September 2014

Enforcement Watch
Issue 14

Mishcon de Reya

EDITOR'S NOTE

Whilst some of the old themes continue to be seen in enforcement cases, readers will see from our commentaries some new themes emerging and some novel issues coming up. Beyond that, in "On the Horizon", we see how the post Lehmans climate continues to be felt in the changes being introduced by the regulators. This is both in changes to the regulatory rules and to the practices being adopted by the regulators. We foresee these playing out in the enforcement field in future.

Adam Epstein
Partner
adam.epstein@mishcon.com
+44 20 7440 7102

With thanks to the Enforcement Watch team

Matt Hancock
Associate
matt.hancock@mishcon.com
+44 20 7440 7471

Rebecca Copcutt
Solicitor
rebecca.copcutt@mishcon.com
+44 20 7440 7130

Katharine Bond
Solicitor
katharine.bond@mishcon.com
+44 20 7440 4780

Enforcement Case Highlights

27 May 2014: Hannam Tribunal decision clarifies various aspects of market abuse
23 July 2014: FCA makes first use of its restriction powers
28 July 2014: Lloyds and BoS fined for LIBOR and other benchmark failings
6 August 2014: Insurance broker receives prohibition for misleading the FCA in the course of his reference to the Tribunal
23 September 2014: Highest ever fine for client asset breaches

On the Horizon

The new "Enhanced Supervision"
Tracey McDermott speech on sustainability gives pointers to enforcement
Impact of FCA/PRA joint consultation on strengthening accountability through new framework for individuals
FCA publishes further details about attestations

Spotlight on the US

Two more SEC whistleblower awards and the first SEC action for retaliation against a whistleblower
Government agencies continue to obtain significant settlements from financial institutions
Settlements and prosecutions for LIBOR manipulation continue
Average prison terms for insider trading increase

27 May 2014: Hannam Tribunal decision clarifies various aspects of market abuse

On 27 May 2014, the Upper Tribunal handed down its long-awaited decision in the Ian Hannam market abuse case.

Mr Hannam was Chairman of Capital Markets at JP Morgan and Global Co-Head of UK Capital Market at JP Morgan Cazenove. In a Decision Notice published in February 2012, the FCA had found that Mr Hannam, once dubbed the "King of Mining", had committed market abuse and it imposed a penalty of £450,000.

The facts of the case are relatively straightforward. The case was based on two emails sent by Mr Hannam to the Minister for Oil in the Kurdish Regional Government which related to one of Mr Hannam's clients, Heritage Oil plc. The information in the first concerned Mr Hannam's belief that a third party bid for Heritage would be made. The second was a postscript which stated simply that his contact at Heritage "has just found oil and it is looking good".

In a lengthy judgment, the Upper Tribunal upheld the Decision Notice for market abuse, and Mr Hannam was fined £450,000. A link to the judgment can be found here http://www.tribunals.gov.uk/financeandtax/Documents/decisions/Hannam-v-FCA.pdf

Comment

The primary significance of the judgment is that it clarifies a number of the terms used in the market abuse provisions under FSMA.

It is helpful first to set out some of the relevant provisions from FSMA:

- The definition of market abuse includes the disclosure by an insider of *"inside information…otherwise than in the proper course of the exercise of his employment, profession or duties"*.
- In order to constitute *"inside information"*, the information needs to be *"of a precise nature"* and such that, if generally available *"would be likely to have a significant effect"* on the price of investments or related instruments.
  - Information is deemed *"precise"* if it indicates *"circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur"*, and *"is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event"* on price.
  - The information will only be *"likely to have a significant effect on price"* if it was of a kind that *"a reasonable investor would be likely to use as the basis of his investment decisions."*.

The Upper Tribunal made a number of important findings as to the proper construction of some of the above terms:

- Entirely inaccurate information would likely not constitute *"inside information"*. However, information which was partly accurate and partly inaccurate would satisfy the test where, despite there being inaccurate information, the information nevertheless conveys the fact of the relevant *"circumstances"* or "events".

- Where the relevant *"events"* indicated by way of the information are in the future, the FCA must prove that there is a *"realistic prospect"* (but not that it is *"more likely than not"*) that they will occur. Where they are past, they must be proven.

- Where a statement indicates an individual's *"genuinely and reasonably held belief"*, this will still constitute *"inside information"* even if that belief turns out to be mistaken.

- In order for the information to be deemed to have a *"possible effect"* on price it must, by virtue of it, be possible to predict the direction of the price movement.

- Information will be *"likely"* to have a significant effect on price and *"likely"* to be used by an investor, where this effect is a *"real"* and *"not fanciful"* prospect.

- In respect of the proviso that disclosure of inside information will be permissible if *"in the proper course of…employment"*, reliance on the ability of a firm to selectively and confidentially disclose inside information for the purposes of facilitating commercial opportunities will only be permitted where such is *"strictly necessary"* and only on strictly confidential terms. An individual will not be acting *"in the proper course of…employment"* where an action is outside the firm's procedures or the Takeover Code.

- Inside information includes information which merely confirms a commonly held view.

The Upper Tribunal further found that the standard of proof to be met by the FCA in proving that an individual has committed market abuse was the civil standard (ie "on the balance of probabilities") and not the criminal standard ("beyond reasonable doubt").

The constructions adopted by the Upper Tribunal were strict but otherwise unsurprising. Of perhaps most significance for firms is how strictly the FCA will apply the limited exception for disclosure to those brought "inside". It is vital that firms adhere to strict internal procedures in this respect, in particular as to the means of ensuring that insiders are fully aware of the confidentiality constraints upon them.

23 July 2014: FCA makes first use of its restriction powers

The FCA has, for the first time, used its statutory powers to impose restrictions.

The subjects of the action were two firms, Financial Limited and Investments Limited. Both are networks and are subsidiaries of the Financial Group, with Financial Limited being by far the bigger firm. At the time of the Final Notice, between them, they supervised over 300 Appointed Representatives (“ARs”) and approximately 350 Registered Individuals (“RIs”). They advised customers on pensions, investments including unregulated collective investment schemes, mortgages and general insurance/protection products.

Among the failings identified were the lack of an adequate risk management framework, inadequate recruitment processes, inadequate training and the absence of an adequate system of reviewing files. The FCA found that over 60,000 customers were exposed to the real risk that the firms' ARs and RIs would make recommendations, including in relation to high risk products, which were unsuitable.

While the FCA considered that the identified breaches warranted a combined financial penalty of over £13 million, it determined that this should be reduced to nil on grounds of hardship. Instead, the FCA imposed a restriction preventing the firms from appointing any AR or RI for a period of 126 days.

http://www.fca.org.uk/static/documents/final-notices/financial-limited.pdf
http://www.fca.org.uk/static/documents/final-notices/investments-limited.pdf

Comment

The details of what gave rise to the failings are not themselves of particular interest for the purposes of this publication.

Culture

By way of background, it is interesting that this is a case where the FCA has again stressed the cultural aspects. The FCA talked of poor compliance culture and stated that the cultural focus resulted in the ARs being treated as customers rather than the end consumers who received the advice. The topic of culture has become much more of a theme in recent times (see for example Enforcement Watch 12 "McDermott sets out enforcement thinking" and Enforcement Watch 13 "State Street £22.9m fine for transition management failings").

How the FCA used its powers

Perhaps of more central interest is that this is the first case in which the power to impose a restriction has been employed.

The suspension power under section 206A FSMA has been available to the FSA/FCA since August 2010. As well as suspensions, it permits the FCA to impose for such period as it considers appropriate[1],

[1] Subject to a maximum of 12 months

such limitations or other restrictions in relation to the carrying on of a regulated activity by the person as it considers appropriate.

The FCA's policy in relation to the imposition of these new sanctions is set out in the FCA Handbook at Chapter 6A of DEPP. This makes it clear that their purpose is primarily deterrence and that they will, in most cases, supplement rather than replace a financial penalty. DEPP suggests the sanction will be imposed in a number of specified circumstances, one for example being where the FCA has previously taken action in respect of similar breaches and has failed to improve industry standards. In effect, the financial penalty regime and the suspension/restriction regime are considered separately and in parallel by the FCA. If the FCA decides to impose both, it will then decide whether the combined impact is disproportionate.

However, somewhat differently, the FCA will also consider a suspension or a restriction as an alternative to a full financial penalty where the FCA has determined that the imposition of a financial penalty would cause serious financial hardship. This is what happened in this case. The firms provided verifiable evidence to establish that imposing any financial penalty would cause serious financial hardship. The FCA decided that a restriction would be a more effective and persuasive deterrent than the imposition of a financial penalty reduced to nil and statement of misconduct alone.

The issue then was what should be the length of the restriction. The restriction could only be imposed by reference to the breaches since August 2010 (although breaches went back to 2008), as that was the time when the new power was introduced.

The Handbook states that a large number of factors, broadly in line with those relating to the calculation of financial penalties, will be considered in determining the length of the restriction. The FCA considered various factors when determining the length of the period of restriction eg lost revenue. However, unfortunately, the Final Notice sheds little light on how these factors will actually be applied in practice. Aggravating factors in this case included the poor compliance culture and the fact that Enforcement had previously successfully taken action against Mr Charles Palmer, a SIF and owner of the group of companies.

It is clear that the 30% reduction for early settlement applies equally to restrictions as to financial penalties. In this case, the restriction was reduced from 180 to 126 days for early settlement.

In the press release that accompanied the Final Notice, Head of Enforcement, Tracey McDermott, stated that the case demonstrates that the FCA *"is able to respond with sanctions that target the specific revenue streams of different types of business"*. This suggests a further motivation for imposing a restriction, namely that, unlike a financial penalty which would impact a firm as a whole and leave the part of the business that engaged in the misconduct only indirectly diminished, suspensions allow the FCA to target sanctions only on that part of the business.

Given that this is a case where the restriction was imposed simply because any penalty would cause severe financial hardship, the case casts no light on how the FCA may in practice look to combine financial penalties with suspensions or restrictions. It does, however, illustrate how firms that cannot meet a financial penalty may look to negotiate settlements with the FCA that permit them to carry on business by agreeing a restriction or limitation instead of a financial penalty.

28 July 2014: Lloyds and BoS fined for LIBOR and other benchmark failings

The FCA has issued a Final Notice against Lloyds Bank plc and Bank of Scotland for manipulation of both the LIBOR rate and the Repo Rate. The fine would have been £150 million (£100 million for the Repo Rate misconduct and £50 million for the LIBOR misconduct), but was reduced by 30% for early settlement.

While much of the LIBOR manipulation was similar to that found in previous FCA investigations (involving submitting false LIBOR rates in order to benefit trading positions), certain features of the misconduct found by the FCA were notable:

- the FCA found that the banks had colluded in the manipulation with another bank, Rabobank, with each bank requesting the other make submissions at certain levels in order to improve their respective trading positions;

- the banks were found to have engaged in the practice of "forcing LIBOR" whereby traders would enter into Forward Rate Agreements (FRAs), then bid aggressively in the cash market in order to influence the other Panel Banks to increase their LIBOR submissions, thus driving up the LIBOR rate to the benefit of those FRAs;

- senior managers at Bank of Scotland gave direct instructions to traders engaged in making LIBOR submissions to ensure that the bank was not an "outlier" in respect of its LIBOR submissions, the aim being to influence public perception as to the creditworthiness of the bank.

One novel element of the Final Notice is that it is the first time that the FCA has levied a fine in relation to the manipulation of the Repo Rate. Until its abolition in December 2012, the Repo Rate benchmarked the rates offered by major banks for dealing GBP general collateral repo transactions. The Repo Rate was set by reference to submissions by Panel Banks, which were required to exercise their subjective judgement in evaluating the rates at which they were dealing general collateral repo transactions.

The significance of the Repo Rate was that it was used by the Bank of England to calculate the fees charged for using its Special Liquidity Scheme ("SLS"), a temporary taxpayer-backed measure introduced by the Bank of England in April 2008 to improve the liquidity position of the UK banking system during the financial crisis. Under the terms of the SLS, banks and building societies could, for a fee, swap mortgage-backed and other securities that had temporarily become illiquid for UK Treasury Bills which, in turn could be used as collateral in Repo transactions in order to borrow cash. The fees for drawing on the SLS were calculated by reference to the SLS Spread, which was the difference between three month GBP LIBOR and the three month Repo Rate.

The FCA found that Lloyds and BoS had sought to reduce the fees due under the SLS by artificially inflating their three month Repo Rate submissions on those days when the fees for drawing on the SLS were calculated. The firms have since paid an agreed amount of £7.76 million to the Bank of England in respect of losses it may have suffered in respect of SLS fees.

The FCA found that the firms had breached both Principle 3[1] and Principle 5[2] in respect separately of the LIBOR and the Repo Rate failings.

The Final Notice can be found at http://www.fca.org.uk/static/documents/final-notices/lloyds-bank-of-scotland.pdf

(See also elsewhere in this edition, the settlement of the Lloyds Libor case in the US "Settlements and prosecutions for Libor manipulation continue")

Comment

Final Notices such as this are starting to look all too familiar – this is the seventh penalty for LIBOR-related failures. Nevertheless, there are certain interesting features to draw from it:

- Fines continue to be large. Although not reaching the dizzying heights of some recent US fines, £105 million is the joint third largest ever imposed by the FCA;

- The Repo Rate abuse and failings have not been seen before. Although it was promptly self-reported by the firms, it is difficult to escape the conclusion that the cheating by the firms of the UK taxpayers was something that the FCA weighed heavily in the balance;

- Once again, a Final Notice specifically mentions a "poor culture". Culture is a theme that the FCA is keen to push (see for example elsewhere in this edition "23 July 2014: FCA makes first use of its restriction powers");

- The FCA will no doubt be pursuing individuals. For example, whilst it concludes that the firms did not engage in deliberate misconduct, it states that the improper actions of many employees involved in the misconduct "were at least reckless and frequently deliberate".

Attestations continue to be a hot topic. The Final Notice criticises Lloyds for having attested to the FCA that its systems and controls in place for its LIBOR submissions were adequate, when it turned out that this was not accurate. See elsewhere in this edition for comment on the likely future use on attestations ("FCA publishes further details about attestations").

[1] Principle 3 states that "A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems".
[2] Principle 5 states "A firm must observe proper standards of market conduct".

6 August 2014: Insurance broker receives prohibition for misleading the FCA in the course of his reference to the Tribunal

Insurance broker Stephen Allen has been prohibited by the Tribunal both for his conduct during the Tribunal reference and for his conduct during separate, unrelated civil proceedings.

The Issues

Stephen Allen was an insurance broker specialising in professional indemnity risks. The FCA's primary case against him was that he had secretly added a fee to the premiums charged to a client, and also that he had diverted funds due to a client and previous employer for his own benefit. In support of its case, the FCA relied on the evidence of one key witness. On the basis of these facts and the witness evidence in support, the RDC found that he was not fit and proper.

Mr Allen referred the matter to the Tribunal, and in the course of the reference, produced a redacted single page extract from a judgment in an unrelated civil case – an action in which Mr Allen was a claimant and where the FCA's key witness gave evidence for the defendant. The redacted page demonstrated that the evidence of the FCA's witness had been rejected by the judge.

The FCA asked for a complete copy of the judgment, but Mr Allen did not provide one, saying that it was irrelevant to the issues in his reference. When the FCA obtained its own copy, it became clear that Mr Allen had also been discredited in the course of the judgment.

The FCA recognised that it could not rely on the evidence of its key witness, and it sought and obtained permission from the Tribunal to amend its statement of case. Having done so, it argued that a person who had been found by the High Court to have advanced what he knew to be a false case, supported by a forged document and other materials which contained false information and who had given untrue evidence himself, was not fit and proper. Further, it argued that even if there were compelling reasons for the Tribunal to conclude that the judge in that case was wrong (this was unlikely as the case has not been appealed), the fact that Mr Allen had produced a redacted and misleading extract from the judgment was sufficient in itself to demonstrate that he was not fit and proper.

Mr Allen argued that the judge had been wrong, the relevant document was not forged, and therefore, the remainder of the judge's findings proceeded from a false starting point. He was able to show conflicts / inconsistencies in the evidence. Regarding his failure to produce a full transcript of the case, Mr Allen said this that was a misguided mistake (he was not legally represented before the Tribunal).

The Tribunal's decision

In reaching its conclusion, the Tribunal thought that it was in an "unprecedented" position – it was asked to make a decision based on facts that were not even foreshadowed in a Warning Notice or Decision Notice. It found that the criticisms by the High Court Judge and the production of the redacted page, even if taken individually, were sufficient to warrant prohibition, and made a direction accordingly.

You can review the Tribunal's decision here. http://www.tribunals.gov.uk/financeandtax/Documents/decisions/Allen-v-FCA.pdf

Comment

Whilst this may in one sense have been considered by the Tribunal to be an unprecedented situation, in another, the matters that it was asked to take in account were not new or unusual. That is, the FIT rules clearly allow the regulator to take into account an adverse finding in civil proceedings and whether a person has been candid and truthful in his dealings with the regulator.

Nevertheless, the case has some significant points of interest both in itself and as part of an emerging theme:

- It is true to say that prohibiting individuals for conduct in other proceedings is not an exclusively new phenomenon. (See by way of example the 2010 case of Jared O'Loughnane (http://www.fsa.gov.uk/static/pubs/final/jared_michael.pdf), who was prohibited after having been found by the High Court to have made fraudulent misrepresentations). However, it does appear to be an emerging theme:
  - At the end of last year, David Hobbs was cleared of market abuse but nevertheless prohibited for lying to the FCA in the investigatory process and before the Tribunal. (See Enforcement Watch 12 "13 December 2013: Hobbs receives prohibition for lying in investigation and evidence").
  - That case was followed by Anthony Verrier (http://www.fca.org.uk/static/documents/final-notices/anthony-verrier.pdf), where, as in the O'Loughnane case, the regulator relied solely on findings of the High Court as the basis for its case for prohibition.
  - In the current conduct environment, we suspect that this will not be the last of this type of case that we see.
- In the present case, the Tribunal stated that, even if there had been merit in aspects of Mr Allen's attack on the judgment, the production of the redacted page had been a *"calculated attempt to mislead the regulator"* and showed Mr Allen's *"inability to understand the need for complete candour in his dealings with a regulator"*. It is noteworthy that this itself was sufficient to justify a prohibition.
- The Tribunal stated that Mr Allen could not be fit and proper to conduct activities "*which should be conducted only by the scrupulously honest."* It is not clear whether this represents a move by the Tribunal to try to raise the bar on honesty.
- We commented in the Hobbs case that whilst that case may have been clear cut in terms of lying to the Tribunal, there will no doubt be somewhat less clear cut cases in the future. There are often cases where individuals put forward a version of events that is not accepted, even if the individual is not found to be lying. The case of Mr Allen is perhaps not dissimilar in concept to the case of Mr Hobbs, and accordingly raises that issue once again. It would not be desirable if individuals were concerned that the putting of an

honestly maintained case, if disbelieved, could itself lead to a prohibition. It is to be hoped that the above line of cases does not cause individuals to fear that this may happen and does not cause them to self censor their evidence accordingly.

23 September 2014: Highest ever fine for client asset breaches

Barclays has been fined almost £38 million for failing properly to protect clients' custody assets. Without the 30% discount for early settlement, the fine would have been just under £54 million.

The case relates to breaches of Principle 3 (management and control)[3], Principle 10 (client assets)[4] and related CASS Rules during the period 1 November 2007 to 24 January 2012. They relate solely to Barclays' Investment Banking Division.

Some 95 external accounts held with 11 different third party sub-custodians in 21 different jurisdictions were in issue in the case. 61 of the accounts (holding approximately £13.5 billion of safe custody assets) held the assets of its wholly owned subsidiaries (its "Affiliates"), 33 held Affiliates' clients' safe custody assets (approximately £2.7 billion) and 1 account held the Bank's own clients' safe custody assets (approximately £0.3 billion).

Details of the precise failings found by the FCA fall outside the scope of this publication. However, broadly, they related to (i) systems and controls failings regarding the opening, on-going operation and monitoring of the accounts, and (ii) failing to arrange adequate protection for, maintain its own books and records and perform its own reconciliations in relation to the accounts. Although safe custody assets were at risk, there was no actual loss.

A copy of the Final Notice is at http://www.fca.org.uk/static/documents/final-notices/barclays-bank-plc-sept-2014.pdf

Comment

The level of the fine was substantial. This reflects a number of factors, including the significant value of safe custody assets at risk, the fact the failings continued undetected for a number of years, and the fact that the failings reflected widespread weaknesses in the firm's internal processes. It is interesting that the fine is substantial, despite the fact that the FCA points out that the bank itself reported the breaches (before the bank was aware of their full extent) and that it committed significant resources to investigating the failings and control weaknesses which led to them.

Significantly, it appears that the level of the fine is also intended to send a strong message to the industry that a failure to protect client assets will result in severe consequences. The background to this is Lehmans, which came to represent something of a watershed in terms of the regulator's focus on client money and client assets. Following this, the FCA wrote, for example, to Compliance Officers in 2009 and Chief Executives in 2010 about concerns regarding the management of client money and assets. It also established a specialist client asset unit in 2010. The level of the fine also comes against the background that the regulator had previously imposed sixteen fines for misconduct relating to client assets or client money (a number of which readers will have read about in this publication). Indeed, the Final Notice refers to numerous enforcement actions which had drawn firms' attention to the need for improved focus on the area.

[3] Principle 3: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

[4] Principle 10: A firm must arrange adequate protection for clients' assets when it is responsible for them.

In terms of calculating the penalty, given that the relevant period straddled the new and old penalty regime (see Enforcement Watch 1 "Harsher penalty setting introduced"), the penalty was calculated partly under the old regime and partly under the new.[5] Under the new penalty regime aspect, the FCA considered the case was of a level 3 degree of seriousness (on a scale of 1 to 5) and therefore (for the relevant period of time under the new penalty regime) used the appropriate percentage level as a base figure of calculation, being 0.4% of the value of the safe custody assets.

One particular factor cited by the FCA as aggravating is interesting. This is that, whilst the FCA said that the bank sought to co-operate with the investigation, its ability to respond to the FCA's requests for information quickly and accurately was at times hampered by the failings identified in the Final Notice. In other words, it appears that a lack of co-operation caused by the failings in issue was an aggravating factor, despite the fact that the bank was trying to co-operate. We wonder the extent to which this unusual looking paragraph was the product of negotiation between the parties.

[5] This is the first safe custody assets case that has been brought under the old penalty regime

The new "Enhanced Supervision"

In June 2013, the Parliamentary Commission on Banking Standards recommended that regulators be given new powers to address failings by Banks' senior managers (see Enforcement Watch 11 "Parliamentary commission makes far reaching recommendations". However, in response, the FCA, PRA and Treasury concluded that in fact their existing powers were (if exercised appropriately) adequate to bring about the changes the Commission required. Against that backdrop, the FCA June 2014 paper "Tackling Serious Failings in Firms" is a policy statement by the FCA as to how it does and will in the future use its existing Supervisory powers (such as s.166 "skilled-person" reports and attestations (a subject covered elsewhere in this publication"FCA publishes further details about attestations") to address failings in standards, governance and culture.

Readers of this publication will be interested in how the paper touches Enforcement. In that respect, we note that one aspect of the Commission's focus was the need for a better developed area of operation between the spheres of day-to-day Supervision and Enforcement. The FCA agreed, and in response has developed "Enhanced Supervision". This new approach will be formally applied to Firms that pose a "serious risk" to the FCA's objectives, due to a serious failure of culture, governance or standards, such that a normal supervisory approach would be inadequate.

The paper gives some indicative examples of red flags that may (and the FCA stress that it will be a matter for judgment on a case-by-case basis) lead to a Firm being placed into "Enhanced Supervision":

- The occurrence of numerous or especially significant conduct failings;
- A poorly functioning board;
- Control areas such as Risk, Compliance and Internal Audit being inadequately managed, under-resourced or unable to make their voices heard at Board level; and
- Evidence of other weakness in the way that the Board and senior managers influence culture (e.g. in relation to remuneration).

Once a Firm enters "Enhanced Supervision" the FCA will seek to use its existing powers (such as the skilled person report) to return a firm to normal supervision. The implementation of the FCA's plan will be regularly monitored. If the plan is not proving effective, then the FCA will consider changing it, for example by requiring a firm to undertake or cease certain action (under s.55L FSMA – the OIREQ powers). In some cases, "Enhanced Supervision" will be followed by an enforcement investigation.

Comment

To enforcement watchers, the concept of "Enhanced Suspension" has a number of interesting aspects:

- The "Enhanced Supervision" regime is consistent with the FCA's new pro-active approach. Whilst not an enforcement measure in itself, the measure does smack of quasi-enforcement. It is assumed that Enforcement would be involved in some capacity.
- There is no clarity as to the controls, if any, that there will be on the power to put a firm in "Enhanced Suspension". The paper simply

talks of firms being made "formally" subject to "Enhanced Suspension and being notified that they are subject to it.

- It will be interesting to see how many firms made subject to "Enhanced Suspension" emerge safely from that state and in how many cases enforcement or other punitive action follows.

Tracey McDermott speech on sustainability gives pointers to enforcement

On 22 July 2014, the FCA published a speech by Tracey McDermott (Director of Enforcement and Financial Crime) on the topic of sustainability, that was given at the Thomson Reuters Compliance & Risk Summit in London. In some respects, the speech recapped on what the FCA had been doing in the 15 months since its creation. In that sense, enforcement watchers may not regard it as terribly new. Nevertheless, there were still some aspects of interest for those of us involved in enforcement, and we have pulled out the following:

- McDermott made the point that there were many areas in which the FCA continued to see "disappointing results" from its work. One specific example she gave was anti-money laundering controls. She went on later to say that the FCA would continue to assess anti-money laundering processes and controls in major banks and those staff responsible for them. In 2014/2015, the FCA would, she said, be extending this to some smaller firms that may present high levels of money laundering risks, as well as carrying out focussed thematic work. The indications are that AML enforcement action may well be on the horizon.

- On a similar theme, McDermott warned that the FCA was continuing to prosecute insider dealing cases and that it had a number of investigations and prosecutions in the pipeline.

- McDermott also had something to say on the conduct of the subjects of investigations. In the context of individuals, she commented that the FCA expected them to co-operate with investigations openly and honestly. She then contrasted the conduct of firms and individuals who engaged fully with the enforcement process with those who "maintained implausible and incredible explanations for events only to backtrack at a late stage". Whilst she was silent on what the consequences of those two types of conduct were, it was plain what attitude McDermott was saying the FCA took towards them. We have already seen the stance the Tribunal will take to those who mislead (see for example elsewhere in this edition "Insurance broker receives prohibition for misleading the FCA in the course of his reference to the Tribunal"). We shall have to see whether there is any shift in sanctions in future, depending on the stance the subject takes to the investigation process.

- The FCA, said McDermott, needed to be able to rely on assurances given to it by the regulated community. It has increased penalties, she said, where assurances had been given that problems had been fixed when they had not. It is interesting that McDermott chose to highlight this. It seems to us that part of this message is yet again that attestations are important and that they need to be accurate (see on this elsewhere in this edition "FCA publishes further details about attestations"). As we have been saying for some time, we see attestations continuing to form a part of enforcement actions in future.

- There is a strong message about changing behaviours, and how that is not to be achieved by an army of compliance staff looking over people's shoulders. Instead, McDermott was looking to reinforce various messages, including about "putting conduct in the board room", senior accountability and ensuring that approved persons act as gatekeepers. As readers of this publication will have heard us comment, culture is a word that we increasingly see in Final Notices. The indications are that that will continue for some time.

Impact of FCA/PRA joint consultation on strengthening accountability through new framework for individuals

In Enforcement Watch 11, we reported on the recommendations made by the Parliamentary Commission on Banking Standards (PCBS) for improving the banking sector (see "Parliamentary Commission makes far reaching recommendations"). Subsequently, in Enforcement Watch 12, we reported on the resulting changes introduced by the Financial Services (Banking Reform) Act 2013 (the Act) (see Enforcement Watch 12 "New Banking Reform Act introduces new senior management/significant harm regime"). Whilst the Act provided the framework, we pointed out that much of the detail would be the subject of FCA and PRA consultation.

The FCA and the PRA have now produced their joint consultation paper. The proposed rules are designed to improve personal responsibility and accountability in the banking sector. Indeed, the regulators state that they intend for the proposals to create a new framework to encourage individuals to take greater responsibility for their actions, and that the proposals will make it *"easier"* for both firms and regulators to hold individuals to account.

The rules (in whatever final form they may be introduced) are likely to have a real impact on enforcement actions in the future. From amongst the mass of detail in the paper, we summarise some of the key aspects and how they may impact enforcement in future.

The new senior manager regime

The Act brought in a new regime applying to individuals performing a "senior management function". These were broadly speaking to be roles that involved or might involve a risk of serious consequences for the authorised person or for the business or other interests of the United Kingdom. The PRA and the FCA have specified in the paper those roles that each of them proposes to designate as senior management functions.

The combined list of proposed PRA and FCA senior management functions [6] extends to 18. Whilst a large number of them are the same as current functions, the proposals detail the responsibilities and key functions that the regulators would expect to be caught by them. These are interesting and include for example prescribed responsibilities, such as "leading the development of the firm's culture and standards in relation to the carrying on of its business and the behaviours of its staff" and "embedding the firm's culture and standards in relation to the carrying on of its business and the behaviours of its staff in the day-to-day management of the firm." The combined scope of the intended proposals would mean that the specified senior management functions would extend to all board members of relevant firms, as well as a number of other roles, such as heads of key control functions and major divisions. In larger, more complex firms, executive committee members would also be likely to find themselves captured by its scope.

The regulators also propose to issue rules and guidance requiring relevant firms to prepare, maintain and update a "Responsibilities Map". This is to be a single document that describes the firm's management and governance arrangements.

[6] The FCA specifies a number in addition to the PRA

Certification Regime

The Act also introduced a certification scheme for non senior management function employees whose roles may, in the regulators' view, be capable of causing significant harm to any authorised person or any of its customers. These individuals would not be approved by the regulators, but the relevant firms would be required to certify them as fit and proper once a year.

The consultation paper proposes that a wide population of employees comes within the scope of the certification regime. It is proposed to extend not only to customer facing roles and any other significant influence function roles under the current Approved Persons regime which are not otherwise covered by the senior management regime, but also to any individuals that supervise / manage a certified person.

A new set of "Conduct Rules"

As required by the Act, the old Statements of Principle and Code of Practice for Approved Persons will be replaced with a set of Conduct Rules with far wider application. Whilst the PRA proposes the Conduct Rules apply to all those approved as Senior Managers or who fall within the certification regime, the FCA proposes that they also apply to all other employees of relevant firms, except staff carrying out purely ancillary functions[7].

Comment

There is much in the proposed rules that is worthy of comment. By way of introduction, it should be remembered that

- this is a consultation paper. (The consultation period closes at the end of October 2014). Having said that, the framework is already in place under the Act. Further, the regulators' consultations (with noteable exceptions) tend broadly to go through in the form appearing in the consultation.

- the regime came out of the PCBS recommendations, and so broadly applies only to UK banks, building societies, credit unions and PRA designated investment firms. For the time being at least, it does not apply to other firms.

The practical implications of these proposals would be widespread. In some respects, the proposals are quite intricate and would need real working through by firms to assess how they apply to their businesses. Having done so, firms would need to work carefully through the various responsibilities, precisely who filled them and (in the current environment perhaps) who was prepared to fill them, and put arrangements in place to ensure they could comply with the wide ranging obligations imposed by the rules.

From an enforcement perspective, however, there are other points to note. Perhaps the central point is that this regime comes to a large extent out of the desire to restore trust, improve culture and hold individuals to account. Readers will recall the reversal of the burden of proof introduced by the Act in respect of senior managers (see Enforcement Watch 12 "New Banking Reform Act strengthens actions against individuals"). The potentially large number of people coming within the senior management regime and the very wide responsibilities and functions for which they would be responsible

---

[7] E.g. Catering staff, security guards and others carrying out a role which would be fundamentally the same in a non-financial services firm.

is almost bound to have a real impact on enforcement cases in future against individuals. Senior managers will find the playing field somewhat less even.

Further, the increased number of people it is proposed to sweep up under the certification regime, and also the FCA's proposal to include all other employees except those carrying out an ancillary function, will extend the number of people susceptible to enforcement. This is of course against a background where there has been some frustration in the recent scandals about those at institutions who the regulator may wish to punish but who were either not approved or not carrying out regulated activities.

Although it does not necessarily give rise to an increased enforcement risk, it is worth also mentioning the issue of notifications firms will be required to make to the regulator about individuals. This is an area that often gives rise to conflict between individuals and their firms. It can of course, in the worst analysis, also prompt enforcement action. We note that the Act requires a variety of new notifications to the regulator about various breaches by individuals (although in one respect, the paper proposes to limit the notifications). Further, the proposed rules look to extend the obligations on firms obtaining references and the precise details they should take from previous firms. If these go through, we foresee greater scope for conflict when possible rule breaches are in issue.

FCA publishes further details about attestations

As readers will no doubt know, the FCA (and the FSA before it) have for a few years now been using the supervisory tool of seeking attestations. Whilst a supervisory tool, we regard attestations as potentially also very significant in the enforcement sphere (see below in the "Comment" section).

Attestations were the topic of an exchange of correspondence between the FCA Practitioner Panel and the FCA earlier this year, with the exchange of letters being published on 26 August. Of note are the comments by Clive Adamson (Director of Supervision) in his letter dated 22 August 2014. He notes amongst other things:

- That he had concluded that it would be helpful for the FCA to clarify externally its views on when it expects to use attestations;
- The purpose of attestations is to gain personal commitment from an approved person that specific action has been or will be taken;
- The aim is to ensure there is clear accountability and senior management focus on those specific issues;
- Attestations will usually be sought from the most relevant SIF holder;
- The most usual types of attestations are:
  - Notifications: where the FCA will ask that it is notified if an emerging risk changes in nature, magnitude or extent;
  - Undertakings: that certain action will be taken within a particular timescale;
  - Self-certification: that a risk has been mitigated or resolved;
  - Verification: confirming not only that issues have been resolved or risks mitigated, but also that there has been appropriate verification (eg by internal audit).
- The FCA is strengthening its governance processes around attestations.

Comment

As we state above, attestations are significant in terms of enforcement.

For example, attestations are a means by which the FCA seeks to impose personal accountability. In an enforcement context, this is both a response to a public clamour to see such accountability and also a means by which the FCA no doubt hopes to be able to punish individuals where failings emerge.

As we have previously observed in this publication, inaccurate or untrue attestations can be, and have been used, in disciplinary cases against subjects (see by way of example elsewhere in this edition "28 July 2014: Lloyds and BoS fined for LIBOR and other benchmark failings").

As the FCA further builds its pro-active approach, and as the public continues to want to see individuals being held responsible, we believe that attestations will be increasingly relied on by the FCA in enforcement cases.

Two more SEC whistleblower awards and the first SEC action for retaliation against a whistleblower

The Securities and Exchange Commission continued to make use of its authority to reward whistleblowers, making two new awards to whistleblowers who provided information after their companies failed to internally address the improper activities. Additionally, for the first time, the SEC used its authority to take action against a firm that illegally retaliated against an individual who had provided information to the Commission.

On July 31 the SEC announced a $400,000 award to a whistleblower who provided information concerning a fraud that enabled the SEC to perform a more rapid investigation than would otherwise have been possible. The SEC notably highlighted the fact that the whistleblower had first tried to use internal company procedures to address the improper activity, but that the company refused to correct the problems.

Similarly, on August 29, the SEC announced a $300,000 award to a whistleblower who had audit and compliance functions at a company. According to the SEC, despite the employee's reporting of potential wrongdoing to appropriate personnel within the company, the company took no action. The employee thereafter reported the same information to the SEC, which led directly to an SEC enforcement action.

Finally, on June 16 the SEC announced that it had, for the first time, used its authority under a rule adopted in 2011 to bring an anti-retaliation enforcement action. According to the SEC, Albany, N.Y.-based hedge fund advisory firm Paradigm Capital Management and its owner, Candace King Weir, improperly engaged in a prohibited principal transaction by conducting transactions with C.L. King & Associates, a broker-dealer that Weir owned. Neither Paradigm nor Weir disclosed the common ownership on both sides of the transaction to the client, in violation of securities laws. This misconduct was reported to the SEC by Paradigm's head trader. Once Paradigm and Weir learned of the report, they purportedly took retaliatory measures against the trader which ultimately led to the trader's resignation. Paradigm and Weir agreed to settle the SEC's charges and pay disgorgement of $1.7 million, prejudgment interest of $181,771, and a $300,000 penalty for their alleged violations of the anti-retaliation rules and improper principal transactions.

For more information, see:
http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542578457
http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812
http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307

Comment

These new awards demonstrate the SEC's willingness to take swift action where a company ignores internal reports of wrongdoing and then retaliates against the employee who made the report. These actions are further examples of the SEC's demonstrated policy of providing cash rewards to those who come forward with information concerning fraudulent behavior, which is intended to encourage self-reporting and cooperation with governmental authorities.

Government agencies continue to obtain significant settlements from financial institutions

Government agencies have continued to aggressively pursue wrongdoing against large financial institutions, concluding four more settlements with U.S. banks.

On July 3, the Department of Justice announced a settlement with SunTrust Mortgage Inc. relating to the Department's criminal investigation of SunTrust's administration of the Home Affordable Modification Program. According to the Department of Justice, SunTrust misled mortgage servicing customers, making misrepresentations to borrowers and failing to process applications in a timely manner. SunTrust agreed to pay $320 million and implement remedial measures to resolve the investigation.

On July 24, the SEC charged Morgan Stanley & Co. LLC, Morgan Stanley ABS Capital I Inc., and Morgan Stanley Mortgage Capital Holdings LLC with misleading investors in a pair of residential mortgage-backed securitizations known as Morgan Stanley ABS Capital I Inc. Trust 2007-NC4 and Morgan Capital I Inc. Trust 2007-HE7. According to the SEC, the three Morgan Stanley entities misrepresented the current or historical delinquency status of mortgage loans underlying the securitizations. Morgan Stanley agreed to settle the charges by paying $275 million in disgorgement, prejudgment interest, and a penalty. This money will be placed into a fund designed to return money to injured investors.

On August 21 the U.S. Department of Justice and SEC announced a $16.65 billion settlement with Bank of America Corporation (BoA) -- the largest civil settlement with a single entity in American history -- to resolve a host of charges from a variety of federal and state agencies against BoA and current and former subsidiaries. The settlement includes a $5 billion penalty under the Financial Institutions Reform, Recovery and Enforcement Act, $7 billion of relief to affected individuals, and $1 billion to resolve claims by the Federal Deposit Insurance Corporation. BoA will also pay $943 million to settle the claims of California, Delaware, Illinois, Kentucky, Maryland, and New York. For the SEC's part, BoA agreed to pay $245 million to resolve charges that it failed to provide important information to investors concerning known uncertainties regarding potential increased costs related to mortgage sales between 2004 and 2008. The settlement also resolves fraud charges brought by the SEC related to a residential mortgage-backed securities offering. The settlement requires BoA to admit wrongdoing and be monitored for compliance with the settlement obligations. It also does not absolve individuals from civil or criminal liability, nor BoA from potential criminal prosecution.

Finally, on September 12, the U.S. Federal Housing Finance Agency (FHFA) announced a settlement with HSBC to resolve alleged violations of federal and state securities laws by HSBC North America Holdings Inc. The claims relate to private-label mortgage-backed securities purchased by Fannie Mae and Freddie Mac between 2005 and 2007. The settlement calls for a payment of $550 million to Fannie and Freddie Mac.

For more information, see:
http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542719632
http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542355594
http://www.justice.gov/opa/pr/2014/August/14-ag-884.html
http://www.justice.gov/opa/pr/2014/July/14-ag-697.html
http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Settlement-with-HSBC.aspx

Comment

These settlements indicate that the U.S. government has not waivered on its policy of holding banks accountable for their unlawful mortgage lending related activities. The record settlement with Bank of America is noteworthy not only for its size, but also because it required the bank to admit a statement of facts and does not absolve it or its employees of liability. It is possible that such a significant settlement is, at least in part, a response to public concern in the United States that regulators believed some large financial institutions are "too big to fail", and thus could not be subject to significant civil and criminal penalties. Given the continued and significant prosecutions and settlements, there is no reason to believe that the U.S. government will cease its investigations and prosecutions of financial institutions believed to have engaged in fraudulent mortgage related activities. We expect to see further significant settlements with those financial institutions currently under investigation.

Settlements and prosecutions for LIBOR manipulation continue

U.S. government authorities have continued to pursue the entities and individuals responsible for manipulating the London Inter-Bank Offered Rate (LIBOR), recently resolving two more investigations.

On July 28 the Department of Justice announced that Lloyds Banking Group plc agreed to settle charges relating to its role in a scheme to manipulate LIBOR. As part of the settlement, Lloyds will enter a deferred prosecution agreement requiring an $86 million penalty and to admit and accept responsibility for misconduct set forth in an extensive statement of facts. Lloyds will also need to continue cooperating with the Justice Department's ongoing investigation into LIBOR manipulation by other financial institutions. This latest settlement brings the total amount Lloyds has paid to financial regulators to almost $370 million. (See elsewhere in this edition "28 July 2014: Lloyds and BoS fined for LIBOR and other benchmark failings").

On August 18, British citizen Paul Robson, a former Yen trader for Dutch bank Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank), pled guilty in a New York federal court to participation in a conspiracy to manipulate the Yen LIBOR. The prior month another former Rabobank trader, Japanese-national Takayuki Yagami, pled guilty to similar charges in New York federal court. Rabobank itself previously had agreed to settle the Department of Justice's investigation by entering into a deferred prosecution agreement requiring a $325 million penalty. Notably, the Department of Justice highlighted the role of British and Dutch financial regulators in referring the case and assisting with the investigation of these former traders and Rabobank.

For more information, see:
http://www.justice.gov/opa/pr/2014/July/14-crm-786.html
http://www.justice.gov/opa/pr/2014/August/14-crm-872.html

Comment

Given its now longstanding efforts to combat LIBOR manipulation, and as discussed in Enforcement Watch 9 ("Banks continue to face legal and financial repercussions from the LIBOR scandal"), the U.S. government's continued action against suspected LIBOR manipulators comes as no surprise. Still, these recent criminal dispositions are notable. First, unlike the mortgage backed securities investigations, the U.S. government is still targeting individuals involved in LIBOR manipulation, not just financial institutions. Second, the U.S. government is successfully working with its foreign counterpart governments on cross-border LIBOR investigations. The combination of active enforcement and international cooperation is likely to yield further prosecutions and settlements in the coming months.

Average prison terms for insider trading increase

According to a recent study published by Reuters, the length of U.S. federal prison sentences for individuals convicted of insider trading have been increasing in recent years, and have reached an average sentencing level that would have been unthinkable just a few decades ago.

Between 2008 and 2013, prison sentences for insider trading convictions increased by 31.8% to an average of 17.3 months. Indeed, in the past few years there have been several notable sentences: in 2011 Raj Rajaratnam was sentenced to eleven years, in 2012 Matthew Kluger was sentenced to twelve years, and just recently Mathew Martoma received a nine-year sentence.

These longer sentences are at least due in-part to what appears to be a reliance on the federal sentencing guidelines. The guidelines are no longer mandatory, but their usage remains a prevalent and persuasive tool of federal prosecutors, and judicial guidepost for federal criminal sentencing. Notably, the guidelines take into account the amount of loss involved in insider trading which provides an upward departure from the base guideline sentencing level for such crimes. Moreover, the guidelines (as amended in 2012), provide a minimum sentence of 15-21 months for those involved in an “organized scheme” to trade on confidential information, as is typically the case in most insider trading actions. Since the financial crisis of 2008, the U.S. Department of Justice has aggressively prosecuted suspected insider trading and similar criminal offenses. The New York Times has commented that the judiciary in the United States District Court for the Southern District of New York – where a large percentage of the insider trading cases are prosecuted – endeavor to match each other’s sentences so that sentencing terms will be consistent for similar crimes, and not otherwise affected by random events, such as the court’s independent judicial assignment system for all new cases. The result has been the imposition of increasingly longer sentences after conviction or guilty plea. It is also notable that U.S. courts have been imposing more prison sentences (rather than monetary punishment) for insider trading than ever before.

For more information, see:
http://www.reuters.com/article/2014/09/02/us-insidertrading-prison-insight-idUSKBN0GX0A820140902
http://dealbook.nytimes.com/2014/09/09/punishments-for-insider-trading-are-growing-stiffer/

Comment

The Reuters' report demonstrates that, since the financial crisis of 2008, the U.S. government and judiciary are aggressively prosecuting and severely punishing financial related crimes. Given the request for and imposition of increasingly extreme sentences by the U.S. government and judiciary, it is more important than ever for defense strategies to include an analysis of prison exposure and how it may be limited through and by cooperation with the government.