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Enforcement Watch
Issue 1

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EDITORS NOTE

I have been involved in defending enforcement cases for almost 20 years. At various times, I have heard regulators talk about getting tough. Now, for the first time, we are seeing them act on their rhetoric.

This will be a regular briefing, highlighting some recent developments and providing comment. We will set out some of the enforcement actions the FSA has taken, and highlight a number of other developments that might impact on what they do in the future.

Welcome to the inaugural edition of Enforcement Watch.

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20 January: Standard Life Assurance Limited

The FSA fined Standard Life £2.45m for serious systems and controls failings that resulted in the production of misleading marketing material for its Pension Sterling Fund. The fine would have been £3.5m but was reduced by 30% as a result of settlement at an early stage.

Details of the Case

Standard Life Assurance Limited ("SLAL") became responsible for the Pension Sterling Fund in July 2006 following the demutualisation of the Standard Life Group. As at November 2008, there were almost 97,000 retail consumers in the Fund, which had a value of just under £2bn. The Fund was intended primarily for the investment of pensions and was considered appropriate for individuals approaching retirement.

The majority of the Fund was invested in floating rate notes. Despite this, marketing material produced by a third party data producer, as well as marketing literature issued by SLAL, showed for much of the period in question that the Fund was 100% invested in cash.

The FSA was clear that SLAL's actions were not deliberate or reckless. Nevertheless, it failed to have proper systems and controls in place in relation to the production of the material, the ongoing monitoring of it and the proper investigation of concerns raised in relation to it.

SLAL were found to be in breach of:

- Principle 3 (A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems).
- Principle 7 (A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading).
- The FSA imposed a financial penalty on SLAL. The headline figure is £3.5m, although it was reduced by 30% to £2.45m for early settlement.

Comment

The result is interesting for a number of reasons. First, it reflects the FSA's intention to impose substantial fines as part of its policy of credible deterrence. The fine was imposed despite SLAL clearly having taken the matter seriously by reporting it to the FSA, engaging a third party to perform an independent review and compensating consumers to the tune of £102m.

Second, it sends a signal about the FSA's intentions as regards financial promotions, particularly where retail customers are involved.

Third, the FSA found that the business operated in distinct silos. It found that the result was that marketing material issues were passed from area to area without any one business area or committee having overall responsibility for ensuring the marketing materials were accurate. Interestingly, there was no simultaneous blame laid at the door of any one individual for failure to ensure the proper systems were in place. It remains to be seen whether the FSA in future looks to apportion blame individually rather than just at a corporate level.

12 February: Largest Fine Against an Individual for Market Abuse

Three senior executives committed market abuse by dealing on inside information. The individuals brought their conduct to the attention of the FSA, did not set out to commit market abuse and were not familiar with the legal requirements. Yet the FSA levied very substantial penalties on them.

Details of the Case

The three individuals concerned were the Chief Executive Officer, the Chief Commercial Officer and the Exploration Manager of Genel Enerji SA, a Turkish registered company with oil operations in Northern Iraq.

Genel Enerji entered into a joint venture with Heritage Oil plc relating to an oilfield which Heritage had a licence to operate. Heritage was listed on the LSE. Aware that some positive drilling tests had been carried out by Heritage, the three individuals all purchased shares in that company. All sold their shares at a profit on the day the results of the drilling tests were announced.

Following the event, each sought advice about the propriety of his dealing and, through their legal advisers, disclosed it to the FSA. None set out to commit market abuse and none knew about the legal requirements. The FSA nevertheless imposed on each a substantial fine in addition to the disgorgement of their profit:

- Mehmet Sepil:
    - disgorgement of financial benefit of £267,005; and
    - £700,000 additional financial penalty (reduced from £1m as a result of early settlement)
- Murat Ozgul:
    - disgorgement of financial benefit of £5,240; and
    - £70,000 additional financial penalty (reduced from £100,000 as a result of early settlement)
- Levent Akca:
    - disgorgement of financial benefit of £10,062; and
    - £84,000 additional financial penalty (reduced from £120,000 for early settlement)

Comment

Market abuse has always been known as a “no fault” offence (see also the Winterfloods case discussed at **22 April: Court of Appeal rules on Market Abuse Test**). Nonetheless, the extent to which a course of action is “deliberate” is something that the FSA will weigh in deciding the level of penalty. In this case, given the lack of knowledge of the men and their actions after trading, the FSA’s penalties can be viewed as heavy. The fine of Mehmet Sepil was the largest up to then by the FSA against an individual for market abuse.

What this shows is that market abuse remains a key priority for the FSA, and that ignorance (even of those not involved as directors of a listed company) will not be any guarantee of any great leniency from the FSA.

24 February 2010: Heavy Penalties in Respect of Structured Products and Pension Switching

This is the first enforcement penalty following the FSA's review of the marketing and distribution of Lehman backed structured products. The firm suffered a heavy penalty and also submitted to a string of other measures. The case also relates to pension switching.

Details of the Case

RSM Tenon Financial Services Limited ("Tenon") is a high net worth financial advice firm which had 68 advisers in 11 offices around the UK at the relevant times.

Tenon was part of the FSA's thematic review of quality of advice provided in connection with Lehman-backed structured products. The FSA organised for the review of a sample of 22 transactions, with regard particularly to investment risks, credit risk and liquidity risk.

3 transactions (14%) were considered unsuitable;

In 14 transactions (64%), there was insufficient evidence on the file to determine whether the advice was suitable or unsuitable.

The FSA also reviewed Tenon's pension switching business, and identified failings in relation to the adequacy of its sales and compliance processes in preventing or minimising the risk of unsuitable sales.

The FSA concluded that Tenon was in breach of Principle 3 (Management and Control), Principle 9 (Customers: Relationships of Trust) and a number of the COBS 9.2 obligations regarding assessing suitability. This included a failure to operate an effective compliance monitoring programme. The relevant principles and Rules are reproduced in full at the end of this section.

As a result of the above, the following consequences ensued:

1. Tenon was fined £700,000 (a 30% discount from £1m as a result of early settlement)

2. Tenon will conduct a past business review of all its sales of structured products backed by Lehmans to assess suitability. It will offer suitable redress both to customers who received unsuitable advice and to those where the firm is unable to demonstrate that the advice was suitable.

3. Tenon will conduct a past business review of sales of all structured products excluding Lehman backed structured products between 1 November 2007 and 1 December 2009 to assess suitability. It will offer suitable redress both to customers who received unsuitable advice and to those where the firm is unable to demonstrate that the advice was suitable.

4. Tenon will conduct a past business review of its pension switching business between 6 April 2006 and 1 December 2009 to assess suitability. If appropriate, the firm will then implement a customer redress programme for pension switching business conducted during the period.

5. The FSA will oversee the past business reviews and redress processes, and an independent third party will review the work undertaken by the firm.

6. Tenon will instruct a skilled person (s166 of the Financial Services and Markets Act) to undertake a review of its current sales and compliance processes relating to the sale of all its investment products, to assess their appropriateness and the suitability of recommendations made to customers.

Comment

In our view, one of the casualties of the credit crunch has been consumer confidence in financial services.This is something that the FSA is clearly working hard to try to restore by sending the appropriate enforcement message. The action it has taken in this case is a good example of this. Further, it fits one of the FSA's statutory regulatory objectives, the protection of consumers. It is interesting to note that the disciplinary sanction would have been even more severe were it not for the significant steps in mitigation taken by Tenon.

Footnoted Rules:

- Principle 3 (Management and Control): "A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."

- Principle 9 (Customers: Relationships of Trust): "A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment."

- Rule 9.2.1 (2) R "When making the personal recommendation or managing his investments, the firm must obtain the necessary information regarding the client's:

    a. knowledge and experience in the investment field relevant to the specific type of designated investment or service;

    b. financial situation; and

    c. investment objectives;

  so as to enable the firm to make the recommendation, or take the decision, which is suitable for him. "

- Rules 9.2.2R (1) "A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:

    a. meets his investment objectives;

    b. is such that he is able financially to bear any related investment risks consistent with his investment objectives; and

    c. is such that he has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio.

- Rules 9.2.2R (2) The information regarding the investment objectives of a client must include, where relevant, information on the length of time for which he wishes to hold the investment, his preferences regarding risk taking, his risk profile, and the purposes of the investment.

- Rules 9.2.2R (3) The information regarding the financial situation of a client must include, where relevant, information on the source and extent of his regular income, his assets, including liquid assets, investments and real property, and his regular financial commitments. "

10 March 2010: Immunity for Bertie Hatcher in Malcolm Calvert Case

Hatcher profited from inside information. In return for his assistance in the prosecution of Malcolm Calvert, the FSA agreed to sanction Hatcher using its regulatory powers rather than its criminal powers.

Details of the Case

Hatcher was a retired bookmaker and insurance broker. He received share tips from a third party who he had known for some 20 years and who had recently retired from a senior position in a financial institution. The third party informed him that he had a good source of share tips. They agreed to split the proceeds of trading in agreed proportions.

Hatcher purchased shares in the tipped companies as a result solely of the tips he received. In each case, the tips were given to him shortly before positive announcements were made to the market. The FSA determined that Hatcher was guilty of market abuse on the basis that he possessed relevant information about the companies and that the standard of his behaviour fell below the standard to be expected. It fined him the sum of £56,098, being the total of profits retained by him after tax.

Comment

The case is interesting as it indicates a move towards an immunity style of prosecution. (See "On the Horizon" for commentary on **Immunity from Prosecution**, that discusses the introduction of criminal law immunity in April this year.)

The FSA reached agreement with Hatcher back in 2008 that he would provide ongoing assistance to the investigation into Malcolm Calvert and give evidence if necessary. It published details of Hatcher's case only in March 2010 in order to coincide with the result of the Calvert prosecution. It was as part of this agreement that the FSA agreed to sanction Hatcher using regulatory powers rather than criminal powers. Insufficient detail is given in the Notice against Hatcher to be able to determine whether the FSA would have been successful in any criminal prosecution against him. However, the facts are fairly stark and it is not difficult to imagine that there was sufficient evidence.

The FSA's line was that they were mindful of the need to encourage people to come forward to assist in the investigation and prosecution of insider dealing and market abuse. They stated "We will continue to enter into agreements of this sort where we believe it is in the public interest and interests of justice for the FSA to do so." (Its willingness to do so may, however, be influenced to some degree in the future by the OFT's bad experience in the recent BA cartel case).

Clearly, those faced with accusations in future will need to consider carefully the scope that there may be to enter into similar agreements with the FSA.

April 2010: Four Substantial Fines for Transaction Mis-reporting

Four firms received a total of just under £4.8m fines for failures in relation to their transaction reporting. These show the FSA will impose large penalties to ensure they have proper data in their fight against market abuse, market manipulation and insider trading.

Details of the Cases

Four cases came into public view in April this year. All four relate to a greater or lesser degree to a failure to report transactions accurately or to report them at all.

The specific rules relating to transaction reporting are at SUP 17. They require transaction reports containing mandatory details to be submitted to the FSA by the end of the next business day following the day on which the firm entered into the transaction. At the end of each working day, transaction reports received by firms are loaded onto the FSA's transaction monitoring system.

Instinet Europe Limited: Instinet is an agency broker undertaking riskless principal trading by matching trades.

Its work prior to the implementation of MiFID in November 2007 was insufficient to ensure that its transaction reporting processes and procedures would be fully compliant with MiFID requirements. Its subsequent breaches largely resulted from these errors. 22.1m transactions had not been properly reported. By way of example, some had not been reported at all due to the netting of trades into one trade per equity per day, whilst others were booked late and then not reported. The firm undertook a number of reviews into transaction reporting during the relevant period, but the FSA found these to be inadequate.

The FSA considered the matter sufficiently serious to warrant a significant financial penalty. It fined Instinet £1.05m (a discount of 30% to reflect early settlement).

Getco Europe Limited: Getco is a proprietary trading firm undertaking market making on electronic markets.

Its breaches also stem from MiFID, but in a different way from Instinet. One set of its breaches related to reporting of LSE trades, where it had been relying on a third party to report the trades, and who had misinformed Getco that it was doing so. The other set of breaches related to the reporting of non LSE trades, in which a number of transaction reporting errors took place despite Getco's daily reconciliation process. The errors in total related to 46.3m transactions.

Again, the FSA considered the matter sufficiently serious to warrant a significant financial penalty, fining Getco £1.4m (after taking account of a 30% discount for early settlement).

Four Credit Suisse entities ("the firm"): these follow on again from the implementation of MiFID. They break down into two types.

First, in relation to LSE trades, Credit Suisse planned to continue to transact report through an external Approved Reporting Mechanism (an external ARM) after MiFID. It mistakenly believed that the ARM was continuing to report post MiFID, although in fact it had stopped doing so 12 days after the provisions came into force. It had failed to develop and implement controls to confirm that those reports were being submitted, whether in compliance with SUP 17 or at all. It consequently failed to report 30m transactions.

Second, as to non LSE trading, the firm failed to report correctly 10m transactions, representing approx 8% of reportable transactions in the relevant period. The errors ranged from such matters as reporting using GMT rather than BST during British Summer Time through to reporting transactions on exchange and MTFs as "off exchange".

Again, the FSA considered the matter sufficiently serious to warrant a significant financial penalty, fining the firm £1.75m (after taking account of a 30% discount for early settlement).

Commerzbank: Commerzbank is an incoming EEA branch passporting into the UK under MiFID. As such, it was not required to comply with the FSA transaction reporting requirements prior to MiFID. The London MiFID project team only identified the issue relatively late in the day. The majority of transaction reporting problems resulted from the deficiencies in the system that they built. In the relevant period, this resulted in an estimated 10% of transactions not being reported, and 84% being inaccurately reported. What comes out at a number of stages is that Commerzbank had treated transaction reporting as an area of low risk and that there was a consequent failure to escalate to compliance and management.

The FSA imposed a fine of £595,000 (discounted by 30% for early settlement).

All 4 firms were found to have breached SUP 17 (transaction reporting).

In addition, Instinet was also found to be in breach of Principle 2 (Skill, Care and Diligence) and Principle 3 (Management and Control) as it did not have adequate systems and controls in place to meet the transaction reporting requirements and it failed to take adequate steps to review its processes and the accuracy of its transaction report data. The FSA expressly took no action in respect of Commerzbank's systems and controls (as it is an incoming EEA branch, these are a matter for the home state regulator).

Comment

The FSA uses transaction reporting to detect and investigate suspected market abuse, market manipulation and insider trading. What the penalties illustrate, including the fact that they are levied against a wide variety of institutions, is that the FSA is looking to ensure it has the raw data to help it detect market abuse and the like. This is clearly important to it in circumstances where market abuse remains towards the top of its agenda, and where the FSA's figures show particularly that price movements ahead of public takeovers are high.

13 April 2010: Northern Rock Deputy Chief Executive Banned and Fined £504,000

The FSA determined that David Baker's conduct, despite initially having been taken on compassionate grounds, demonstrated a lack of integrity and that he was therefore not considered fit and proper.

Details of the Case

Baker had a career of over 30 years in the regulated sector and had not previously been the subject of regulatory action.

He was a director during the relevant period and, for part of it, had responsibility for the Debt Management Unit (the DMU). The DMU staff perceived that they were under pressure to maintain the firm's reported arrears and possession figures at half the Council of Mortgage Lenders' (CML) figures. Where a possession order had been made against the mortgaged property but physical possession not yet taken, such cases were not included either in the arrears figures or the possession figures. They were thus excluded from all reported data for impaired loans. At a certain stage during the relevant period, Baker became aware that this was the case. He obtained confirmation from a senior and suitably qualified colleague that pending possession cases had been appropriately accounted for in the bad debt provisions and that there was no obligation to amend the soon to be published 2006 accounts.

Baker worked to resolve the issue by increasing resources to the DMU to obtain possession in these cases and therefore to bring them within the figures. He did not escalate the matter. He made the decision not to disclose immediately on compassionate grounds because he believed the likely result would have been either dismissal or other serious disciplinary consequences against a DMU employee. He believed such action would have been disproportionate.

Baker’s responsibilities changed such that in due course he no longer had controlled function responsibility for the DMU. However, his role continued to mean that he received management information that he knew to be incorrect. He also participated in a web cast about the firm’s 2006 accounts, in which he discussed the arrears levels and possession figures, giving reasons for them, knowing that the reported data for impaired loans was wrong. In particular 1,917 pending possession cases had not been reported. If they had been included, the stated possession figures would have risen from 662 to 2,579 cases (ie 0.42% of the loan book as compared to 0.89%).

The FSA found that Baker breached Principle 1 in that he failed to act with integrity in carrying out his controlled function because:

- he did not escalate the issue when informed of the omission from the figures;
- he agreed on a course of action which was not transparent and did not have immediate effect;
- he knew the reported possession figures in the 2006 accounts were wrong; and
- he made misleading statements to market analysts.

There was no evidence of financial benefit to Baker as a result of his conduct.

The FSA found that the conduct was of a “particularly serious nature”. It made a prohibition order against him and imposed a financial penalty of £504,000 (down 30% for early settlement).

Comment

It is no great surprise that the FSA requires proper data to be disclosed internally and from there, on to the market. It is equally no great surprise that it requires exacting standards from those exercising controlled functions (particularly at significant influence level) nor that it would no doubt have been keen to ensure that wrongdoers at Northern Rock were severely punished. Nevertheless, the action will serve as a reminder of the standards the FSA expects.

22 April 2010: Court of Appeal Rules on Market Abuse Test

Winterfloods and two of its traders took to the Court of Appeal the question of whether the market abuse they were accused of required them in effect to have intended to commit market abuse. The Court of Appeal ruling found that it did not. It gives important guidance on how the Code of Market Conduct is to be interpreted.

Details of the Case

The events in question relate back to 2003 and 2004.

In outline, Simon Eagle (see **20 May: New Record Individual Fine for Market Abuse**) executed a fraudulent plan that drove up the price of shares in an AIM listed company Fundamental-E Investments plc. The market maker, Winterfloods, and two of its traders were found to have been the unwitting instruments of Eagle's share ramping scheme. The decision making body of the FSA, the RDC, found that Winterfloods and the traders were guilty of market abuse.

That decision was appealed by Winterfloods and the traders, first to the Financial Services and Markets Tribunal, and then to the Court of Appeal. They appealed on both occasions on the basis that the market abuse of which they were accused required intent if they were to be found guilty and that no intent to commit market abuse had been proved. The types of market abuse of which they were accused were those relating to false impressions and distortion of the market.

When the offence of market abuse was first introduced, it was widely described as a "no fault" offence. However, a close reading of the Code of Market Conduct produced under the statute might suggest that, at least for certain market abuse offences, intent is required. The Court of Appeal determined that the matter was worthy of being heard by that Court and it gave the respondents permission to appeal. However, when the three man Court of Appeal fully heard the case, it rejected the argument. It found that the market abuse complained of was after all a "no fault" offence.

Comment

The case is unusual as there is so little in the enforcement field that is ultimately determined by the higher Courts. The types of market abuse and the way in which they are framed have changed since the matters complained of. Nevertheless, the case is interesting of itself for two reasons.

First, because it determines a question about intent in relation to market abuse of the type complained of, not before tested by the Courts.

Second, market abuse is often a grey area. The Code is one of the few guides to interpretation of market abuse. The Court examined the articulation of the Code and the Act. It specifically considered the following, in the circumstances of this case: if a certain type of provision in the Code (an "Evidential Provision") identifies types of behaviour that do constitute market abuse, does that necessarily mean that types of behaviour falling outside it do not constitute market abuse? The Court of Appeal held that this did not follow. In so doing, it provided a guide to interpretation of the Code and its relationship with the statute that will be useful in considering market abuse in the future. It seems that the Code is to be interpreted on a more restrictive basis.

As for the penalties levied, they have some precedent value. However, given that they related to matters from over 5 years ago (which was prior to the new harsher penalty setting regime – see "On the Horizon" for commentary on "**Harsher Penalty Setting Introduced**") and were decided on their facts back in summer 2008, caution needs to be exercised.

18 May 2010: The FSA do a Deal with Johnny Cameron (RBS)

A former head of investment banking has done a deal with the FSA in which he has severely restricted what he may do in the future on financial services. In return, the FSA has agreed not to take enforcement action against him.

Details of the Case

On 18 May, the FSA announced that it had ended its year long investigation into Johnny Cameron, former Executive Director and Chairman of Global Markets at RBS. Cameron agreed not to take any further full time employment in the financial services industry, or to perform any significant influence function in relation to any regulated activity.

In return for the undertaking, the FSA agreed not to take any disciplinary action against Cameron. It did however say that, whilst it had not made any findings of regulatory breach, on the information currently before it, it did not believe that he would meet its current standards for approval for a significant influence function. Were it not for his undertaking, the FSA has said that it would have taken steps to seek a prohibition order against him.

Comment

The case represents the first big RBS scalp to be taken, even though in a somewhat fudged way as it involves an undertaking rather than a regulatory finding.

It is interesting nevertheless to see the FSA settling in this way. It demonstrates that, in appropriate cases, it is prepared to achieve its goals by settling without feeling that it must take disciplinary action. There may be many reasons for this, including for example freeing up resources as well as achieving certainty of outcome; we will probably never know. What the FSA will feel of course is that it has captured a big name at RBS and in so doing, no doubt, has sent an important message to the industry.

Given the nature of the agreement between the parties, no details of the underlying issues have been released. It is therefore difficult to read too much into what the case indicates about the FSA's likely stance in other similar situations. We will not now know for example what evidence the FSA had against Cameron and how likely it would have been to succeed in any disciplinary action.

20 May 2010: New Record Individual Fine for Market Abuse

Architect of dishonest share ramping scheme, Simon Eagle, has been banned and fined £2.8m for market abuse.

Details of the Case

Simon Eagle was the controller of stock broking firm SP Bell, and was its Chief Executive. In the period 2003-2004, he dishonestly carried out a share ramping scheme in relation to one particular stock. In so doing, he dishonestly used clients' accounts, exposed individual clients to financial debts of some £9m and made a personal profit of approximately £1.2m. (He was the architect of the scheme in which Winterfloods was unwittingly used to commit market abuse – see **22 April: Court of Appeal rules on market abuse test**).

He has been fined £2.8m, representing £1.3m disgorgement (including interest) and £1.5m penalty. This is a record fine on an individual. He has also been prohibited from being an Approved Person.

Comment

In one sense, the case is unsurprising. Eagle carried out patently fraudulent activity and it is no surprise that he should attract the most serious of punishments. The case however precedes the FSA's recent policy on increased punishments (see "On the Horizon" for commentary on **Harsher Penalty Setting Introduced**), and it is interesting to speculate on what level of punishment Eagle might have faced if he had been judged according to the new regime.

A new Financial Services Act to Beef up Enforcement

The new Financial Services Act was passed on 8 April 2010. The new Act amends the existing Financial Services and Markets Act 2000. As far as enforcement actions go, the new Act includes the following provisions:

- It gives the FSA the enforcement power to suspend the permission of a firm or to impose restrictions or limitations on the carrying on by it of a regulated activity. In either case, it will be able to do so for up to 12 months, thereby giving the FSA increased enforcement flexibility.

- It will permit the FSA both to withdraw a firm's authorisation and to fine it for the same offence. Up until now, it has only been able to do one or the other. This is in keeping with its harsher penalty setting and its policy of credible deterrence.

- The theme of greater enforcement flexibility is carried over into the regime for individuals. Up until now, as a matter of enforcement, the FSA has been able to fine individuals (approved persons), to ban them and to censure them. The new Act amends the law by giving the FSA new powers. The new Act permits the FSA also to suspend an approved person from carrying on a function and/or to impose restrictions on that person's performance of certain functions for a period of up to two years. This is a significant departure for the FSA toolkit of punishment against individuals.

- The limitation period for actions against approved persons is extended from two years to three years.

- The FSA has historically had the power to punish a firm for permitting a person to perform a controlled function without approval. The new Act gives it the power also to punish the individual for acting without approval. In effect, for this contravention, it extends its powers to cover such unapproved people as if they were approved.

- The FSA has been given powers to make rules requiring firms to establish and operate redress schemes in certain situations. In order to do so, various preconditions must apply. These include where it appears that there may have been a widespread or regular failure to comply with requirements and where such failure has in turn caused consumers to suffer loss.

In addition, the FSA published a consultation paper in April 2010 entitled "Implementing Aspects of the Financial Services Act 2010". This sets out details of how the FSA proposes to exercise these new powers. The consultation ends on 25 June 2010.

Harsher Penalty Setting Introduced

In July 2009, the FSA consulted in detail on its proposal for harsher financial penalty setting. The FSA has been determined to impose harsh penalties and it was difficult to imagine that it was ever going to be swayed from its determination to do so.

Accordingly, earlier this year, it published its policy statement (effective from 6 March 2010) not much changed from its original proposals.

The new framework creates a structured five-step penalty-setting framework. The five steps are:

1. Removing any profits made from the misconduct (what is known as “disgorgement”);
2. Setting a figure to reflect the seriousness of the breach;
3. Considering any aggravating and mitigating factors;
4. Achieving the appropriate deterrent effect; and
5. Applying any settlement discount.

One of the critical elements in this is the figure set at Step 2. There are detailed provisions in relation to this, but essentially fines will be based on:

- Up to 20% of a firm’s revenue from the product or business area linked to the breach over the relevant period;
- Up to 40% of an individual’s salary and benefits (including bonuses) from their job relating to the breach in non-market abuse cases; and
- A minimum starting point of £100,000 for individuals in serious market abuse cases.

This is effectively a decision to increase penalties. The FSA rightly recognises that more of its decisions may be challenged as a result.

Whilst the process is transparent, considerable discretion is afforded to the FSA and so penalties will perhaps not be quite as consistent as might be thought.

One feature is that different percentages apply to individuals as compared to firms. The FSA’s rationale for this is that “action against individuals has a significantly greater impact in terms of deterrence than action against firms, and… focus on individuals is a key component of our credible deterrence strategy”.

23% Increase in next Year's Enforcement Budget

In March this year, the FSA published its Business Plan for 2010/2011, setting out its priorities. In support of its delivery of its “credible deterrence” philosophy, the document places a significant emphasis on enforcement.

The budget for Enforcement and Financial crime rises from £53.9m to £66.1m (ie 22.6%). The FSA describes this as “reflect[ing] our continued investment in credible deterrence, combating financial fraud and market abuse in line with our three year financial crime strategy…”

Lord Turner wrote: “the FSA is now committed to a more robust approach to enforcement…”

Hector Sants commented: “The focus of our enforcement action has shifted to taking a harsher stance.”

Enforcement Activity Currently in the System

The FSA has also given notice of other enforcement activity currently going through the system.

Although it announces criminal prosecutions, the FSA does not usually announce other "civil" enforcement cases. Most of it stays in private unless and until there is a guilty finding made. There have been three notable recent exceptions.

- In April 2010, following up on its findings on its thematic review on the quality of pension switching advice, the FSA reported that 4 firms were currently going through the enforcement process on the issue.

- Also, in April 2010, one suspects in response to political pressure, the FSA announced that, following preliminary investigations, it had decided to commence a formal investigation into Goldman Sachs International in relation to recent SEC allegations.

- Also, in April 2010, the FSA announced that two banks had been referred to Enforcement in respect of complaint handling (see "On the Horizon" for commentary on "Poor Complaint Handling").

Activity Steps up in Criminal Arena

Since the start of the year, the FSA has been very visible in its stepped up activity in the criminal arena, often in relation to insider dealing. It has made arrests in connection with a number of different cases, and secured a conviction against Malcolm Calvert, formerly of Cazenove.

- In January, the FSA confirmed that it had commenced criminal proceedings against 4 former directors of iSOFT Group plc for the offence of conspiracy to make misleading statements contrary to s397 of the Financial Services and Markets Act 2000 and s1 of the Criminal Law Act 1977.

- Also in January, 3 men were arrested in connection with an FSA investigation into suspected insider dealing. Search warrants were executed at four addresses. One was subsequently charged in April.

- On 17 February, Semperian PPP Investment Partners Limited Partnership pleaded guilty to an offence under s191(3) of the Financial Services and Markets Act 2000 by acquiring an authorised firm before it had received the necessary approval for change of control. It notified the FSA, but then failed to wait for approval. Although it only received a fine of £1000, a change in the law means that firms could in future receive an unlimited fine. The prosecution reflects the FSA's increased emphasis on fitness and propriety and its greater muscularity in pursuing enforcement type activity.

- On 11 March, Malcolm Calvert, a former equities market maker at Cazenove was sentenced to 21 months imprisonment for insider dealing, having made a profit of £103,883.

- On 15 March, the FSA announced that it had charged investment banker Christian Littlewood and his wife Angie Littlewood with 13 counts of insider dealing and one count of conspiracy to commit insider dealing. The offences relate to trading in a number of different London Stock Exchange and AIM listed shares between 2000 and 2009. On 30 March, the FSA announced that it had also commenced proceedings against a third person, Helmy Omar Sa'aid, following his being returned from a French overseas territory.

- On 23 March, six people were arrested and 16 addresses were searched in the FSA's largest ever operation against insider dealing. The men were arrested on suspicion of being involved in a long running insider dealing ring. A seventh was arrested on 24 March.

- On 31 March, seven people were charged with conspiracy to deal on inside information obtained from two major investment banks. The charges followed raids in July 2008 and were unconnected with any of the above.

Immunity from Prosecution

On 6 April this year, the FSA finally received statutory power to offer immunity from prosecution. This comes in the shape of an amendment to s71 of the Serious Organised Crime and Police Act 2005. It gives the FSA (amongst other prosecutors) the ability to give a person an immunity notice if it considers it appropriate for the purposes of the investigation or prosecution of an offence.

The notion of granting immunity is not new territory for the FSA. Whilst this criminal law immunity has only recently been introduced, there has previously been a common law immunity. In that connection, it is interesting to note two points.

First, a provision was specifically brought into the FSA's Enforcement Guide in December 2008 in support of that common law immunity. It stated that where two or more individuals were acting together, and one of those individuals provided information to the FSA and gave it full assistance in the prosecution of the other, the FSA would take that co-operation into account in deciding whether to prosecute the assisting individual or to bring market abuse proceedings against him.

Second, the case of Bertie Hatcher referred to elsewhere in this briefing (see **10 March: Immunity for Bertie Hatcher in Malcokm Calvert Case**) demonstrates that the FSA was already thinking in this way in summer 2008.

The FSA has historically used common law immunity only sparingly. The introduction of a new criminal law immunity, coupled with a re-invigorated and more muscular regulator, may well mean an increased use of its immunity powers in order to assist prosecutions.

A Proposal to Tape Mobile Phones

Recording of mobile phones was not part of the new rules on recording that came into force in March 2009. On 18 March 2010, however, the FSA published proposals to remove the exemption for recording mobile phone communications.

The proposal is to extend taping rules so:

- firms record and keep copies of all relevant conversations made on mobile phones provided to individuals by firms; and
- also to introduce a new rule that requires firms to take reasonable steps to ensure conversations that involve taking client orders or dealing in financial instruments do not take place on private phones.

Even before the introduction of the taping rules for landlines, a very large number of firms recorded conversations. The use of mobile phones in and around firms has long been a taboo subject. Calls do however take place and, when it comes to enforcement action, the regulator often looks at telephone records in order to try to draw inferences from call patterns. In future, if the rules go through, the enforcement prosecution landscape will change. Where the FSA has in the past sought to rely on inference, there will now be more certainty. The FSA specifically talk about introducing the new rules in the context of monitoring and enforcing market abuse, still a key objective of theirs.

Responses to the consultation are due by 14 June 2010.

Proposals to bring more Individuals within the Regulatory net

On 30 March, the FSA published a consultation on client assets. The consultation arises to a large degree from the Lehmans failure and looks at the ways the client asset rules can be strengthened.

One proposal is the creation of a new controlled function with specific responsibility for client money and assets. It is proposed that this should be a senior individual within the firm with responsibility for oversight and protection of client assets and money. Proportionate to the size of the firm, the FSA proposes that this should be one named individual who may be interviewed for the post and who will hold an FSA significant influence controlled function. The idea is that one person must have overall responsibility for the role, even though many people may have roles to play in relation to client assets across the firm.

The proposal is in keeping with a widening of the regulatory net more generally. For example, it is consistent with the FSA's message last year that potentially all proprietary traders are brought into the approved persons regime.

The consultation period closes on 30 June 2010.

A Boost in assisting Overseas Regulators

Under the Financial Services and Markets Act 2000, the FSA has a duty to take appropriate steps to co-operate with overseas regulators who have similar functions. It responds to a very large number of requests. Published figures for 2008/2009 state that the FSA responded that year to 830 international requests for assistance.

In summer 2009, Amro and Creon sought judicial review of the FSA's decision to appoint investigators to obtain a whole range of documents from their accountants in the United Kingdom in support of an SEC action against others.

At first instance, in August 2009, the Judge held that the FSA went too far in its investigation in support. He found that they should have exercised greater scrutiny of what the SEC was requesting before appointing investigators and before requiring wide ranging documents from a third party. The decision went to the heart of the co-operation between the regulators, and the FSA appealed it to the Court of Appeal.

In relation to an investigation of this particular type (under s171), the Court of Appeal held that the appropriate test to be applied was whether the production of documents sought was "relevant to the purposes of the investigation". It specifically commented that this was "a relatively low hurdle" and that it was not constrained by tests from outside the statute (such as the requirements under Memoranda of Understanding between the regulators).

What this case does is to give the green light to co-operation between the regulators based on relatively low levels of engagement. It will encourage the FSA to continue its support for overseas regulators in a way that is relatively unconstrained and that allows it to assist in a large number of cases.

Poor Complaint Handling

Complaints handling is of real importance to the FSA. It has publicly stated that ensuring that firms treat customers fairly is at the heart of its consumer protection agenda.

In April this year, the FSA published a report containing the results of its review of complaint handling in banking groups. The FSA stated that its review found evidence of poor complaint-handling within most of the banks it assessed. It did say, however, that the fact that it found good and compliant practices in parts of some banking groups demonstrated that it was possible for banks to handle high volumes of complaints and deliver consistently fair outcomes for complainants.

The FSA concluded that the banks included in its review needed to take action to improve the standard of their complaint handling. Five banks are undertaking major changes to the way they deal with complaints. Two of the five have been referred to Enforcement for further investigation.

The review makes interesting reading, highlighting as it does the areas that have the most significant impact on the quality of bank's complaint handling. For example, significantly, it points to the fact that most of the banks assessed had not embedded a culture that focused on delivering fair outcomes for complainants and that lack of senior management engagement was one of the key drivers of a poor culture.

Consumer protection is an important objective for the FSA. The FSA says that it strongly encourages all firms to take note of its findings and, where appropriate, to act on them. Tellingly, the FSA says that it will continue to focus on complaint handling "as part of our more intensive and intrusive supervision of conduct risks." As a matter of Enforcement, we suspect that this is not the last that has been heard of poor complaint handling, whether at a firm or an individual level.