

PART FOUR

Financial Crime

To achieve progress in combating financial crime, a regulator needs to establish a coherent organisational approach which is integrated across, and makes the most of, all of its regulatory functions. It also has to achieve close cooperation with its partner organisations and with industry.

This section of the report shows:

- **resources applied to combating financial crime (including counter-terrorist finance)**

The FSA devotes under 10 per cent of its resources to its financial crime objective. The FSA could improve the effectiveness with which it uses the current level of resources and does not need to increase significantly the total amount of resource in the short term. It could also consider the weight it gives to financial crime risks within its risk assessments (paragraphs 4.5 to 4.25).

- **integrating the FSA's work on financial crime with its other supervisory work**

The FSA has given greater emphasis to financial crime within its internal structure in recent months, consolidating three functions into a new Financial Crime Division. It did so to address concerns that financial crime issues had insufficient weight in the FSA's day-to-day supervision of financial institutions and its risk assessments (paragraphs 4.26 to 4.34).

- **the integration of the FSA's work on combating financial crime (including counter-terrorist finance) with other agencies in this field**

The FSA has recorded some important achievements in working with other UK agencies responsible for financial crime reduction in the UK. In particular it has acted as a catalyst to lead a wide range of organisations to adopt a common approach to financial crime issues (paragraphs 4.35 to 4.44).

- **the FSA's communication and information sharing with business about financial crime**

The FSA has increasingly encouraged financial institutions to adopt a risk-based approach, particularly in respect of their money laundering controls, so that institutions do not impose unnecessary identity checks on low risk consumers. The FSA's new approach has been widely applauded by financial institutions (paragraphs 4.45 to 4.51).

- **the FSA's use of its enforcement powers and penalties**

The FSA adopts a proportionate approach to using its enforcement powers on financial crime. It seeks to use criminal prosecutions and significant civil fines only for serious wrongdoing and uses a clear process of escalation to reflect the seriousness of the case. Business leaders increasingly perceive the FSA's approach as more effective than an alternative, more punitive approach, such as that taken by US regulators. (paragraphs 4.52 to 4.66).

Introduction

4.1 Under the Financial Services and Markets Act 2000 (the Act), the FSA must work to "reduce the extent to which it is possible for a [regulated] business... to be used for a purpose connected with financial crime".⁹⁰ The Act defines financial crime as including:

- fraud or dishonesty;
- market abuse (misconduct in, or misuse of information relating to, a financial market, which can be prosecuted under either a civil or criminal regime); or
- handling the proceeds of crime (or money laundering).

4.2 The FSA is the lead UK authority on market abuse and supports others on anti-money laundering⁹¹ (HM Treasury is the lead authority) and fraud (no national lead has been established).

4.3 Financial crime covers a very disparate, and evolving, set of criminal activities. It includes fraud against individuals or financial institutions, laundering the proceeds of crime through a financial institution, financing of terrorist activity through a financial institution, misuse of confidential market information (often known as insider dealing), as well as misconduct relating to markets, whether that is manipulating transactions, distorting markets or misleading behaviour that could affect the value of an investment. Financial crime also has an increasingly international dimension with the growth of cross-border criminal activity.

4.4 As a result, the FSA's work on financial crime covers a variety of circumstances, including:

- a regulated firm is unknowingly used by a third party as a conduit for financial crime (e.g. money laundering, market abuse or fraud against the firm's customers);
- a regulated firm is the victim of financial crime (e.g. fraud against an insurance firm);
- a regulated firm or person commits financial crime (e.g. market abuse); and
- a third party, that is not regulated by the FSA, commits market abuse.

In each case, the FSA is interested in the systems and controls that regulated firms have in place to prevent, detect and report any of these instances.

Allocation of resources to financial crime

4.5 Developing a coherent organisational approach to financial crime requires the FSA to:

- gain an understanding of the nature and scale of the problem, by developing estimates of crime types where possible;
- define what it aims to achieve, and develop a strategic approach which includes goals or targets and an approach to monitoring progress; and
- identify and allocate resources to the areas of highest risk.

Estimating the scale of financial crime

4.6 The FSA produced a Financial Crime Strategy in May 2006. This strategy sought to gain a better understanding of the scale and incidence of financial crime, and the impact on the UK and financial institutions.

4.7 There are inherent difficulties in producing any macroeconomic estimates of fraud, money laundering and market abuse. Research techniques used in other areas (such as surveys or gathering data from firms) are often not possible or unlikely to produce realistic data for levels of financial crime.⁹² Compared to other areas of its work, such as Financial Capability (Part 5), the FSA has taken longer to start the process of measuring and quantifying the extent of financial crime. This delay is in part due to the FSA having to rely on a network of partners for information about crime, or to produce estimates on which they can base their own analysis.

4.8 There are now several streams of activity to estimate the scale of financial crime:

- **work by the Home Office on the proceeds of crime** – the Home Office is due to publish its analysis of turnover of the organised criminal economy in the UK. This figure, based on conservative estimates of revenue for the major organised crime type such as drugs or people smuggling, totalled more than £11 billion a year and additional research suggested it may be at least £15 billion. Separately, the *Financial Challenge to Crime and Terrorism* speculates that about £10 billion is laundered through the regulated sector annually.⁹³
- **other external research** – there has also been other research and analysis in the academic and private sectors on the nature and scale of financial crime. For example, PriceWaterhouseCoopers conducts a biannual survey of firms to determine their experience of financial crime.⁹⁴ And the Association of Chief Police Officers commissioned the University of Cardiff to develop fraud estimates which conservatively estimated that fraud, excluding income tax and EU fraud, cost the UK £13.9 billion in 2005 and suggested the actual figure was likely to be a £20 billion annual loss to the UK through fraud.⁹⁵
- **the FSA's approach** – in the absence of generally accepted estimates of the levels of financial crime, the FSA has commissioned its own research in three areas:
 - **market abuse**: looks at price and other distortions in the markets ('market cleanliness').⁹⁶ The 2007 report suggested that the measure of informed trading is higher than it was before the introduction of FSMA;⁹⁷

- **fraud and money laundering:** aims to establish an agreed methodology for measurement; and
- **perceptions of financial crime:** asks firms and their Money Laundering Reporting Officers about their views on financial crime.

4.9 Until this current and planned research yields results, the FSA is not able to measure accurately its performance against its statutory objective relating to financial crime. This also means that the FSA continues to develop and implement its strategic response without a clear picture of the scale of financial crime.

Developing a strategic response

4.10 The Financial Crime strategy produced in May 2006 explained the FSA's planned approach to combating money laundering, terrorist financing and fraud. It did not cover market abuse, which remained the separate responsibility of the FSA's Enforcement Division and the Market Monitoring Department. The strategy outlined how the FSA aims to focus supervisory work on poor performing sectors or groups of firms, as well as to influence international standards for reviewing money laundering controls.

4.11 To date, the FSA has focused mostly on tackling money laundering. Its response on fraud is under development, after the publication of the government's Fraud Review in July 2006, which recommended the establishment of a dedicated National Fraud Strategic Authority. Its work on terrorist financing is also still evolving. It aims to bring together industry, government

and law enforcement agencies to develop a common understanding of how to combat the problem. But the sums of money involved are often too small for financial services institutions to detect with their current systems before an issue arises.

4.12 The FSA's strategic approach has been influenced by:

- **the rapidly changing nature of financial crime:** **Figure 14** shows three important areas of change that have affected the FSA's work to date;
- **placing reliance on industry:** the FSA believes that there are greater commercial incentives for firms to invest in systems to counter fraud than money laundering. It has therefore relied on the private sector to develop its response to fraud, while it has placed greater emphasis on money laundering.

4.13 The FSA has developed both a high-level and a day-to-day approach to measuring and monitoring progress in its financial crime work. The high level approach is incorporated into the FSA's new, organisation-wide performance system, called the Outcomes Performance Report (the Outcomes report is covered in detail in Part 1 of this report). This groups a variety of indicators and measures that relate to the financial crime objective, including: authorisations rejected by the FSA; consumer enquiries to the FSA; financial crime cases referred to Enforcement; measures of 'market cleanliness'; and number of Suspicious Activity Reports submitted by regulated firms (Appendix 4b shows the relevant measures in the Framework for financial crime).

14 Changes in the financial crime landscape

Change	Issue
Public Interest	<ul style="list-style-type: none"> ■ The profile of counter terrorist finance has risen dramatically in the UK since the July 2005 terrorist attacks in London. Developing a response to this issue, in addition to ongoing money laundering requirements, now occupies a significant amount of effort.
Jurisdiction	<ul style="list-style-type: none"> ■ Firms from newer European accession countries, such as Romania and Bulgaria, can be 'passported'¹ into the UK. This may alter the nature of the risks that some regulated firms pose in respect of financial crime.
Technological	<ul style="list-style-type: none"> ■ The widespread introduction of 'Chip and PIN' technology to bank cards has led to fraud being displaced to other methods. ■ Firms' information security systems and controls are increasingly susceptible to attack (particularly for customer details).

Source: National Audit Office

NOTE

¹ Any EU firm which wishes to carry on business in another European Economic Area State may do so if it is within the scope of a relevant EU Single Market Directive. The exercise of this right is known as 'passporting'.

4.14 On day-to-day progress, for example, staff training was a prime area of focus for the Financial Crime Sector team in 2006-07. Recently, the FSA has also developed a database for recording significant frauds reported by firms to FSA supervisors (since early 2006, this shows nearly £40 million in actual losses and £245 million in potential losses).

4.15 The 18 financial crime metrics in the Outcomes report and its other operational indicators will help the FSA to monitor its financial crime activity. It will have to review the Outcomes report to ensure that the metrics are meaningful. At a higher level, however, the FSA has not clearly defined what it aims to achieve from its financial crime work. Without some view of its target outcomes, these measurement efforts will not provide performance information to monitor progress or to inform future planning.

Identifying, and allocating supervisory resources to, financial crime risk

4.16 The FSA's allocation of resources is based on which firms or issues pose the greatest risk to its objectives. In supervising firms, the FSA calculates risk based on the impact and probability of an event taking place. Larger firms tend to take up more of its resources, because any event that occurs in a larger firm will have a wider effect on financial markets and consumers than a similar event in a smaller firm. The FSA also uses its risk dashboard to identify, rank and develop responses to market or non-firm specific risks.⁹⁸

4.17 Assessing risk to the FSA's financial crime statutory objective is problematic because of the impact of financial crime on society in general. If criminals are able to launder the proceeds of crime through a financial institution, or access finance to fund terrorist activity, the negative consequences for society are greater than the direct financial disadvantages for the institution or market. Criminal or terrorist activity with very negative outcomes for society in general could stem from large or small sums of money, and the transaction could take place in large or small firms. In terms of risk assessment, this means the size of a firm provides a weaker proxy for impact. There is debate about the extent to which the wider impact of financial crime on society should be considered as part of the FSA's statutory objective.

4.18 The FSA's assessment of the 'probability' of a risk crystallising is also very important in the area of financial crime. Smaller firms are less likely to have staff dedicated to compliance and may have fewer staff focusing on internal anti-crime systems and controls. Under new regulations, firms are increasingly able to rely on other

firms' anti-money laundering controls in chains of transactions,⁹⁹ so the importance of small firms in the anti-money laundering system increases.

4.19 The FSA deploys resources directly and indirectly across the organisation to address risk to its financial crime objective. The teams working directly on financial crime include the Financial Crime Sector Team, the Financial Crime Policy Unit and the Intelligence Department (all now part of the Financial Crime and Intelligence Division), plus a proportion of the Market Monitoring Department and the Enforcement Division.

4.20 Just as important are the indirect resources that the FSA deploys in its supervision of firms, although financial crime is just one aspect of the supervisory process. To deal with its large regulated population, the FSA has had to differentiate the level of scrutiny of financial crime issues applied to different sized firms (**Figure 15**).¹⁰⁰ Larger firms receive targeted and regular scrutiny from their supervisors. Over 20,000 smaller firms are reviewed through a computerised checking system of firms' self assessment reports. At present, there are no financial crime-related checks amongst the 24 checks¹⁰¹ the FSA carries out on the reported information. But it does carry out adhoc reviews to examine closely anti-crime awareness and standards among the small firm population.¹⁰²

15 Scrutiny of firms' financial crime controls by the FSA

Relationship managed firms (larger firms)

- Risk assessment of firm's controls (e.g. accepting customers) based on research and past knowledge of firm
- Visits to firm (interview senior management and money laundering reporting officer)
- Post-visit communication¹ to resolve issues
- Often selected for the FSA's thematic work

Medium-sized and smaller firms

- Firms submit reporting returns – these are processed with 24 'checks'
- Correspondence with firm to resolve problems
- Visits are very rare – but road shows and other targeted information are provided
- Firms sometimes selected for thematic work

Source: National Audit Office

NOTE

- ¹ For the largest firms, there is an ongoing relationship with their supervisor, and communication may be daily.

4.21 The FSA's overall approach to risk assessment of firms may not capture all financial crime risks. Although it carries out additional review work based on new risks identified, the FSA's deployment of resources, based on a firm's aggregate risk level, is weighted heavily towards larger firms. To address this problem the FSA could increase its education efforts with small firms.

Monitoring the current level of resources allocated

4.22 The FSA cannot calculate precisely the resources it devotes to financial crime. This is because time spent on supervising firms, which forms a significant part of the financial crime effort, is not recorded by statutory objective. It is made more difficult because the FSA's time recording system reports only on time allocated, and not cost of that time (Part 1).

4.23 The National Audit Office has analysed the available data on resources spent by the FSA on financial crime. We have made conservative estimates of the full resource cost using two alternative methods, with details in **Figure 16**:

- Hours of work spent by FSA staff as a proportion of total staff time; and
- Proportion of total budget, based on estimated percentage of time spent.

4.24 Using staff time data, we calculated that just under 50,000 person days (or 220 person years) have been deployed across the FSA on financial crime. Based on average staff numbers for 2005-06, this means that about eight per cent of total FSA staff time was deployed in pursuing the financial crime objective. Using the FSA's budget estimates, we calculated that the total proportion of costs dedicated to financial crime work was £25 million, just under nine per cent of gross expenditure for 2005-06.¹⁰³ Until the FSA has developed its activity based costing to more accurately identify the resources devoted to financial crime it cannot determine whether this level of resourcing is necessarily sufficient.

4.25 The FSA may not need to increase the number of staff working directly on financial crime. Instead, it can integrate this work more effectively across the whole organisation, to ensure a suitable level of emphasis across all its regulatory functions.¹⁰⁴

Integration with supervisory work

4.26 The FSA's supervisory staff have to balance a large number of competing priorities in their role. Effective integration of financial crime work into their day-to-day work relies on:

- financial crime issues having sufficient profile and weight; and
- staff developing adequate knowledge and expertise.

The profile of financial crime within the supervisory function

4.27 The FSA has four statutory objectives, and supervisors have to maintain a focus on issues such as prudential standards (e.g. credit, market, operational, insurance and liquidity risks), whether a firm is Treating Customers Fairly and the firm's business model and products.

4.28 Until the end of 2006, the FSA used an advocacy approach, with a small specialist team seeking to raise the profile of financial crime amongst supervisors and other staff across the FSA. Despite the efforts of this team when the National Audit Office survey of FSA supervisors asked about the regularity of their contact with the Sector Team three in every five respondents 'Rarely' or 'Never' had direct contact.

4.29 From 1 January 2007, the FSA has established a new Financial Crime and Intelligence Division within the Wholesale & Institutional Markets Business Unit. This should raise the profile of financial crime across the FSA. The Division will be more visible within the FSA's organisational structure, and by increasing the resource commitment (notably with an operations team to undertake more issue-based work), it signals the importance senior management attach to financial crime issues.¹⁰⁵

4.30 These structural changes should also ensure that the organisation can derive benefits from housing all financial crime issues within a single Business Unit. For example, better linkages may be possible between the two arms of intelligence gathering and analysis: the Intelligence Team and the Market Monitoring Department. It will also encourage FSA staff to take a more cohesive view of financial crime, by including anti-money laundering, fraud and market abuse together in one business unit.

16 Resources applied to combating financial crime by the FSA

Area	Approximation of resources in 2005-06 in (a) time and (b) cost
FSA – Direct resource costs	
Financial Crime Sector Team (and network)	<p>(a) 1,800 days per year (FSA estimate).</p> <p>(b) Part of the Regulatory Services Business Unit budget of £52 million. Assuming 1–2 per cent of this budget, and 100 per cent of time spent on financial crime, equates to an annual resource cost of around £0.8 million.</p>
Policy & Intelligence Department	<p>(a) 10,400 days per year (FSA estimate from i-Time recording system).</p> <p>(b) Part of the Regulatory Services Business Unit budget of £52 million. Assuming 3–4 per cent of this budget, and 100 per cent of time on financial crime, equates to around £1.8 million.</p>
Enforcement Division	<p>(a) 12,700 days per year (FSA estimate from i-Time recording system).</p> <p>(b) Divisional budget is £32.6 million and 25 per cent of time¹ is spent on financial crime. The annual resource cost is around £8 million.</p>
Market Monitoring Department (and Markets Division)	<p>(a) 3,500 days per year (FSA estimate).</p> <p>(b) Part of the Wholesale & Institutional Markets Business Unit budget of £66.9 million. Assuming 3–5 per cent of this budget, and 60 per cent of time, equates to around £1.5 million.</p>
General Counsel Division	<p>(a) 100 days per year (FSA estimate).</p> <p>(b) Part of the £32.9 million Corporate Services budget. Assuming 7–8 per cent of this budget, and one per cent of time, equates to around £0.03 million.</p>
Direct resources spent: approx 28,500 days or in the range of £12 million (crude estimate)	
FSA – Indirect resource costs	
Supervision	<p>(a) With the current systems, it is virtually impossible to gather any robust data about resources input to financial crime. A rough estimate is 10 per cent of total time, which is 15,000 days per year.</p> <p>(b) Core part of £96.3 million Retail Markets and £66.9 million Wholesale Markets budget. Assuming 75 per cent of these budgets, and 10 per cent of time spent on financial crime, equates to an annual resource cost of around £12 million.</p>
Regulatory Transactions (e.g. Authorisations)	<p>(a) Data is similarly poor, but a rough estimate of time is 4,400 days.</p> <p>(b) Part of the Regulatory Services Business Unit budget of £52 million. Assuming 15 per cent of this budget, and 10 per cent of time spent, equates to around £0.8 million.</p>
Other areas	<p>(a) Areas such as the Knowledge Management and Risk Review also contribute, but there is little data – between 200–500 days.</p> <p>(b) Assuming 1 per cent of Regulatory Services and Corporate Services budgets, and between 5–7 per cent of time, equates to around £0.8 million.</p>
Indirect resources spent: approx 19,600 – 19,900 days or in the range of £13 million (crude estimate)	
External costs	
Firms	The FSA commissioned Real Assurance to estimate administrative costs to firms to comply with regulations. ² Anti-money laundering rules equated to about 40 per cent of total costs, and over £250 million (e.g. customer identification, transaction records, and staff training).

Source: National Audit Office and FSA

NOTES

¹ This estimate appears reasonable given that the National Audit Office analysis of enforcement cases shows that financial crime related cases make up between 12 to 20 per cent of cases opened. Given these cases are often complex and time consuming, they may take more effort proportionately than other cases.

² http://www.fsa.gov.uk/pubs/other/Admin_Burdens_Report_20060621.pdf (p.5-6 and Annex 1).

Developing financial crime expertise

4.31 In 2005, the FSA recognised that it needed to provide its staff with better training and development on financial crime. It started by creating a computer-based training course for all staff to provide a basic level of knowledge. It then identified 593 staff who required more in-depth development. From mid-2006, the FSA delivered 21 intermediate training courses, reaching about 60 per cent of its target group (342 out of 593 staff). It also provided presentations on how staff should use the Joint Money Laundering Steering Group Guidance to industry, which reached 138 staff.

4.32 Given the importance of this training effort, we surveyed supervisors about their perceptions of financial crime. Two in five respondents had already attended the intermediate training course. Of these respondents, 70 per cent felt that they had ‘Often’ (14 per cent) or ‘Sometimes’ (56 per cent) been able to apply the training in day-to-day work. But under 40 per cent of respondents felt confident when reviewing a firm’s financial crime prevention arrangements, as compared to 50 per cent for a firm’s treatment of its customers, or 70 to 80 per cent for the interactions with the firm’s compliance staff and senior management.

4.33 Qualitative responses to the National Audit Office survey highlighted concerns about their work on three areas (see Appendix 4c for detailed comments):

- The profile of financial crime issues within the organisation is not high enough.
- Supervisors are not sufficiently encouraged to focus on financial crime issues.
- Training needs to be more practical and better tailored to sector or firm size.

4.34 The FSA should make use of the increased profile of the new Financial Crime and Intelligence Division to assist staff in developing their expertise in financial crime issues.

Working with the anti-crime community

4.35 The FSA is required by the Act to “take such steps as it considers appropriate to cooperate with other persons...in relation to the prevention or detection of financial crime” including the sharing of information.¹⁰⁶ Effective joint working and cooperation on financial crime is based on:

- developing strong relationships and taking a leadership role where appropriate;
- cooperation based on the powers, roles and skills sets of each organisation; and
- open sharing of information.

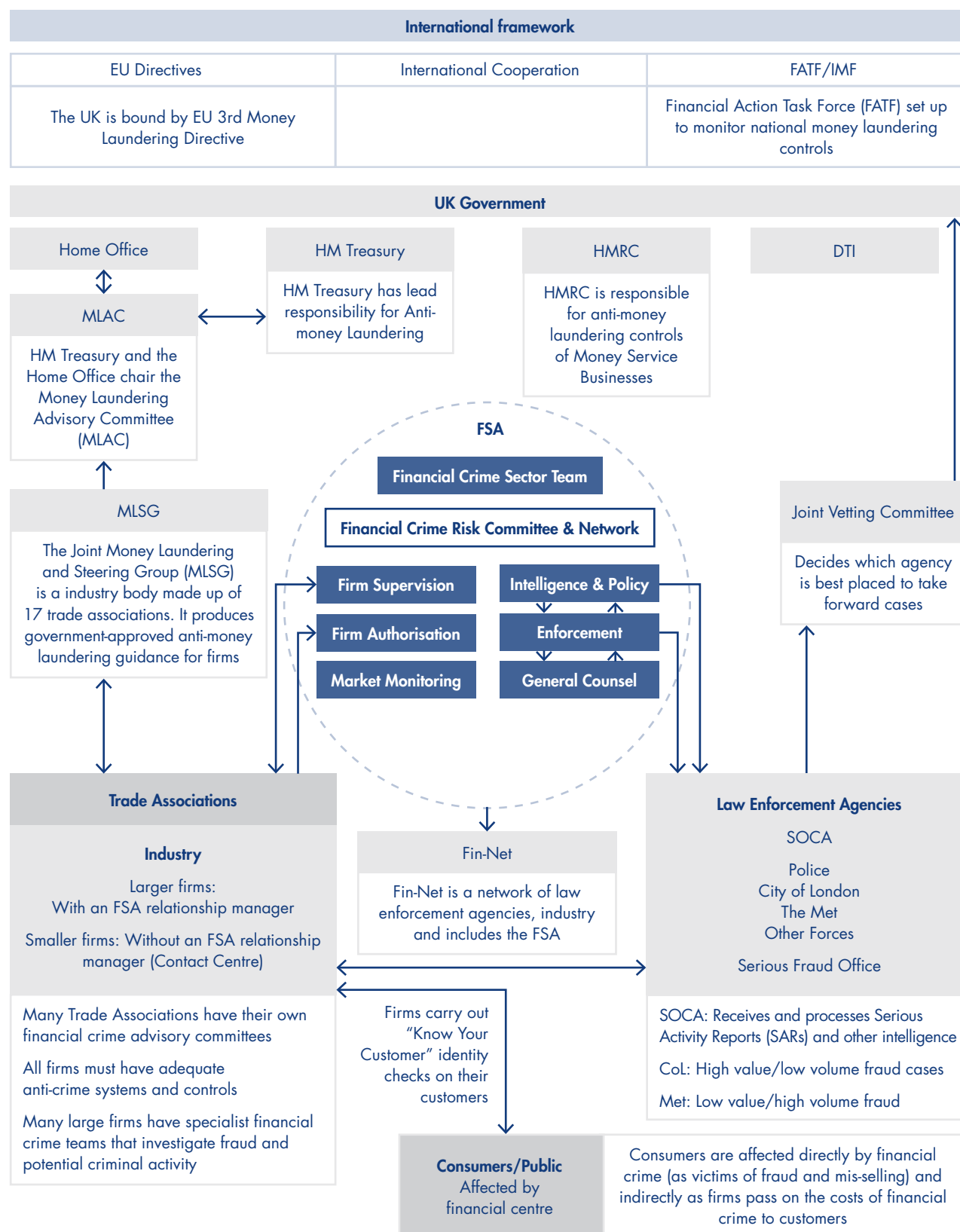
Developing strong relationships and taking a leadership role

4.36 Figure 17 sets out the relationships between the FSA and its external partner organisations. These organisations are:

- the Police
 - the City of London Police (Economic Crime Department);
 - the Metropolitan Police Service (Economic and Specialist Crime Command); and
 - other regional police forces.
- Serious and Organised Crime Agency (Proceeds of Crime Department)
- Serious Fraud Office
- HM Treasury (Financial Crime team within Financial Services Division)
- Home Office (Organised and Financial Crime Department)
- HM Revenue & Customs (Anti-Money Laundering Unit & Criminal Investigations)

4.37 The FSA, led by its Financial Crime Sector Team, has developed strong relationships with each organisation and facilitated law enforcement networks with industry. It has acted as a catalyst to bring together all the relevant parties. In discussions with National Audit Office, both law enforcement agencies and industry praised the role played by the FSA in developing a cohesive and effective financial crime community. It has pressed for a single cross-government strategy on money laundering (launched by HM Treasury in October 2004) and now fraud (launched by the Attorney General’s office in July 2006¹⁰⁷). The FSA is now addressing other issues that require a coherent approach, such as terrorist financing. It also seeks to stimulate debate on upcoming issues, such as information security.¹⁰⁸

17 The FSA's relationships with external bodies



Source: National Audit Office

NOTE

This figure shows the range of relationships between the FSA and other bodies on financial crime. The Serious Fraud Office is a government department.

Joint working and cooperation

4.38 The FSA cooperates on a day-to-day basis with law enforcement agencies on investigations, cases and other issues. The National Audit Office held interviews with its primary partners, to determine the level of joint working and cooperation. All of the law enforcement partners interviewed were largely positive about their working relationship with the FSA, particularly the Financial Crime Sector Team and the Enforcement Division. Figure 17 outlines the nature and scale of these working relationships.

4.39 Some of the partners interviewed felt that law enforcement activity could make more effective use of the FSA supervisors' in depth knowledge of the financial service industry. They also noted the inherent tension between the enforcement role of the FSA (in terms of firms' anti-crime controls) and the objective of encouraging firms to be open with the law enforcement community and report suspicions. **Figure 18 on pages 45 and 46** summarises our interviews.

Working with international regulators

4.40 Financial crime, particularly money laundering and terrorist financing, is not contained within national borders. The FSA works with a wide range of international organisations and regulatory counterparts in other countries to combat financial crime.

4.41 The FSA works particularly closely with the Financial Action Task Force (FATF), an international body that carries out mutual evaluations of member¹⁰⁹ countries' anti-money laundering regimes and determines a 'rating' of compliance with its 49 recommendations.¹¹⁰ The FSA plays a leading role within FATF, with one of its staff members working up to 90 per cent of the time with FATF on policy issues and training secondees to FATF in how to carry out evaluations (another four staff are now trained to carry out evaluations). It is also leading a FATF research project to produce guidance on how to implement a risk-based approach to managing money laundering risks.

4.42 The FSA also works closely with the International Organization of Securities Commissions (IOSCO). One of the four areas of focus for IOSCO is enforcement of securities law, and the FSA has ensured that important issues are being tackled by this group. Recent issues covered include engaging uncooperative jurisdictions and freezing or repatriation of proceeds of crime capital.

4.43 The Act requires the FSA to cooperate with, and investigate on behalf of, overseas regulators.¹¹¹ This cooperation ranges from responding to information requests (such as reviewing bank account details or identifying market trading data), to conducting interviews, providing testimony or carrying out parallel investigations.

4.44 Given the size of the financial services industries in the US and UK, one of the most active of the FSA's international relationships is with the US Securities and Exchange Commission. In its annual performance account, the Securities and Exchange Commission publishes the number of requests to and from foreign regulators for enforcement assistance.¹¹² It receives an average of 400 requests a year and makes about 350 requests. The FSA does not publish similar data. However, in our interview, the Chairman of the Securities and Exchange Commission told us that cooperation with the FSA accounts for a very significant proportion of this activity.

Working with industry

4.45 The FSA relies heavily on the cooperation of the financial services industry to support it in maintaining clean and orderly markets and in combating financial crime. Effective working with industry relies on:

- building cooperative relationships;
- proactive sharing of information; and
- providing feedback to industry.

Building cooperative relationships

4.46 Two important factors have influenced the FSA's relationships with firms in the area of financial crime. Firstly, there is an inherent tension in the FSA's role. Principle 11 of the FSA Handbook requires that "a firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice".¹¹³ For example, the FSA would expect a firm to report any weakness in its own anti-money laundering or fraud controls. On the other hand, the FSA can sanction a firm for having inadequate anti-crime controls, and failure to have the requisite systems in place can also be a criminal offence under the Money Laundering Regulations 2003.¹¹⁴

18 Working relationships with the FSA

Partner

Serious and Organised
Crime Agency (SOCA)

Proceeds of Crime
Division

Nature of working relationship

Role in financial services sector

- Responsible for Suspicious Activity Report regime on money laundering and any money laundering prosecutions

Relationship with Financial Services Authority

- Strong relationship with regular communication
- Personnel sharing (e.g. secondments), training and presentations
- SOCA provides summary Suspicious Activity Report information to FSA. FSA feeds back information on the quality of reporting from the regulated sector

Risks or potential areas for improvement in relationship

- SOCA want to encourage reporting by firms, so it is cautious about the potential for FSA to use reporting information against firms
- Potential for FSA supervisors to feed industry knowledge and expertise to SOCA

City of London Police

Economic Crime
Department

Role in financial services sector

- Financial crime investigations, predominantly commercial fraud

Relationship with Financial Services Authority

- Strong relationship with increasing cooperation and some intelligence sharing
- Main focus is support to FSA enforcement cases for searches, seizure, arrest, questioning, charging and bail (MoU signed in 2005)¹
- Shared training (e.g. search procedures, warrants and financial markets)

Risks or potential areas for improvement in relationship

- Receives no funding for support to FSA. May need to formalise relationship in future as City of London police cannot always guarantee assistance if there are other demands on resources.

The Metropolitan
Police Service

Economic & Specialist
Crime Command

Role in financial services sector

- Tends to focus on high volume, low value fraud, often working with industry on proactive prevention (e.g. frauds using Western Union)

Relationship with Financial Services Authority

- Fairly regular contact on broad issues

Risks or potential areas for improvement in relationship

- Some concern about the interplay between regulator and law enforcement in terms of incentives for firms to report – may require protocols in future
- Current focus on money laundering may direct firms' resources away from fraud

Serious Fraud Office
(SFO)

Role in financial services sector

- Complex fraud cases

Relationship with Financial Services Authority

- Good relationship, mostly with the FSA's Enforcement Division
- Both on Joint Vetting Committee which decides which agency will take upcoming cases
- FSA refer cases to SFO and SFO request information from FSA. There are no joint cases
- FSA support for Fin-Net (industry, law enforcement & regulator network) invaluable

Risks or potential areas for improvement in relationship

- Communication and information flows with supervisors sometimes difficult
- Potential for conflict between regulatory and SFO investigations

18 Working relationships with the FSA *continued*

Partner	Nature of working relationship
HM Revenue & Customs	<p>Role in financial services sector</p> <ul style="list-style-type: none"> ■ Investigation of tax-related offences ■ Anti-money laundering supervision of money service businesses and high-value dealers <p>Relationship with Financial Services Authority</p> <ul style="list-style-type: none"> ■ Good relationship with both areas of HMRC, with open cooperation ■ Intelligence sharing, cooperation on approach to supervision, and policy liaison <p>Risks or potential areas for improvement in relationship</p> <ul style="list-style-type: none"> ■ Limitations to information sharing (e.g. taxpayer database) due to limits on legal gateways ■ Approach to money laundering supervision is more visit-based than that of FSA

Source: National Audit Office interviews with FSA and law enforcement agencies

NOTE

1 City of London and FSA had 4 major joint investigations in 2006 involving 10 searches, three arrests and substantial seizures.

4.47 Secondly, previous experience has influenced the reactions of firms to the FSA on financial crime (Figure 19). The FSA has now developed a far more positive relationship with industry in terms of joint working on money laundering, particularly with the network of firms' Money Laundering Reporting Officers. It is important that the FSA ensures a similar cooperative approach is maintained if and when new, high-profile financial crime issues (such as terrorist finance) arise in the future.

Sharing information and providing feedback

4.48 The FSA relies on information provided by industry to identify potential areas of financial crime, and to maintain awareness of emerging issues. The two formal means of reporting are:

- **Suspicious Activity Reports (SARs)** – any knowledge or suspicion of money laundering/criminal proceeds must be reported immediately to the Serious Organised Crime Agency (Proceeds of Crime Act 2002 and Money Laundering Regulations 2003).
- **Suspicious Transaction Reports (STRs)** – firms must report transactions suspected of constituting market abuse to the FSA (EU Market Abuse Directive 2005).¹¹⁵

4.49 Although the FSA is not the lead agency for the SARs regime, the Serious Organised Crime Agency provides summary information to the FSA on the level and trends of SARs received from the financial services industry. Early findings from European Commission research into pan-European SARs regimes shows that reporting levels in the UK are much higher than in many other European

countries, particularly from legal professionals. Reasons suggested for this difference include higher penalties for non-reporting in the UK and several high-profile enforcement actions. The FSA carried out a review of the STR regime in 2006. It received 266 reports in the first 15 months of operation and found that firms were generally complying with their reporting obligations.

4.50 In the new risk-based and more principles-based regulatory regime for money laundering/terrorist finance, firms have the freedom to determine their own solutions to the risks they face, rather than prescriptive rules from the FSA. The FSA has focused on providing information and assurances to industry, so that firms are not inhibited for fear of enforcement action by the FSA. For example, the Financial Crime Sector Team sent two published 'comfort' letters to firms via the Joint Money Laundering Steering Group, to emphasise the FSA's "commitment to supervising in ways that promote the risk-based approach".¹¹⁶ The FSA's Markets Division has responded to requests from firms by producing a self assessment tool in November 2006, which suggests questions that a firm could run through. Further clarification has been provided by the FSA in speeches to industry; for example the FSA's Chief Executive's address to the Financial Crime Conference in January 2007 emphasised what the FSA expects of firms, focusing on the creation of a strong culture towards controls and effective scrutiny of financial crime risks and improved information sharing.¹¹⁷

4.51 Despite the positive relationships with industry and the wealth of information interchange, a number of firms and industry representatives told the National Audit Office that they would like more feedback and guidance from the

19 High profile anti-money laundering fines issued by FSA

In 2001, the FSA launched an investigation into the anti-money laundering controls at 23 banks in the UK with accounts linked to General Abacha, the former President of Nigeria.¹ At 15 of the banks, it found significant control weaknesses, which the FSA considered demonstrated that much of the sector had not adequately responded to the Money Laundering Regulations 1993. High profile fines were imposed on high street banks from 2002 to 2004 to sanction those with poor anti-money laundering controls.

Date	Firm	Fine (£ million)	Breach
17 Dec 2002	The Royal Bank of Scotland plc	£0.75m	Customer identification and record keeping
7 Aug 2003	Northern Bank	£1.25m	Customer identification
10 Dec 2003	Abbey National plc Abbey National Asset Managers	£2.0m £0.32m	Control weaknesses, reporting and customer identification
15 Jan 2004	Bank of Scotland plc	£1.25m	Customer identification records

There were, however, unintended consequences of this enforcement approach. Firms reacted to what they saw as a highly prescriptive approach from the FSA. Many banks implemented a 'tick-box' approach to complying with their money laundering obligations, particularly 'Know Your Customer' requirements.² Consumers bore the burden of this change, facing what they considered irritating requests for multiple items of identification on both new and existing basic accounts.

By 2004, the FSA saw that the industry was focusing unduly on the identification part of customer due diligence, and began efforts to communicate a change in emphasis to firms. This became known as "defusing the ID issue". The FSA brought together industry, government, law enforcement and consumer stakeholders to develop more realistic standards and pledged that enforcement action against a firm would be considered only if there was evidence of "particularly aggravating circumstances".

It worked with the Joint Money Laundering Steering Group to revise its industry guidance, which was formally endorsed by Treasury in February 2006. This coincided with FSA abolishing its detailed rules in the Money Laundering sourcebook and replacing them with high-level provisions for senior management controls. From September 2006, the UK money laundering regime was officially a risk-based regime. This means that senior management of firms have to understand their exposure to money laundering (and terrorist finance) and then decide how they establish and maintain requisite anti-crime systems and controls to address those risks.

Source: National Audit Office

NOTES

1 The FSA investigation identified 42 personal and corporate account relationships linked to Abacha family members and close associates in the UK. Turnover on the 42 accounts amounted to US\$1.3 billion for the four years between 1996 and 2000 (<http://www.fsa.gov.uk/pages/Library/Communication/PR/2001/029.shtml>).

2 FSA Money Laundering Rules (no longer in existence), rule 3.1.3, "firm must take reasonable steps to find out who its client is by obtaining sufficient evidence of the identity of any client who comes into contact with the relevant firm to be able to show that the client is who he claims to be".

FSA on what the risk-based regime will mean in practice. Smaller firms particularly want more feedback, as they have less compliance infrastructure than larger firms to deal with new information. There may be scope to provide more practical guidance to firms in this transition period, such as peer benchmarking or worked examples.

Using enforcement

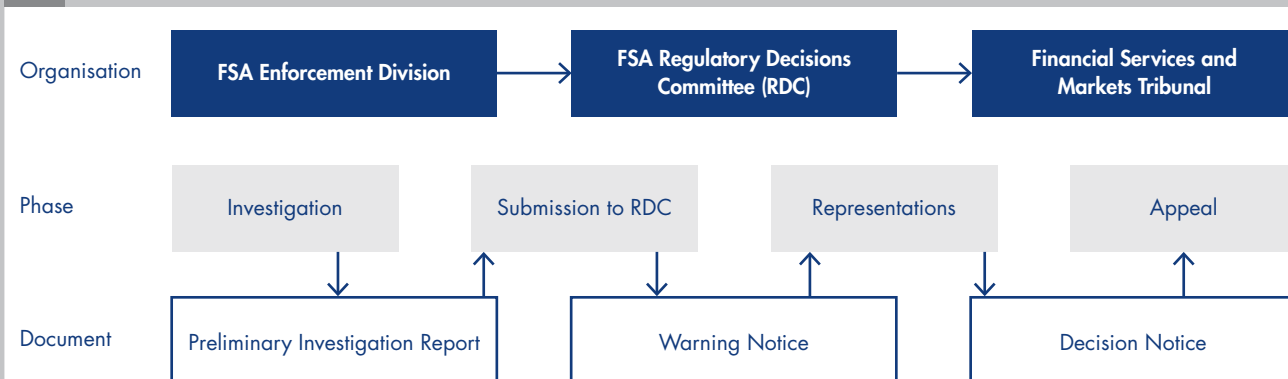
4.52 The FSA's enforcement role supports the organisation's four statutory objectives. The terms of reference provided to the National Audit Office for this review, however, focus on enforcement only in relation to financial crime.

4.53 The Act gives the FSA power to investigate and take enforcement action against regulated firms ("authorised persons") and regulated individuals ("approved persons") for specific offences or rule breaches. It also has wider

power to take action against other persons in instances of market abuse and breaches of listing rules.¹¹⁸ The FSA can pursue criminal prosecution¹¹⁹, civil process, or regulatory enforcement, depending on the nature of the problem. The penalties available range from public censure and withdrawal of a firm or individual's authorisation to financial penalties; and criminal sentences (**Figure 20 overleaf** shows the FSA's enforcement process).

4.54 Enforcement is one of a range of tools available to deal with non-compliant behaviour. Eight per cent of the FSA's total budget goes to the Enforcement Division, which has 270 staff. The FSA cannot and does not seek to pursue every potential case but aims to use it selectively in support of its priorities and strategic objectives. To achieve this aim it must identify and handle enforcement cases and set penalties in a proportionate way.

20 FSA enforcement process



Source: National Audit Office

4.55 The FSA's proportionate approach is reflected in the following key activities:

- integrated intelligence and detection;
- a strategic picture of enforcement priorities and a clear prioritisation process for selecting cases and powers to be used;
- adequate throughput of cases; and
- monitoring and self-review.

The intelligence gathering function

4.56 Intelligence is an important resource for any regulator, for example in assessing risk and where it has a law enforcement role. Information, often of a selective nature, has to be collected and reviewed systematically from both within and outside the organisation.

4.57 The FSA has two main areas that gather intelligence related to financial crime: an Intelligence team and a Market Monitoring team. Their different roles are outlined in **Figure 21**. In the past, the two areas have been separated but from 2007 both are within the Wholesale and Institutional Markets Business Unit.

4.58 The FSA reviewed both elements of its intelligence function during 2006 and produced an Intelligence Strategy in July 2006. There are four issues influencing the ongoing effectiveness of the FSA's intelligence-gathering function:

- Consistency of systems for handling intelligence – the FSA has now established a dedicated team to receive, log and distribute intelligence.

- Internal flow of intelligence and information – The National Audit Office survey of supervisors included questions about interacting with the intelligence gathering process. Although at least four out of every five respondents were Clear or Somewhat Clear as to which teams within the FSA they should pass sensitive information or intelligence, nearly half said they Rarely or Never pass on such information.
- Legal constraints to information sharing – in our discussions with the FSA and other law enforcement bodies, concerns were raised about legal restrictions on information sharing with government departments, for example HM Revenue & Customs.
- Investment in IT systems – the Intelligence team told the National Audit Office that there is a lack of connectivity between some intelligence systems. The FSA is, however, investing heavily in a significant upgrade to its transaction monitoring system. The current report storage system is being replaced by SABRE II, which will allow sophisticated analysis of market data and trading patterns.¹²⁰ The FSA has noted, however, in its analysis of MIFID that the increase in the number of independent trading platforms expected to enter the market could make it harder to monitor market abuse.¹²¹

Enforcement priorities

4.59 Each year the FSA determines its enforcement focus in terms of types of cases and sectors, which it describes in the annual report. The FSA has five enforcement priorities for 2006-07, one of which relates to financial crime (market abuse).¹²²

21 Roles of the FSA's intelligence teams

Team	Role	Size
Intelligence (within Financial Crime and Intelligence Division)	<ul style="list-style-type: none"> ■ Responsible for gathering intelligence from outside sources and across the FSA ■ Manages the 'SIS' database, used by other regulators and agencies in UK and beyond ■ Deals largely with law enforcement agencies, government and other regulators 	33 staff
Market Monitoring (within Markets Division)	<ul style="list-style-type: none"> ■ Responsible for monitoring transactions and reviewing transaction reporting from firms, for market abuse or manipulation¹ ■ Manages 'SABRE' market monitoring system² ■ Conducts initial review of intelligence, to screen for cases that require further action ■ Formal referral process with Enforcement Division ■ Deals predominantly with firms and FSA 	40 staff

Source: National Audit Office

NOTES

1 There are often varied sources of intelligence for the different types of market abuse. An announcement-related price spike could trigger an Insider Dealing enquiry, a Misleading Statement will relate to an announcement or rumour in the market, and Market Manipulation will typically rely on tip-offs from the market about certain activity.

2 The FSA's bespoke securities and transactions database.

4.60 The FSA then has a case by case prioritisation process which is applied at the operational level. It uses 12 questions to assess the merits of prioritising any individual case. The FSA's case load is then reviewed regularly by a group of senior managers to ensure that its enforcement choices are suitable and being pursued appropriately in terms of:

- cases which are of significance in the priority areas;
- type of case (criminal prosecution, civil proceedings, or regulatory enforcement); and
- penalties and sanctions (public censure, variation or withdrawal of permission to carry out certain activities, financial penalties or criminal sentences).

Case throughput

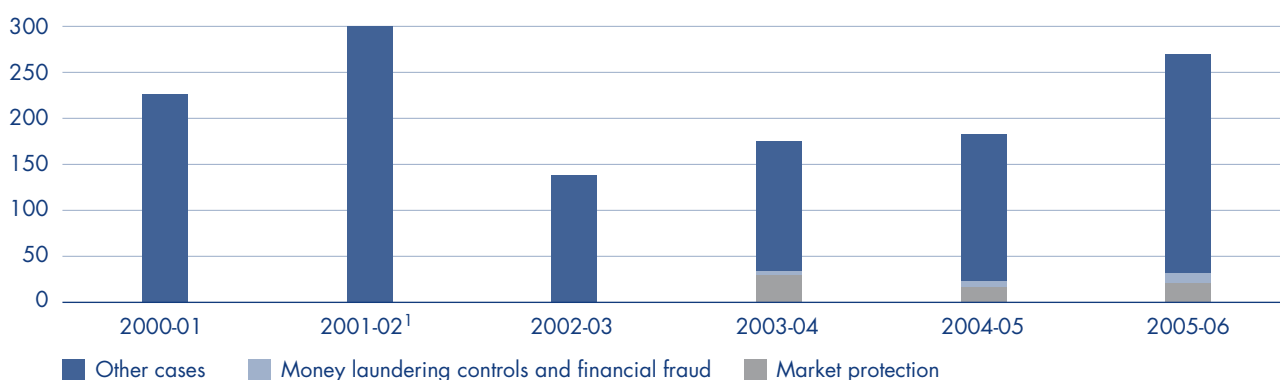
4.61 After a peak in 2001-02, when it took on the enforcement caseload of the self-regulatory organisations that merged to form the FSA, the FSA has opened an average of 200 cases each year. **Figure 22 overleaf** shows market protection¹²³, money laundering controls and financial fraud cases make up between 12 and 20 per cent of case opening volumes. This reflects the additional complexity and resources involved in these types of case. In 2005-06, out of a total of 269 cases opened, 22 cases related to market protection and 10 to money laundering controls and financial fraud.

4.62 Overall, the FSA converts approximately two in every five enforcement cases it opens into formal action against the firms or individuals involved and took formal action in 81 cases in 2005-06 against the firms or individuals involved. In 2005-06 the FSA closed 30 financial crime related enforcement cases. In 43 per cent of these cases there was no case or no further action was taken. Seventeen per cent resulted in a fine and 10 per cent in a conviction/sentence. Criminal cases require a significant investment of resources and involve longer timescales. The FSA is working to develop its criminal investigation capacity to enable it to pursue criminal as well as civil cases, for example by recruiting criminal lawyers, ex-police officers and other investigative specialists.

4.63 Financial penalties are not issued in all cases where the FSA takes action. In 2005-06, 17 cases involved financial penalties totalling £17.4 million, £14 million of which was for one market protection case and £505,000 related specifically to financial crime. Although market abuse and money laundering cases account for only a small proportion of total enforcement cases they generally account for a relatively high percentage of the total financial penalties issued (**Figure 23 overleaf**). The FSA has publicly indicated that it expects to impose higher penalties in the area of market abuse and insider dealing in the interests of achieving effective deterrence.

22 Enforcement cases opened by the FSA between 2000-01 and 2005-06

Number of cases opened



Source: FSA and National Audit Office

NOTES

- 1 The total figure for 2001-02 is 444 cases.
- 2 Segmented data is only available from 2003-04.

4.64 Enforcement outcomes generate significant publicity and can play a significant role in making consumers and the industry aware about issues of concern. The FSA can therefore use enforcement outcomes as a way of changing behaviour and achieving effective deterrence. It may also use information on enforcement outcomes to increase consumer knowledge and understanding of the financial services markets. As the FSA's approach develops, so it may adapt its use of enforcement. For example, as it becomes a more principles-based regulator it may increasingly enforce on the basis of a breach of one or more of its Principles of Business.

Monitoring and self-review

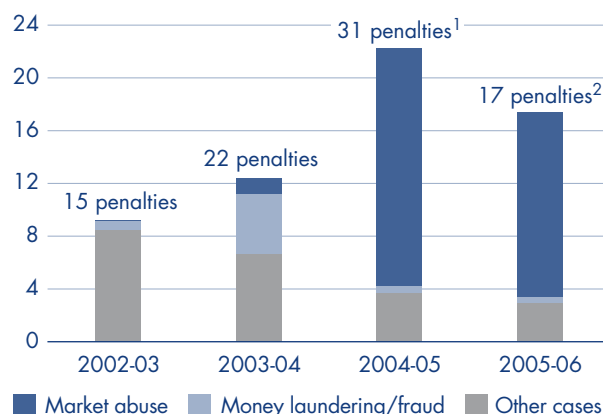
4.65 The FSA has a lower enforcement case volume than some other financial regulators. In the US, for example, in the financial year 2006 the Securities and Exchange Commission (SEC) initiated 914 investigations and separately filed 218 civil proceedings and 356 administrative proceedings.¹²⁴ The proportion of case types does, however, appear to be similar between the FSA and the SEC. The SEC aims to pursue between 12 and 15 per cent of its caseload in market manipulation and insider dealing cases. This is a similar proportion as the FSA caseload in these areas. The FSA's enforcement case volume reflects its supervision-led approach in which enforcement is regarded as only one of the tools for dealing with non-compliant behaviour and resources are allocated accordingly.

4.66 The FSA could explore the feasibility of benchmarking itself against international peers to give it a better understanding of what suitable enforcement

goals it could establish in terms of case types, throughput, timescales and even staffing of the enforcement function.¹²⁵ This sort of comparative work, whilst very difficult to carry out, may help confirm whether the levels of resourcing of enforcement in the UK match the relative size and importance of its financial markets.¹²⁶ It may require the FSA to encourage other regulators to produce outcome-focused market measurements so it can determine which would be the most suitable comparators.

23 Financial penalties issued by the FSA

£ million



Source: FSA

NOTES

- 1 Includes £17 million penalty imposed on Royal Dutch/Shell.
- 2 Includes £13.96 million penalty imposed on Citigroup.