the range of decisions which the regulator could reasonably have taken, in the light of its statutory duties and policies. In making this assessment, I have the benefit of reviewing all of the regulator's records, including material which is confidential.

Issues of confidentiality

I should also make it clear that there are some difficulties in deciding what information can be released. This is partly because s348 of the Financial Services and Markets Act 2000 (as amended) prohibits by law the disclosure of a wide range of information relating to the business affairs of those who are regulated, and also because of the FCA's confidentiality policy which is designed to encourage regulated firms to be open with the regulator, and to avoid prejudicing investigations – there is a good explanation of that policy at https://www.fca.org.uk/site-info/information/information-we-can-share.

However, within those constraints it is clearly in the public interest that as much information as possible is shared with complainants and the public, since without that information it is hard for people to consider whether or not the regulators are performing their duties adequately and reasonably. Furthermore, in this particular case the matters at issue are largely already public knowledge. For those reasons, I have secured the FCA's agreement to disclose the significant issues behind their decisions in this case, in order that the complainant – and, assuming that the decision is published, the wider public – can consider the regulator's reasoning.

Regulatory background

There has been regulatory involvement in the matter of the Lloyds Bank ECNs from their inception in 2009. From the records which I have seen, the FSA supervised the design and execution of the ECNs in 2009, although principal responsibility for the design and execution rested with Lloyds.

CoCos were referred to in the FCA's Policy Statement PS13/3 issued in June 2013 which, while focussing on unregulated collective investment schemes, highlighted the dangers of CoCos for retail investors and announced a forthcoming consultation on the subject. Temporary product intervention rules restricting the retail distribution of CoCos were brought into force in October 2014, and at the same time the FCA consulted on permanent rules. In June 2015, the FCA announced that permanent rules would come into force on 1 October 2015 (see https://www.fca.org.uk/news/ps15-14-restrictions-retail-distribution-regulatory-capital-instruments).

In relation to the particular issue of Lloyds ECNs, in March 2014 Lloyds made a cash buy-back offer to UK retail investors (broadly at average market price), warning that should ECNs subsequently become disqualified as regulatory capital, investors might be faced with being forced to redeem their ECNs at par. This warning was based upon a clause in the ECN prospectus which entitled the bank to buy back the ECNs at par if there was a capital disqualification event (CDE) – a regulatory decision to cease to recognise certain instruments as capital for the purposes of determining capital adequacy. At the time of the buy-back offer, there were complaints from investors to the regulators that they were being pressurised into selling by the threat of an enforced sale despite the fact there was some doubt about whether the clause upon which Lloyds were relying was enforceable.

You alleged in your response to my preliminary decision that, in the run-up to the cash buy-back offer, Lloyds created a false market in the assets, thus depressing the price. I should say that this allegation was not part of the complaint considered by the FCA, nor my investigation, so I have not considered it further in this decision.

In December 2014 Lloyds announced their intention to instigate the buy-back at par, on the grounds that the ECNs had now been discounted as capital for the purpose of regulatory stress testing. Lloyds sought approval from the Prudential Regulation Authority (the approval was, in legal terms, to approve the loss of capital resulting from the call). That decision was one for the PRA but the PRA – for good reasons, in my view – chose to consult the FCA.

Even though the focus of this complaint is the decisions from December 2014 onwards, I have included this quite lengthy background because it demonstrates that there is an extensive regulatory background, and that the regulators were well aware of at least some of the potential issues well before the bank's decision to call at par.

The specifics of the complaint

I turn now to the focus of the complaint, which is that the FCA failed to protect the ECN investors. This complaint has three main limbs. One is that the regulator should have intervened in relation to the Lloyds call at par; the second is that there was a conflict of interest associated with Karina McTeague's involvement in these matters; and the third is that the FCA's decision to exclude potential future retail investors from CoCos depressed the value of the ECNs for existing retail investors.

Failure to intervene

It is a matter of fact that that the regulator left it to the investors to decide whether or not to challenge the validity of Lloyds' decision to call at par. In the event, the investors did challenge the decision in the courts, and were successful (although the matter remains subject to an appeal).

The FCA could have intervened. In a number of letters to investors, sent in February 2015, the FCA made it clear that it had decided not to intervene, but that it was keeping the matter under review. The question for me to consider is whether the FCA's decision not to intervene was within the range of decisions which it might reasonably have made.

I have carefully reviewed the regulator's records. From these, it is clear that the FCA gave detailed consideration to the arguments for and against intervention. The key points in their consideration were as follows.

First, the FCA were aware that Lloyds' interpretation of the clause upon which they were relying for their call at par was open to challenge.

Second, it was open to the FCA to ask Lloyds to seek a declaratory judgment to settle the matter one way or the other.

Third, the fact that retail investors might lose money as a result of the call at par was not, in itself, a ground for intervention (the risk of a call at par had been apparent at the time the ECNs were issued, and even if – as you state – the risk required "deep reading" of the prospectus retail investors had been reminded of that at the time of the buy-back offer the previous year; and it was not the role of the regulator to protect investors from all risks). However, there was a danger that retail investors might be disadvantaged in comparison with institutional investors, since the latter might be able to secure a private settlement with Lloyds in a way which retail investors probably would not. One advantage of a declaratory judgment would have been to help put retail and institutional investors on an equal footing – one of the FCA's principal objectives in this matter.

Fourth, the FCA had to beware of setting a precedent: there might be many examples of ambiguous call clauses in financial instruments, and it was primarily a matter for the courts to resolve such disputes, not for the regulator. If the regulator were – in effect – to commit itself to further such interventions, there was a danger not only of significant additional costs but also significant disruptions to the operation of the market.

Fifth, the likely financial scale of consumer detriment in this matter was, while significant to the individuals concerned, below the usual threshold for the FCA's intervention.

In my opinion, all of these considerations were valid ones. The FCA carefully considered the advantages and disadvantages of various forms of intervention before reaching their decision not to intervene. They asked Lloyds to notify them of any litigation on the issue, with the purpose of ensuring that in the course of any litigation the FCA could check that retail investors were not being improperly disadvantaged.

I consider that the decision not to intervene cannot be said to have been unreasonable, the decision having been reached after careful analysis of the factors involved in a way which is consistent with the FCA's regulatory approach. I recognise that a case could have been made for regulatory intervention, but it is not within my remit to rule on the relative merits of competing arguments in cases such as these.

This matter illustrates well the difficulties of the exercise of regulatory discretion. One of the reasons why I have sought and obtained the FCA's permission to set out their analysis at some length is that – while it is essential that proper confidentiality is maintained, particularly when market-sensitive decisions are being taken – in cases such as this, where the matters are already in the open, an explanation of the rationale for decisions is an important means of testing the effectiveness of the regulator, and promoting a debate on regulatory policy. The alternative – a simple statement from me that, having studied the papers, I have come to the view that the FCA's decision was not unreasonable – does not seem to me to meet the need for transparency and accountability.

Conflict of Interest

I am satisfied from the papers presented to me by the FCA that Karina McTeague's involvement in the matter does not give rise to an *actual* conflict of interest. However, the perception of conflict arising is very important, and it is unfortunate that the FCA have put themselves in a situation in which such a perception has arisen. I recommend that, in future, the FCA is mindful of the risk of such perceptions of conflicts arising, and adopts procedures which ensure that this does not recur.

Exclusion of retail investors from CoCo purchases

I understand that you are dissatisfied that as a retail investor you were prevented from converting your holding into tier 1 additional capital CoCos. However, the Financial Services Authority (the FCA's predecessor) consulted on banning the promotion of unregulated collective investment schemes and close substitutes in relation to ordinary retail investors in the UK. On 4 June 2013 the FCA issued Policy Statement 13/03, restricting the distribution of the above schemes to retail investors, and your holding falls within that category. In August 2014 the FCA announced the introduction of temporary product intervention rules (from 1 October 2014) restricting the retail distribution of contingent convertible securities (CoCos).

In my view, it is here that paragraph 3.5 of the Complaints Scheme applies, in that a complaint about the regulators' general policies is excluded from the Scheme.

You also emphasise an apparent discrepancy between a statement made by Martin Wheatley to retail investors on 17 March 2014 and Andrew Bailey on 20 February 2015 about the nature of the PRA involvement should a CDE occur. Those two statements were as follows:

> Martin Wheatley (17th March 2014): "The final determination of whether such event [i.e. a CDE] has taken place….would be for LBG in close cooperation with the PRA."
>
> Andrew Bailey (20th February 2015): "I must reiterate that whether or not a CDE has occurred is not a decision for the PRA…..The PRA is not permitted to consider whether a CDE has occurred or whether LBG is or is not contractually entitled to redeem the ECNs."

Although this matter was not one of the the formal elements of your original complaint, and therefore was not subject to investigation, I asked the FCA for further comments on this point, to which it replied:

> 'We regret that our previous communications may have caused confusion for some
>
> consumers. By way of clarification, we note that it is a matter for the Prudential
>
> Regulatory Authority, which has taken over the FSA's role as prudential supervisor of
>
> banks, as to how LBG's capital instruments (including ECNs) are treated for prudential purposes. Whether any change in how the ECNs are treated for prudential purposes
>
> falls within the ECNs' contractual definition of a "capital disqualification event" is a
>
> question of legal interpretation that can only be decided by the courts.'

I note that the FCA accepts there may have been some confusion regarding the two statements, and expresses regret, but its answer falls short of explaining how and why such a contradiction arose.

Whilst this discrepancy does not, I believe, have a direct bearing on the gravamen of the complaint, which is whether the FCA made an unreasonable decision not to make a regulatory intervention, and whilst Martin Wheatley's statement gave consumers no guarantee about the circumstances in which LBG could declare a CDE, it is highly unsatisfactory that the then Chief Executive of the FCA should make such a loose and potentially misleading statement on a matter such as this. It is essential that where there is overlap between the operations of the PRA and the FCA, there should be no discrepancies in the description of the way in which regulation will operate. I recommend that the FCA should publicly confirm that it has learned the lesson of this issue, and has taken steps to ensure that any future statements relating to the respective roles of the PRA and FCA are properly checked.

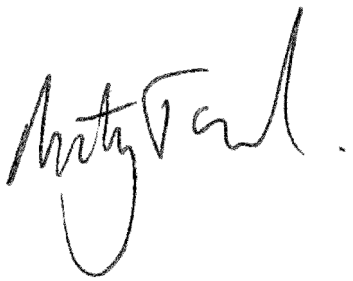
Conclusion

1. The FCA should not have excluded element one of your complaint from the scheme. For that reason, I have investigated it.
2. I am satisfied that the FCA's decision not to intervene was within the range of decisions which it could reasonably take.

3. On the matter of the conflict of interest, even though I am satisfied that the FCA's decisions were not influenced by a conflict, I recommend that the FCA should take steps to avoid putting itself into a situation where a perceived conflict of interest could arise.

4. The FCA should confirm that, in the light of the confusion which may have been caused by Martin Wheatley's statement of 17th March 2014 about the role of the PRA, for which the FCA has expressed regret, it has taken the necessary steps to reduce the likelihood of a recurrence.

Yours sincerely



Antony Townsend
Complaints Commissioner