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Fine Outcomes
Making better use of regulatory fines

Marcus Corry and Graham Mather

November 2013

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"I can also announce that further awards from the Libor banking fines have gone to good military causes, with money for Combat Stress to help veterans with mental health issues and funds for Christmas boxes for all our troops on operations this year and next…Those who have paid fines in our financial sector because they demonstrated the very worst values are paying to support those in our armed forces who demonstrate the very best of British values."

Chancellor George Osborne

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Fines

Background

1. This study considers fines levied by financial and economic regulators; the incentives which apply, the effect of the fines and the relative merits of fines compared with other forms of measure including direct consumer redress.

2. Regulators have concurrent competition powers with the OFT and the incoming CMA, but this study is limited to those fines imposed under sectoral powers and does not extend to enforcement actions imposed under competition powers.

3. Current enforcement frameworks of five key regulators – Financial Conduct Authority, Ofcom, Ofwat, Office of Rail Regulation and Ofgem – place an emphasis on fines to address regulatory breaches.

4. A number of issues arise including:

    i. the methodology for assessing and levying fines;
    ii. the uses to which fines are put;
    iii. patterns of fines across the sectors and recent trends;
    iv. other forms of penalty, redress or compensation and their comparative merits.

5. The objective of this study is to examine the role of fines in the regulatory structure and to offer some suggestions on future policy approaches drawing on a comparative examination of current practice.

The powers of the regulators

6. Britain's economic regulators were established at the outset of privatisation. The "independent" model of regulation which they represent is admired internationally and has been transplanted to many other countries.

7. To fulfil their statutory duties at arm's length from Government, regulators have powers including to impose sanctions on companies and in some cases upon individuals.

8. These enforcement powers have been developed in regulatory statutes in the absence of an overarching cross-sectoral framework. Despite similarity in the statutes, this has allowed a level of variation to develop within the powers and approaches of the five regulators featured in this report.

9. The Financial Services Authority and its successor the Financial Conduct Authority (**FCA**) have the power under the Financial Services and Market Act[1] to impose a financial penalty or to publish a public censure against an approved person or firm. The FCA also has the power to vary or cancel an authorized person's permission[2] and similarly has the power to prohibit individuals who are not fit and proper from carrying out functions in relation to regulated activities[3].

10. Importantly the FCA has the further power to apply to the court for a restitution order or alternatively has the administrative power to require restitution[4]. FCA retail enforcement actions therefore include a redress element for consumers, with most redress packages secured without the need to seek restitution orders. In 2012 the regulator secured in excess of £150 million in redress for consumers.

11. The FCA can ultimately prosecute a range of criminal offences in England, Wales and Northern Ireland[5].

12. The powers of **Ofgem** are set out in the Gas Act 1986, the Electricity Act 1989 and the Enterprise Act 2002. The regulator has the power to impose a financial penalty[6], the power to make interim orders and under its principal objective and enforcement powers has accepted other measures in lieu of

[1] Financial Services and Market Act 2000, sections 63, 66, 123, 131, 205 and 206

[2] Financial Services and Market Act 2000, section 45

[3] Financial Services and Market Act 2000section 56

[4] Financial Services and Market Act 2000, section 382 and section 384

[5] Financial Services and Market Act 2000, sections 401 and 402

[6] Gas Act 1986, section 30, and Electricity Act, section 27

penalty, notably consumer redress.[7] Ofgem has imposed nominal penalties on regulated utilities to take account of voluntary redress packages for consumer packages. It does not, however, currently have the power to compel consumer redress packages.

13. Ofgem is currently undertaking a full review of its current enforcement and penalty powers which will include considering how to apply the new powers of consumer redress which Ofgem has sought from Government and which will be secured via the Energy Bill currently going through Parliament. The penalty policy will be reviewed as part of this process. The new consumer powers are broad and enable Ofgem to order companies to take actions which Ofgem considers necessary to remedy the consequences of a licence breach.

14. With the rail sector, under the Railways Act 1993, where the **ORR** is satisfied that a licence holder is contravening a condition of its licence, it must issue an enforcement order, unless the act is covered by one of a number of exceptions[8]. An order "*may include a reasonable sum"* to be paid by the licence holder for failure to comply with the order.

15. The ORR uses these powers to issue contingency penalties with specified targets and a corresponding sliding scale of fines. However the ORR may also levy a financial penalty for breach of licence even if it does not issue an order.

16. The Water Industry Act 1991 empowers the regulator Ofwat with its enforcement sanctions. **Ofwat** is under a duty to impose an enforcement order where it believes that there has been, or is-going a breach of obligations, except where the breach is "trivial"[9]. Where there has been a breach the regulator can impose a financial penalty[10].

17. *In extremis* and with the consent of the Secretary of State, Ofwat can apply to the High Court for a special administration order. The High Court can only make a special administration order where (a) it is satisfied that there has been or is likely to be a contravention of a principal duty or an enforcement order that is serious enough to make it inappropriate for the company to continue to hold its appointment or licence; or (b) the company is or is likely to be unable to pay its debts.

18. **Ofcom** acts under a number of Acts of Parliament and other legislation. These include the Communications Act 2003, the Wireless Telegraphy Act 2006, the Broadcasting Acts 1990 and 1996, the Digital Economy Act 2010 and the Postal Services Act 2011. Ofcom is the regulator for the UK communications industries, with responsibilities across television, radio, postal, telecommunications and wireless communications services.

19. **Ofcom** has a number of broad fields of regulatory oversight with separate powers for each field. Firstly, under the Communications Act 2003, it is responsible for enforcement of broadcasting standards, as outlined in the Broadcasting Code. When a broadcaster has deliberately, seriously or repeatedly breached the Code, Ofcom has the power to impose a statutory sanction. There are a range of sanctions including issuing a direction, making a broadcasting correction, imposing a fine and ultimately revoking the licence. It is also responsible for the implementation of the EU Electronic Communications Directives, and is the regulator and competition authority for telecommunications in the UK.

20. Secondly, Ofcom also has responsibilities to enforce consumer protection laws[11]. Ofcom has a range of regulatory remedies available to correct the behaviour of operators. These include issuing notifications, securing formal undertakings from companies, imposing a financial penalty and seeking an injunction or order from the courts.

21. Finally under the Wireless Telegraphy Act 2006 Ofcom is responsible for regulating legal use of the UK radio spectrum and preventing illegal broadcasting. Under the legal framework Ofcom has the power to seize equipment, to issue suspension notices against manufacturers and marketers of illegal

[7] Gas Act, section 28 and Electricity Act, section 25

[8] Railways Act 1993, section 55

[9] Water Industry Act, section 18

[10] Water Industry Act, section 22A

[11] Communications Act 2003

apparatus, and if necessary bring criminal proceedings. Since 2011 Ofcom has had the power to issue fixed penalties for breaches[12].

22. From the outline of the legislative frameworks it is evident that the broad 'tool kit' of sanctions available to the regulators is largely alike: Regulators have the ability to compel regulated companies to carry out a certain course of action, whether through enforcement orders, notifications or censures. Furthermore, as one of the more severe tools in the kit, regulators all share the power to impose financial penalties.

23. However there is a significant level of disparity surrounding the specific powers conferred in relation to financial penalties. It is evident that some of the regulators have been granted a lot more flexibility over these powers.

24. Furthermore the FCA alone enjoys separate parallel powers to impose financial penalties and enforce consumer redress packages respectively: in contrast to the enforcement actions of the other regulators, which merges financial penalties and consumer redress packages.

Regulatory guidelines

25. The variation in specific powers of enforcement is reflected in the differing approaches set out in the regulators' guidelines as to how they implement their enforcement frameworks. This is particularly noticeable with the most visible sanction available to regulators: financial penalties.

26. The **FCA** enforcement guide book[13] outlines a list of factors which the regulator will rely upon when establishing whether to impose a financial penalty. These include the nature, seriousness and impact of the suspected breach and the conduct of the individuals involved. If the breach was deliberate, frequent or sustained and resulted in a significant benefit to the company then a financial penalty is likely to be imposed.

27. The FCA guidelines state that the penalty-setting regime is based on three principles:

    i. Disgorgement: to ensure the company does not benefit from breaches
    ii. Discipline: to ensure a company is penalised for wrongdoing.
    iii. Deterrence: aiming to prevent future breaches.

28. This has led to a two stage process as to how the FCA determines the level of a financial penalty: the first stage is to strip the company of any benefit attained from the breach. The second is an additional figure to reflect the seriousness of the breach, taking account of any aggravating or mitigating factors[14].

29. In parallel with financial penalties, the FCA will use its restitution and redress powers to secure redress packages in retail actions, for consumers who have been detrimentally impacted by the breach. The Penalty Policy of Ofgem [15] sets out the criteria when deciding whether it would be appropriate to impose a penalty. Factors tending to make the imposition of a financial penalty more likely than not include whether the contravention or the failure has damaged the interests of consumers or other market participants, and whether to do so would be likely to create an incentive to compliance and deter future breaches. Factors tending to make the imposition of a financial penalty less likely than not include whether the contraventions were of a trivial nature; whether the principal objective and duties of the Authority preclude the imposition of a penalty; and whether the breach or possibility of a breach would not have been apparent to a diligent licensee.

30. The **ORR** guidelines take account of the six penalty principles set out in the Macrory report *Regulatory Justice: Making Sanctions Effective*[16]. The ORR enforcement framework has one main objective: to change the behaviour of the company so as to deter non-compliance.

[12] The Wireless Telegraphy (Fixed Penalty) Regulations 2011

[13] The Financial Conduct Authority Handbook DEPP Chapter 6.2 : Deciding whether to take action

[14] The Financial Conduct Authority Handbook DEPP 6.5 Determining the appropriate level of financial penalty

[15] *Utilities Act Statement of policy with respect to financial penalties,* October 2003*,*

[16] Macrory, *Regulatory Justice: Making Sanctions Effective*, 2006

31. Where it is decided that a financial penalty is to be imposed the ORR guidelines sets out three principles for consideration.

    i. Proportionality
    ii. Adjustments for mitigating and aggravating factors
    iii. Financing duty

32. In assessing proportionality the issue is one of seriousness, looking at the actual and potential harm to third parties and the culpability of the offender, including whether the licence holder had acted negligently, recklessly, knowingly or intentionally.

33. The ORR enforcement framework sets out five levels of seriousness, with a corresponding range of penalties up to a statutory cap of 10% of the annual turnover of the company. The penalty ranges are indicative ranges as might apply to the monopoly track.

    i. De minimis breaches normally result in no penalties.
    ii. Less serious breaches carry penalties up to £2 million.
    iii. Moderately serious breaches warrant a penalty between £2 - £10 million.
    iv. Penalties for serious breaches fall within the range of £10 million and £25million.
    v. Very serious fines lead to fines over £25 million up to the statutory cap.

34. The adjustments for mitigating and aggravating factors allows reductions for any steps which have been taken to remedy the breach or for co-operation with the ORR, while allowing increases for the inappropriate involvement of any senior directors or repeated and continuing infringement. The list is not exhaustive and other factors can mitigate or aggravate the offence and sanction.

35. The ORR has a financing duty to act in a manner which does not make it unduly difficult for a network licence holder to finance those activities, however the enforcement guidelines make it clear that where the ORR has decided it is appropriate to impose a financial penalty "it would be inappropriate not to do so just because this would make it difficult for an inefficient operator to finance its functions."

36. **Ofwat** has likewise embraced the Macrory principles in its approach to enforcement: which is set out in the guidelines "*Ofwat's Approach to Enforcement"*.

Table 1
Ofwat's Approach to Enforcement

If we find that a contravention has occurred, we will consider what the appropriate sanction to deal with the contravention is. Our decisions on appropriate sanctions will be informed by the Macrory principles. • A sanction should aim to change the behaviour of the offender. • A sanction should aim to eliminate any financial gain or benefit from non-compliance. • A sanction should be responsive and consider what is appropriate for the particular offender and the regulatory issue. • A sanction should be proportionate to the nature of the offence and the harm caused. • A sanction should aim to restore the harm caused by regulatory non-compliance where appropriate. • A sanction should aim to deter future non-compliance.

37. In determining whether financial penalties are the correct sanction, the guidance simply states that if Ofwat is "satisfied that a company has contravened or is contravening a condition or licence…we can impose a financial penalty." A decision to impose a penalty will be taken in light of an assessment on the seriousness of the offence and the policy objectives of securing compliance and increasing the deterrence effect across the sector.

38. As with its legislative powers, **Ofcom** has a different set of guidelines for each of the three different regulatory frameworks[17]. The guidelines for broadcasting breaches state that a sanction will normally be imposed when Ofcom considers that a broadcaster has "seriously, deliberately, repeatedly, or recklessly breached a relevant requirement". The regulator will decide which sanction is appropriate "after considering all the evidence and the representations of the broadcaster". If it is decided that a financial penalty is appropriate then Ofcom will determine the amount of the penalty with consideration to a number of factors, as set out in the *Penalty Guidelines*. These factors include the degree of harm caused, the duration of the breach, any gain resulting from the breach, any steps taken to remedy the breach and the extent to which the contravention occurred intentionally or recklessly, including the extent to which senior management knew. This list is not exhaustive and Ofcom will also take account of previous similar action and the level of co-operation from the company.

39. The guidelines for consumer and competition breaches highlight that where the regulator has investigated a breach and decided that a financial penalty is appropriate it will first issue a Section 96A notification which can propose a fixed amount penalty in respect of a past contravention and where the contravention is ongoing a daily penalty until the breach is remedied. Ofcom will consider any written or oral representations made, and any steps taken to ensure compliance or to remedy the consequences of the breach in deciding whether to confirm the penalty. The amount of penalty will be set in accordance with the Penalty Guidelines, as outlined above.

40. Finally, in relation to its regulation of radio spectrum, Ofcom announced a new process last year which introduced a sliding scale of action. Illegal use of radio spectrum will automatically result in a notification of breach, to be followed by a fixed penalty of £100 if no action is taken within a specified period. Ultimately, if after a reasonable opportunity, no action is taken then Ofcom can either revoke the licence or initiate criminal proceedings, as appropriate.

41. The outline of enforcement guidelines highlights a notable degree of conformity between the regulators in relation to the factors which are considered when determining the amount of penalty.

42. However, as with the legislative frameworks, there is significant disparity in the guidelines as to when a financial penalty should be imposed, or which factors should be considered in deciding whether a financial penalty is appropriate.

The purpose of financial penalties

43. The ultimate purpose of financial penalties is to ensure compliance with a set standard of behaviour. However the variations in the legislative frameworks and enforcement guidelines have resulted over the past two decades in the regulators developing their own approaches, each with its own focus.

44. The **FCA**'s enforcement framework makes it evident that financial penalties are reserved as a means of punishment and deterrence. Financial penalties are not concerned with, and are not a substitute for, consumer compensation. This is dealt with separately, in the parallel consumer redress and restitution actions.

45. In contrast **Ofgem** has also used its powers to accept other measures in lieu of a penalty to impose nominal penalties, in lieu of consumer redress packages. Therefore it is evident that the financial penalty framework here is concerned with restitution and not based solely on punishment.

46. The power to impose contingent fines signifies that the basis of **ORR**'s financial penalty framework is primarily on compliance; fines are threatened to ensure a change in the behaviour of the company. Where fines are imposed the scope for redress offered by the regulated company is taken into account as a mitigating factor.

[17] Ofcom has set out its guidelines for Broadcasting Standards in the *Procedures for the consideration of sanctions in breaches of broadcast licences*; the guidelines for consumer and competition regulatory enforcement are contained in the *Enforcement Guidelines; Ofcom's guidelines for the handling of competition complaints and complaints concerning regulatory rules*; and the enforcement guidelines for use of radio spectrum are set out within Ofcom's *Enforcement Report; A report on Ofcom's approach to enforcement and recent activity*. Where is has been decided under the above three guidelines that a financial penalty is to be imposed, this is in accordance with the *Penalty Guidelines s392 Communications Act 2003*.

47. Conversely the guidelines by **Ofwat** suggest that the regulator's approach to sanctions is much broader and concerned with redress and restitution, as well as punishment in the form of disgorgement of any gain and deterrence. Furthermore it is evident that, in contrast with the FCA framework, financial penalties are applied as an alternative to other sanctions, and not in parallel.

48. As with the other regulators, the use of penalties within the **Ofcom** regulatory frameworks is linked to punishment of breaches, but the use of daily penalties for a contravention which is ongoing, highlights a greater emphasis towards deterrence.

49. It is clear therefore that financial penalties are being used by each of the regulators to achieve different end goals. This lack of uniformity has led to a varying record of financial penalties across each of the sectors.

50. It is however worth noting that when determining the level of financial penalty there is a shared focus on the culpability of the offender and the level of harm caused by the breach. This can be seen in the fact that financial penalties are increased for reckless or deliberate breaches, and for on-going or persistent breaches. Conversely penalties are reduced for negligent acts and for breaches which have been mitigated through steps to remedy any harm caused, or through co-operation with the regulator.

Use of sanctions

51. As financial penalties are only one of the sanctions made available to regulators under the legislative frameworks, it is first worth placing fines into context alongside the other sanctions available. This study looks only into the financial penalties imposed under regulators' sectoral powers and not those under competition legislation.

52. With the **FSA** there was a joint focus on financial penalties and consumer redress packages. On one hand, in the three years up to 2011/12, the FSA imposed just over £206 million of financial penalties. In the same period the regulator secured consumer redress packages exceeding £260 million.

53. As illustrated in Table 2 the FSA experienced the most dramatic increase in the use of financial penalties. Penalties issued by the FSA dwarf penalties issued by the other regulators.

54. The FSA also secured 15 criminal convictions and issued 174 prohibitions of individuals in the years 2009 – 2012.

55. The regulator **Ofgem** has made wide use of the various sanctions available. Over the past three years the energy regulator has concluded a number of investigations against regulated utilities with the publication of an open letter or with the decision to accept binding commitments from the company.

56. Ofgem has furthermore made use of financial penalties, with a sharp increase for the year 2011/12, when financial penalties totalled £15.4 million. In the past year however the regulator has made greater use of its powers to accept measures in lieu of a financial penalty: in May 2012 Ofgem imposed a penalty against EDF Energy of £1 to take account of a £4.5 million consumer redress package.

57. The **ORR**'s duty to take enforcement action has led to eight actions being taken by the rail regulator since 2007/2008. Three of these actions resulted in financial penalties, totalling £19.4 million. The others resulted in final orders, with binding action plans.

58. An interesting development within the ORR regulation is the use of contingency penalties which are imposed for failure to achieve the targets outlined in the final order. In 2012 an ORR judgement against Network Rail included payment of a penalty should the company fail to meet its commitments, set on a sliding scale of £1.5 million for each 0.1 of a percentage point that it falls below its target.

Table 2
Record of Financial Penalties

Regulator	Year	Number of Penalties	Value of Penalties
Ofcom			
	2011/12	12	3,569,120
	2010/11	4	449,750
	2009/10	8	516,898
	2008/09	23	8,098,500
	2007/08	13	4,210,000
FSA			
	2011/12	142	74,600,000
	2010/11	N/A	98,500,000
	2009/10	N/A	33,000,000
	2008/09	N/A	27,300,000
Ofgem			
	2012/13	3	11,000,000
	2011/12	7	15,400,001
	2010/11	5	9,200,000
	2009/10	1	2,000,000
	2008/09	2	3,000,000
	2007/08	1	25,000
ORR			
	2012/13	1	1,500,000
	2011/12	-	-
	2010/11	1	3,000,000
	2009/10	-	-
	2008/09	1	14,000,000
	2007/08	1	2,400,000
	2006/07	1	250,000
Ofwat			
	2011/12	-	-
	2010/11	-	-
	2009/2010	-	-
	2008/2009	3	45,542,000
	2007/08	2	28,800,000
	2006/07	1	150,000,000

**** For year 2012/13 ORR issued an order on Long Distance performance which could mean the contingent reasonable sum could be in order of £75 million if performance does not improve.***

59. The regulator **Ofwat** has over the past few years decided not to impose financial penalties. In the two financial years of 2007/08 and 08/09, Ofwat imposed £74.3 million in financial penalties. In contrast, for the years 2010/11 and 2011/12 no penalties were imposed, with sanctions instead consisting of voluntary consumer redress packages and price reductions for the next pricing cycle.

60. Finally, with regards to the communications regulator **Ofcom**, the enforcement of sanctions has varied within each of the regulated fields. Within the broadcasting framework there has been 43 penalties

imposed for breaches of the Broadcasting Code in the years 2008/09 to 2011/12. At the same time there have been 3 financial penalties for consumer and competition breaches and no penalties for illegal use of radio spectrum.

61. Over the same period Ofcom issued 13 broadcasting directions, reduced one licence by 12 months and revoked the licence of Bang Media Ltd, for breaches of the broadcasting code. The regulator's consumer and competition team furthermore issued 21 notifications of breach, secured 3 binding undertakings, resolved 21 regulatory disputes, issued one statement of objectives and initiated one civil court action. Finally, for unlawful use of the radio spectrum, Ofcom has seized hundreds of illegal apparatus sets and searched dozens of addresses. The first fixed penalties for illegal use were issued last year.

62. It is evident from the outlined record of enforcement action, by all the regulators, that there is now a wide range of sanctions which are relied upon by the economic regulators within their respective regulatory frameworks.

63. It is also evident that there is wide use of non-financial sanctions, but that these sanctions take different forms depending on the regulator. Ranging from price cycle reductions, to revocation of licences and binding undertakings.

64. Furthermore it can be noted that, with varying degree, the regulators are increasingly shifting to the non-financial penalties, and diversifying their enforcement records.

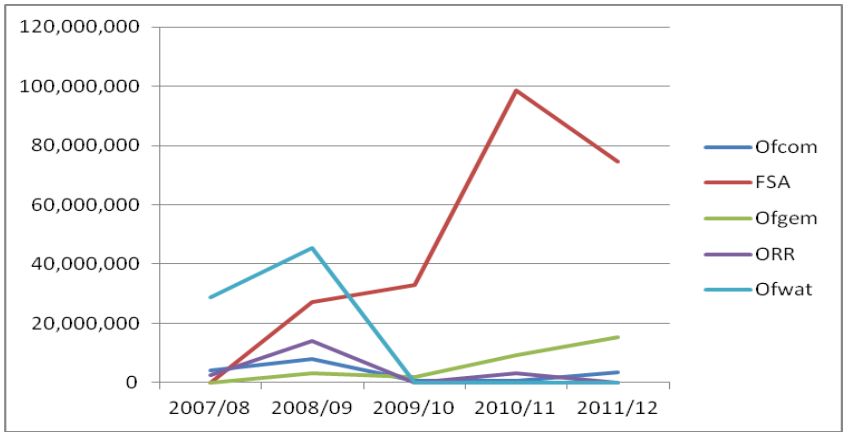
65. Nevertheless, especially with the FSA, there has been a significant reliance upon financial penalties as a major enforcement tool.

Financial Penalties

66. The outline of enforcement actions highlights that the degree to which regulators rely upon financial penalties varies between regulators. This is unsurprising given the different objectives which each of the regulators are looking to achieve in imposing financial penalties.

67. The varying use of financial penalties is more clearly illustrated in Table 3, which outlines the recent trends in fines by each of the regulators.

Table 3
Comparative Trends

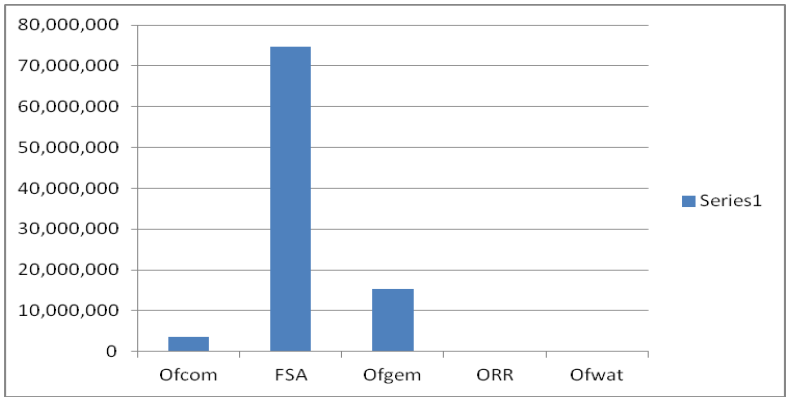


68. It is immediately apparent from this table that the FSA's use of financial penalties has been much greater than the other regulators, and that there has been a huge increase in the level of financial penalties imposed in recent years. However this should be put in context; there has been a similarly dramatic increase in the size of consumer redress packages in recent years.

69. Furthermore Table 3 highlights that the increase in FSA fines is not reflected across the board, with decreases in the fines levied by Ofwat and ORR. This is offset by an increase in non-financial or consumer-focused sanctions.

70. Table 4 shows the total financial penalties imposed by the regulators for the year 2011/12. This re-iterates the anomalous position of the FSA and the drop in financial penalties imposed by the ORR and Ofwat.

Table 4
2011/12 Totals

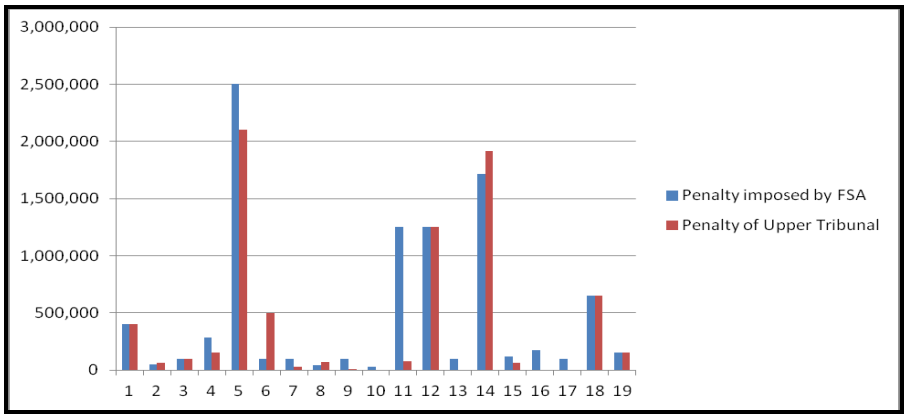


What happens on appeal?

71. Fines and other enforcement measures imposed by the regulators are subject to appeal.

72. In the case of financial services, since 2010 appeals are referred to the Upper Tribunal (Tax and Chancery Chamber), established by the Tribunals, Courts and Enforcement Act 2007. Prior to this, appeals were heard by a dedicated appeals body, the Financial Services and Market Tribunal. It handled 47 appeals from the FSA in the period from 1st April 2011, of which 22 concerned financial penalties. A table showing the results of the appeals is set out at Table 5. Those involved in the operation of the financial services enforcement systems tell us that in practice that they consider the Tribunal to make relatively minor changes to the fines by the regulator itself.

Table 5
Appeals to the Upper Tribunal (Tax and Chancery Chamber)



73. The majority of FSA appeals were upheld in substance by the tribunal, and the tribunal's approach to appeals has been said to exhibit a significant level of trust in the competence of the former FSA committee to set the correct level of penalty. The table does however show that where financial penalties have been adjusted, the Tribunal has increased, reduced and even quashed the penalty imposed by the FSA.

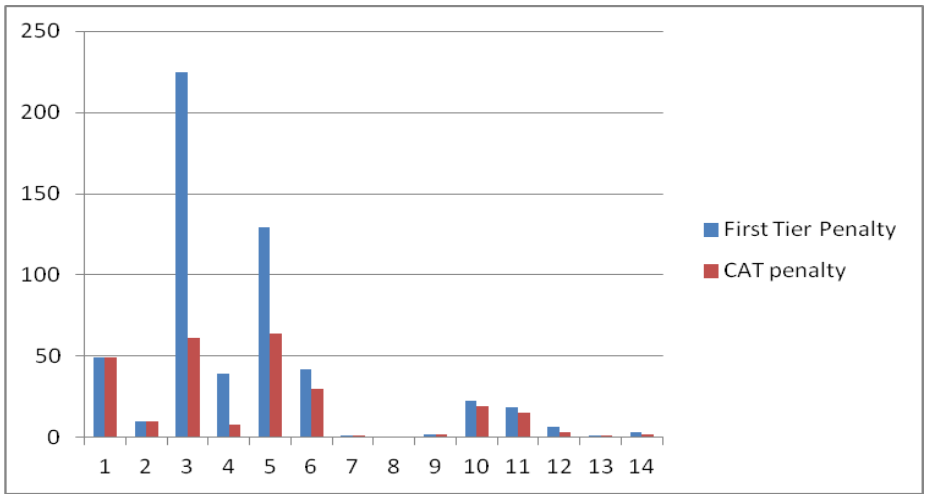
74. In the case of the economic regulators appeal lies to the Administrative Court by way of judicial review. To date there has only been one judicial review of a penalty imposed by the regulators.

75. This relates to a £130,000 penalty imposed by Ofcom on Satellite Entertainment Ltd, based upon issues concerning apparent bias and Article 1 of Protocol No.1 to the ECHR: this judicial review process is currently ongoing.

76. Although this study does not extend to direct examination of the penalties imposed for breaches of competition law the Competition Appeals Tribunal provides a useful benchmark in the way it treats penalties arising from decisions made by the Competition Commission or the Office of Fair Trading, or the economic regulators when using their concurrent competition powers.

77. A table of its recent decisions in such cases is at Table 6

Table 6
Appeals by the Competition Appeals Tribunal (£m)



*Note: This table does not include roofing cases

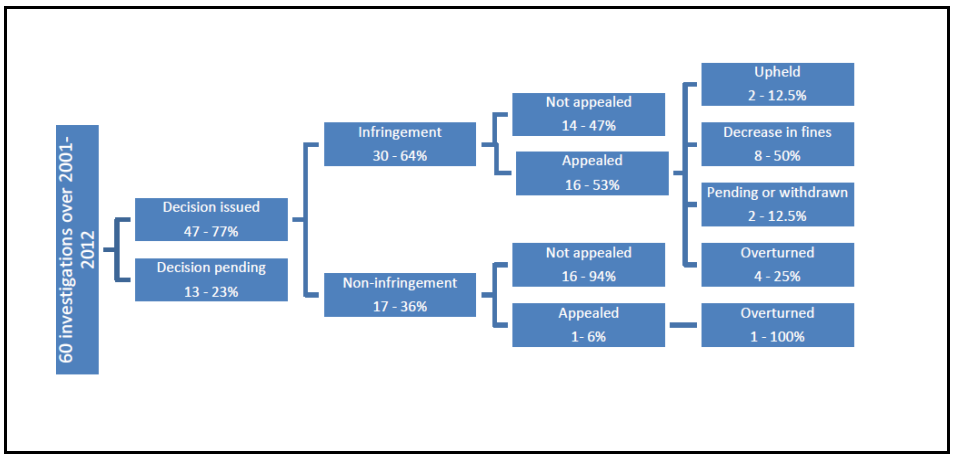
78. The table shows that on no occasion has fines been increased and in some circumstances they have been substantially reduced.

79. Due to the overlap between sectoral and competition powers, it is worth noting that appeals on fines imposed under the competition powers have resulted in a high percentage of fines being decreased. In one particular case not only was the fine reduced by half by the Competition Appeals Tribunal, it was further reduced by half by the Court of Appeal. This trend in appeals could create a perverse incentive for companies to appeal. Government is currently reviewing the appellate frameworks, with an on-going consultation into how best to streamline regulatory and competition appeals[18]. The consultation document outlines the Government's belief that it would be more beneficial for a single appeal body to hear regulatory enforcement appeals. Rather than allowing both the High Court and the CAT to hear these types of appeals, as is currently the case, Government is asking whether respondents agree there should be a single body hearing enforcement appeals, and asking whether this body should be the High Court or the CAT. While the European Policy Forum welcomes this reform as a means of streamlining the enforcement framework, the perverse incentive for companies to appeal will continue if the single appeals body maintains the trend of almost always lowering, and never raising, penalties under its review.

80. Such potential for perverse incentive is further drawn out by a closer examination of the investigations carried out by the Office of Fair Trading. Table 7 shows the outcome of investigations by the OFT over the past decade.

[18] HM Government, Streamlining Regulatory and Competition Appeals: Consultation on Options for Reform, 19th June 2013

Table 7
Outcome tree of OFT investigations listed in Public Registry, 2001 - 2012[19]



81. The table shows that only 12.5% of fines are upheld on appeal, with half resulting in reductions and a further quarter quashed altogether. This situation has the significant potential to undermine or weaken the deterrent effect of fines imposed by regulators.

The issues at stake

82. What is the purpose of the enforcement and fining systems operated by regulators?

83. The differing rationales of fines are illustrated well in the FCA's five steps for penalties: i) Disgorgement, ii) Seriousness of the breach, iii) Mitigating and Aggravating Factors, iv) Adjustment for deterrence and v) Settlement discount.

84. At one level therefore fines are intended to be credible deterrence – an attempt to adjust trends of behaviour in regulated sectors and prevent future non-compliance. There is clearly also a punitive element - to deter requires a punitive sanction and a number of regulators have set out how they attempt to calibrate this. The level of penalty is linked in all regulatory frameworks to the conduct of the companies and seeks to annul any commercial incentive to breach regulations. However the crime and punishment perspective of fines is increasingly looking out-of-date in the modern commercial regulatory environment, with most breaches being non-intentional oversights rather than deliberate acts.

85. Another element of fines, though more visible in the penalties of the economic regulators, is to provide some recompense to society or to those affected by the misconduct. This has proved a challenging issue for regulators, who have in some instances developed parallel systems of explicit consumer redress alongside traditional fining and enforcement sanctions.

86. This is a rich area for a further study as there are indications that a number of regulators are in the process of shifting from traditional fines to consumer redress and would like to go further.

87. The question is interconnected with the decision as to where financial penalties levied for misconduct end up. The decision in turn has incentive effects. One option is for fines to be **retained by the regulator** concerned and used in its general work. This provides an obvious and perverse incentive for regulators to increase fines especially if the result is a net increase in their operational funding; that is to say if it is not sterilised by adjustments from public funds or from other levies on industry used to finance the regulator concerned.

88. Because of these incentive difficulties the trend in recent years has been to shift the payments so that they are **retained by HM Treasury** and not taken into account in the financing of the regulator concerned. While this effectively sterilises the fines and removes the more obvious perverse incentives it does not answer directly some further problematic issues arising from fining policy.

[19] Veljanovski, C., *The Deterrent Effects of the UK Competition Act 1998,* 2013

89. It has also created the situation whereby financial penalties can represent money being taken out of the industry, at the expense of investment, to be given to HM Treasury. This is particularly applicable in the case of fines imposed on Network Rail by ORR.

Fines become routine

90. One challenge which arises is that **fines may become routine**. There are indications that in the United States, where financial penalties on financial services businesses are longer established and tend to be larger than those in the United Kingdom fines are seen as a cost of doing business. Large international banks expect that they may be found guilty of breaches of financial services regulatory norms, that the financial costs involved will be factored into the cost of doing business, and that in some cases due to the prevalence of fines and the wide range of financial services businesses caught by them there is no particular moral oblique in being seen to have been fined.

91. This is of particular concern given that fines are only beneficial to consumers, under the current regime, where they have preventative effect and incentivise future compliance by the regulated companies.

92. Furthermore a recent study on the deterrent effects of OFT investigations estimate about how to be better supplied by questions whether fining provides the level of deterrence that is often assumed by regulatory authorities[20].

93. The study found that fines imposed to date by the OFT were not likely to deter companies, from their low values: the report estimated that over the past decade the average penalty for abuse of dominance was £3, the penalty for contemplating price fixing was £60 and the penalty for engaging in an anti-competitive agreement was £196.

94. The study further highlighted that business confidence in its knowledge about competition law appears to be weak, especially among small firms.

Passed through to consumers

95. Another challenge facing regulators is how to ensure that fines are not in **practice passed through to customers** in higher prices or reduced standards of service. This challenge is difficult especially where the regulator concerned does not operate any form of price control. In such circumstances it may be only press and public attention which can be expected to be effective in preventing those guilty of infringements from passing through the costs.

96. This issue arose recently in the United Kingdom when banks which are partially owned by the taxpayer were fined in relation to the Libor scandal.

97. In these cases the risk was not simply that the fine could be passed to the consumer but that if it remained with the owner that would be the taxpayer, in the role of taxpayer-shareholder, and the fining policy would mean that taxpayers money would end up back in HM Treasury as a financial penalty: a form of round-tripping which would appear at the same time to be self-defeating and also lacking any moral power or credible deterrent effect.

98. To address this question the Chancellor of the Exchequer announced that *"I can also announce that further awards from the Libor banking fines have gone to good military causes, with money for Combat Stress to help veterans with mental health issues and funds for Christmas boxes for all our troops on operations this year and next…Those who have paid fines in our financial sector because they demonstrated the very worst values are paying to support those in our armed forces who demonstrate the very best of British values."*[21]

99. Similarly the Government is proposing to transfer all revenue from collective actions taken by Which? to the legal charity Access for Justice. These collective actions are in addition to fines imposed by the FSA.

100. Even this approach however may not meet an ideal set of incentives. Clearly charities, especially service charities, enjoy high esteem in public opinion and can be considered very worthy. They are

[20] *Sic* at 19

[21] Rt Hon George Osborne, Chancellor of the Exchequer, Budget Speech 2013

however not closely related to those in the markets who have suffered loss as a result of misconduct. One of the consumer bodies described the recent shift of fines revenue to military charities as a political, rather than an economic solution, which failed to follow the rational argument that the people to benefit should be those who had suffered detriment.

Forms of compensation

101. An alternative advocated by a large number of consumer representatives is for the revenue from fines to be directed much more closely towards to the consumers who have suffered from the breach. There has been a steady growth in the number of consumer compensation schemes across the sectors, putting the consumer interests more centrally in the enforcement framework. A notable example is the Delay Repay scheme within rail which secured a total compensation package of £9,549,000 for consumers in 2011/12 alone.

102. The effectiveness of direct compensation to consumers will be impacted by the level of consumer awareness. In the case of rail the level of awareness over entitlement to compensation for late services is low, which inevitably weakens the impact of Delay Repay and related schemes. Companies should therefore be under an obligation to notify consumers, in line with the obligation on airlines to notify passengers of compensation entitled for late flights under EC Regulation 261/2004. With rail notices could likewise be displayed at ticket machines stating "*If your train is delayed for more than x hours, ask the customer services for the details of your rights, particularly with regard to compensation and assistance*."

103. The diversion of revenue from financial penalties to consumers would not necessarily need to be in the form of cash payments. Whether this approach would be feasible for all sectors is unclear: the regulator Ofcom noted that in the case of broadcasting standards breaches, it would be very difficult to quantify the detriment and even more difficult to identify the consumers who had been affected. In the cases where it is not possible to identify those consumers directly affected the revenue could be passed to consumers through benefits in kind, such as enhanced infrastructure investment.

104. There are already precedents for this type of remedy: in 2010 Ofwat waived a financial penalty for South West Water to recognise that the company had provided cash compensation for those directly affected by the breaches and invested in targeted infrastructure schemes for those exposed to the wider effects of the breaches.

105. Similarly in 2012 Ofgem imposed a nominal penalty of £1 on EDF Energy to recognise that the company had agreed to make payments of £4.5 million consumer to benefit consumers as an acknowledgement that it did not reach the expected standards.

106. The fear for consumer bodies with this approach is that companies must not be permitted to reap public relations gains from such enforcement action. This is particularly applicable in those sectors, such as rail, where there is poor consumer awareness over consumer rights and companies' compliance records. It was therefore encouraged that where this approach is adopted the consumer redress package or infrastructure investment must be specific and visible: revenue must be targeted at a certain class of consumers or into a specific project, and not into the company funds for discretionary application.

107. Furthermore, to combat the fear that financial penalties are becoming seen to be routine with little impact on the behaviour of companies, consumer bodies have proposed much greater use of individual penalties, as opposed to company fines.

108. It is also sometimes suggested by consumer representatives that greater impact could be made on the behaviour of companies if regulators were prepared to make greater use of individual criminal powers and sanctions. However it was noted that the role of management, the importance of corporate responsibility and the nature of some regulatory breaches, will mean that company fines will often be more appropriate.

The EU context

109. This discussion on fines, and the issues raised within this paper, is not limited to the UK.

110. In a recent paper by Bruegel, entitled *Do European Fines deter price fixing?*[22], it is questioned whether the objective of cartel fines, "to ensure the maximum level of deterrence while introducing the least possible market distortion", is currently being secured.

111. The analysis found that the wholly deterrent rationale of cartel fines was insufficiently realised in the fines imposed by the Commission to date. The report concluded that "increases in fines are not necessarily the best way to go. Targeting the corporate executives who are responsible for cartels could be a medium to long term objective which could complement corporate fines and ensure a higher level of deterrence."

112. In other words, there have been calls for similar diversification of enforcement tools at the EU level, even where the objective of the fining regime has been identified solely as for deterrence.

113. The call for greater use of individual fines directly reflects the calls of consumer bodies here in the UK, and the shift towards greater diversification is in parallel to the greater diversification of tools applied by the UK regulators.

114. The EU discussion is not examined in depth within this paper but it again highlights that the issues at stake are common concerns throughout fining regimes.

Do new powers have the potential to address these issues?

115. In the majority of enforcement actions brought by regulators, the imaginative solutions to consumer redress have relied upon companies accepting voluntary undertakings in substitution of fines. Regulators are able to create incentives, such as nominal penalties, but cannot enforce such an outcome.

116. A number of consumer bodies have expressed concern at the unequal powers across the regulators, particularly the fact that many regulators lacked to power to compel consumer redress packages, as the FCA is able to do.

117. This raises the issue of whether new powers for regulators are needed to ensure a regulator can enforce such an outcome where appropriate. The Department for Energy and Climate Change has consulted on a proposed new power for Ofgem to compel regulated energy businesses to provide redress to consumers. The consultation closed in July 2012 and the power is now within the Energy Bill going through Parliament.

118. Standardising powers would ensure consumer focus across the regulators and allow greater proportionality between the breach committed and the type of sanction imposed, so that breaches which cause consumers the greatest harm result in sanctions which are much more consumer-focused.

Greater diversification

119. The common theme emerging from both the recent trends in regulators' fines and the calls by consumer councils is the need for regulators to diversify their enforcement actions.

120. This diversification relates not only to the nature of the fine, and whether it there should be greater use of personal fines, compared to corporate fines. It also relates to the purpose of fines: the balance between deterrence and recompense.

121. With the exception of the FCA, which separates fines from consumer redress packages, fines by regulators merge the deterrence and recompense elements of enforcement actions. Even in the case of the FCA the indirect impact on consumers should ensure some element of recompense within the fine.

122. There is variation between the regulators as to the balance of scales between these two elements, but in recent years there has been a shift, most visible in Ofwat, in regulators' approach to fining.

[22] **Mario Mariniello,** *Do European Union Fines Deter Price Fixing?*, Bruegel policy Brief, May 2013

123. The greater use of nominal fines and fines being waived in lieu of recompense measures, whether cash or infrastructure investment, illustrates a growing diversification within fining policy beyond a narrow deterrence focus.

124. Given this emerging trend, it was questioned whether there could be benefit in the economic regulators separating financial penalties from consumer redress measures, in line with the FCA model. This would ensure a more formal diversification between the deterrence / punitive and consumer recompense elements of financial penalties.

125. Notably it is felt in the consumer world that these recompense packages can have a much greater deterrence effect than fines. The PPI scandal and ensuing redress for consumers, which has led to banks setting aside £14 billion, was highlighted as a prime example where focusing on consumer redress, rather than financial penalties, had resulted in the biggest change of behaviour.

126. Furthermore, one consumer council felt this approach to be tricky, with the potential to harm consumers. On one hand by removing their fining powers, it could weaken the team which oversees consumer recompense during negotiations, and on the other hand it could lead to companies trying to limit consumer redress packages as much as possible, due to concerns about getting hit twice.

Conclusions

127. Fines by Britain's regulators have become of major significance in recent years. Over the period studied in this report, Britain's major regulators, the Financial Conduct Authority, formerly the Financial Services Authority, Ofcom, Ofgem and Ofwat and the Office of Rail Regulation have imposed penalties totalling over £500 million.

128. This report has asked some questions about the use of fines. What is their primary purpose? Some regulators use them for punishment of wrongdoing or for deterrence. Others have changed their emphasis from financial to non-financial sanctions. Some regulators have explicitly told offending companies that they can give redress to their customers instead of paying a fine which ends up in the consolidated fund at HM Treasury.

129. As this report shows, regulators have differing statutory frameworks which affect the penalties they can levy. The McCrory guidelines, however, represent a general approach arising from the recommendations of a report commissioned by the then Chancellor of the Duchy of Lancaster, John Hutton, which secures some measure of consistency.

130. The Department for Business, Innovation and Skills should factor this into the work on improved joint working between the regulators, especially as it currently analyses its response to the "Streamlining Regulatory and Competition Appeals: Consultation on Options for Reform[23]".

131. If regulators are looking to change a system in which large sums of money are transferred from utility businesses to HM Treasury's consolidated fund, the Chancellor of the Exchequer himself is clearly aware of this difficulty. In recent financial market infractions, he has ensured that fines have gone to military causes, with money for combat stress and funds for Christmas boxes for troops on operational duty.

132. These changes show that the financial penalties of the traditional model look increasingly outdated and irrelevant. A particularly striking issue arises when banks which have been rescued with tax payer funds are fined for misconduct. The risk is that funds given out of one pocket by the taxpayer roundtrip back into another pocket of HM Treasury.

133. Relatively little work has so far been done on the effect of financial penalties on the businesses which are subject to them.

[23] Streamlining Regulatory and Competition Appeals: Consultation on Options for Reform, Department for Business, Innovation and Skills, June 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229758/bis-13-876-regulatory-and-competition-appeals-revised.pdf

134. Do corporate executives treat fines as a grave matter in circumstances where these have become relatively common occurrences (routine)? Especially in the financial sector fines may be seen as a routine cost of doing business in a heavily regulated area where many banks and financial institutions have infringed both misconduct and mis-selling rules.

135. Are regulatees sufficiently concerned by reputational risk to adjust their behaviour and hence reduce future infringements?

136. If fines are failing to make any significant impact on firms, their reputations or their revenues, and increasingly becoming a series of monetary round trips to HM Treasury, the system has clearly become an ineffective and worthless means of enforcement. In light of such fears consumer bodies have been calling for a shift in focus within the fining regime to put individuals at both Board and executive level under the spotlight.

137. The obvious benefit of a fining system in which the proceeds are remitted to HM Treasury is that it avoids conflicts of interest for regulatory authorities. Because they do not receive a benefit from the fines themselves they have no incentive to ramp up an unnecessarily onerous penal regime designed to boost their budgets. Yet notwithstanding this clear benefit, opinion is moving towards a system in which fines are replaced by consumer redress packages. Instead of paying a fine to HM Treasury a utility business may be required to invest in a particular area of its operation, to enhance customer benefit; to adjust its tariff to benefit customers; or even to compensate customers directly who have been affected by an infringement.

138. The transformation of fines into customer benefits means that a newer form of penalty, one which is seen to give some behaviour redress to customers, is more likely to be used as a regular feature of the regulators' tool kits.

139. Regulated businesses would not welcome the unlimited expansion of these powers. There are obvious incentives on regulators to become active in identifying infringements if the result can be to improve perceived benefits to customers. A well-desired appeal for them may be one way of checking any such impulses.

140. To date there is scarcely any appeal activity in the courts from businesses subjected to regulatory fines. In the parallel area of fines imposed for breaches of competition law some 25 appeals against penalties have been brought before the Competition Appeal Tribunal in recent years; in no case has a fine been increased. This phenomenon, which is the subject of a current government review, may have provided incentives to litigate by those fined. An appeal in this environment, it has been argued, is a one way bet - constrained only by the cost of going to law and the potential that costs may be awarded against a meritless appellant.

141. The common theme which emerges from this report is that there would be benefit in a wider range of techniques to punish infringements and misconduct.

142. Financial services regulation is the pioneer in this field with a larger number of cases and a greater volume of fines. Lessons suggest that shifting from corporate institutions to fines on guilty individuals is a more focused effective a persuasive remedy. It singles out those guilty of wrongdoing. Of its nature it requires a high standard of proof. It guards against fines becoming anonymised and routinised in large corporations. It provides a clear warning to others not to commit wrong doing. It is also self-policing as the higher standards of proof in practice provide guard against any perverse incentives for regulators to make a general increase on fining of companies.

143. Similarly, the ORR has established a link between the enforcement record of Network Rail and the company bonuses for executives: under the current management incentive plan, the pot available for bonuses under the long term incentive plan relates to a measure of the company's financial performance, from which any financial penalty is deducted. This could be strengthened by deducting fines revenue directly from the bonus pot, rather than the period turnover.

144. Additionally , given that all those appointed to public Boards (and in financial services into significant executive roles too) must pass the 'fit and proper' test, there could be benefit in establishing a system

for monitoring and registering details of the individuals responsible for the breach in terms of executive responsibility. Executives who fail these tests could face the ultimate sanction of being banned from working in a particular regulated market.

145. It is also desirable for regulators to continue the shift which has become apparent from fines paid to HM Treasury to the greater use of nominal fines or fines being waived in favour of recompense measures. These may be cash to customers or investment in infrastructure. Direct compensation will always be the most appropriate and proportionate response to a breach which causes direct harm on identifiable consumers. Where it is not possible to identify individual consumers then collective redress through measures such as price reductions or additional investment in infrastructure, for the group or class of consumers most likely to be impacted presents a much more rational and forward thinking approach to enforcement than the transfer of fines to HM Treasury. There are already many examples of regulators taking such steps.

146. Consumers would need to know that they were benefiting from enforcement action, in order to strengthen deterrence and prevent offending companies gaining a false public relations advantage from the remedial measures.

147. The emerging phenomenon that fines are diverted to charitable good causes such as military charities makes political sense but suffers from an obvious disconnect. It does not benefit these whose interests have been damaged by licence breaches or mis-selling. It should be replaced by sustainable long term approaches. The government's proposal to transfer revenue from collective actions taken by Which to the legal charity Access for Justice, examples using proceeds for a more closely related purpose. In the medium and long term consumer bodies are developing a more detailed methodology to deploy funds as closely as possible to the groups of consumers who have been damaged by misconduct.

148. Government is beginning to think about the future organisation of regulation, just as it has been considering the future of the system of regulatory appeals. Factoring new thinking about the best way to penalise misconduct, shifting from the old fining approach paid to HM Treasury to a new approach compensating customers and supporting charities linked to the sectors affected is a valuable potential way forward.

Recommendations

1. **Fining companies in breach of regulatory requirements and then sending the revenue to HM Treasury no longer carries public credibility. It should be phased out.**

2. **Where senior corporate executives are responsible for regulatory breaches, they rather than the company itself should be subject to financial penalty. Additionally breaches and those responsible should be monitored registered. Executives who fail these tests could face the ultimate sanction of being banned from working in a particular regulated market.**

3. **Especially where taxpayers are involved in the business, executive bonuses should be targeted and financial penalties initially met from bonus pools, before targeting general corporate resources.**

4. **Many regulators are already shifting their emphasis from fining companies to requiring them to give customer redress. This approach should be expanded especially as evidence suggests that putting things right for consumers directly affects company behaviour.**

5. **Other regulators should adopt the approach of Ofgem and Ofwat and waive fines replacing them with compensation packages for customers. Where individual customers cannot be compensated measures which benefit groups of those affected could be used.**

6. **Naming and shaming can be an effective deterrent. Compensation packages should be clearly identified to customers as the result of enforcement action. Quarterly statistics of enforcement cases should be published by BIS on behalf of all economic regulators with enforcement powers.**