

# Compliance Monitor

The monthly briefing service for compliance specialists

## Half a decade of FSA Enforcement

On 16th June, the FSA held its third conference on enforcement and investigations. **Andrew Hart** and **Oliver Kerridge** of Freshfields analyse the themes that emerged during the day's proceedings.

The keynote speaker was John Tiner, the FSA Chief Executive and he made the following main points:

### Role of Enforcement within the FSA

Although the FSA does not consider itself to be an enforcement-led regulator, enforcement action is necessary on occasion and is used as part of the FSA's overall risk-based supervisory strategy. Given the large amount of publicity that enforcement action can generate, the FSA uses it to communicate issues of concern and as a deterrent. Enforcement's priorities are in line with the FSA's overall priorities. The Enforcement Division has been restructured to align with the FSA's Wholesale/Retail Business Unit Model. In the wholesale area, Enforcement will be concentrating on market abuse and systematic insider dealing. In the retail area, Enforcement will be concentrating on payment protection insurance, equity release and mortgage endowment complaints handling.

### Enforcement Process Review

The implementation of the results of the Enforcement Process Review has ensured that there is more transparency in the way that the FSA deals with cases and feedback from firms and advisers has generally been positive. The Litigation and Legal Review team has been set up so as to ensure that cases are stress-tested by independent lawyers before the preliminary findings letter is sent out and before matters are put to the Regulatory Decisions Committee (RDC). The FSA Board and the FSA Executive Committee will conduct regular reviews of how enforcement is being conducted.

### Executive settlements

The majority of cases which result in disciplinary action being taken are settled rather than being fought out

through the RDC process. The FSA prefers to settle cases early so that it can communicate messages more quickly and ensure prompt redress. Additionally, the FSA is less willing to allow settlement negotiations to drift and may encourage more formal mechanisms such as mediation in appropriate cases. However, despite the emphasis on early settlement, there will be situations where the FSA will need a period to become fully apprised of the facts before it can enter negotiations. Settlement discussions are conducted by the Enforcement case team together with two FSA directors (one of whom would normally be Margaret Cole, FSA Director of Enforcement) setting out the parameters and approving any settlement. So as to ensure consistency of approach, the RDC and Enforcement Division liaise regularly and discuss the factors the FSA considers important for penalty setting.

### More Principles-based approach to regulation

The FSA will take more enforcement action on the basis of breaches of the Principles alone. However, such action will only be taken in cases where it would have been reasonably predictable that the behaviour in question would be in breach of the relevant Principles. The Enforcement Division is liaising with the RDC to discuss the implications of this approach.

### Commentary

Various points of interest arise from Mr Tiner's speech and the conference in general:

### FSA's priorities

Mr Tiner stated that, in the wholesale area, the Enforcement Division will be concentrating on market misconduct. These cases are notoriously difficult to prove and the FSA has recently suffered two defeats in the Financial Services and Markets Tribunal. In the Plumber case (see *Knocking in the pipes* in the last edition of *Compliance Monitor*), the Tribunal confirmed that the standard of proof to be applied in market abuse cases is a heightened civil one likely to produce similar

results as the criminal burden of proof (beyond all reasonable doubt). In order to circumvent this high burden of proof, the FSA may decide to present future cases as breaches of the Principles.

### **Enforcement process**

One welcome development mentioned by Tim Herrington, Chairman of the RDC, in a separate speech is that the RDC are holding more split hearings. It has always been a concern for firms that they have had to deal with both liability and quantum at the same oral representations session. Additionally, the fact that being referred to Enforcement does not inevitably lead to enforcement action being taken was also highlighted by Margaret Cole in her speech following Mr Tiner's. In that speech she stated that, excluding threshold conditions cases, in 2005/2006 37% of matters investigated by Enforcement concluded with no formal disciplinary action being taken. In a further 9% of cases, private warnings were issued.

Mr Herrington also raised concerns about the Enforcement Division's physical proximity to the RDC. Both bodies sit within the same building and Mr Herrington considered it odd that no information barriers or Chinese walls existed.

### **Settlements**

The fact that the majority of cases which result in disciplinary action being taken are settled rather than fought is a welcome development. Although the FSA stated that it has never decided to refrain from taking enforcement action as a result of the mediation process, in one instance it has decided to refrain from imposing sanctions and instead issued a private warning.

Furthermore, following Shell's settlement with the FSA on a no admission or denial basis, it is interesting to see that the same approach was adopted with Nigel Howe, the broker who was fined £300,000 (reduced to £50,000) for his involvement in market abuse at the time of the flotation of Cypotex PLC on AIM. It is not clear, however, why his Final Notice still has not been released by the FSA given that the Financial Services and Markets Tribunal issued its decision in the Plumber case two months ago (see *Knocking in the pipes* in the last edition of *Compliance Monitor*).

### **Financial Services and Markets Tribunal**

In his speech, Stephen Oliver QC, President of the Financial Services and Markets Tribunal highlighted

the difficulties under the present rules for individuals to receive legal aid when making references to the Tribunal. Recently Tim Baldwin, an equity salesman, was refused costs following his successful reference to the Tribunal because it had not been proved that the regulator had acted "unreasonably". For individuals, this leaves an inequality of arms which Mr Oliver considered was unjust. This may also be one of the reasons why, out of 111 references that have been made to the Tribunal, only 32 have resulted in substantive decisions.

In the same session, Tracey McDermott, the FSA Enforcement Department's Head of Litigation and Legal Review stated that, on occasion, the Tribunal misinterpreted the FSA's rules but the FSA did not consider that it was under a duty to publicise which rules had been misinterpreted. Neither has it appealed any decisions. The FSA believes that the Tribunal is not bound by its past decisions and accordingly, the FSA considers it acceptable for cases to be referred to the Tribunal even though the issue in question is already covered by a Tribunal decision. However, when looking at Tribunal decisions, it is evident that the Tribunal generally does follow previous decisions.

### **Principles-based approach**

The FSA's stated commitment to concluding more enforcement cases on the basis of a breach of the Principles alone is a matter of concern for firms. Although the predictability test set out by Mr Tiner will form some sort of safeguard, even that test is likely to give rise to problems as well as a lack of certainty as to whether particular conduct may be in breach.

First, the FSA's concentration on the Principles will mean that it will be more difficult for compliance officers to ratify transactions given that a much broader view will have to be taken rather than just looking at the FSA Handbook. This also raises the risk of speech-based regulation. Given the broad nature of the Principles, the FSA's guidance on how they are to be interpreted will become more important. Unlike changes to the FSA Handbook such guidance can be formed without a formal consultation process and risks being disseminated in a fragmented fashion making it difficult to find.

Second, if a matter does come under the scrutiny of the Enforcement Division, it may be difficult to prove whether it was indeed reasonably predictable

at the time that the behaviour would be in breach of the Principles. Firms should be judged by the standards and business practices applicable to the time of the relevant behaviour and not with the benefit of hindsight. This risk of retrospective regulation has been acknowledged by the FSA in a speech by its Director of Small Firms on 8 June 2006. This will make record keeping even more important as firms will need to document the current business environment and practices in case the regulator challenges past conduct.

Third, the Principles can be used to blur breaches. For example, partly because of the inflexibility of the detailed rules, the line between traditional misselling (ie, the sale of unsuitable products) and other related breaches, such as the lack of records or failure to handle complaints properly has become increasingly blurred. A number of enforcement cases relating to products that are generally understood to have been missold are not really misselling cases at all. Similarly, as highlighted above, Principle breaches may be presented as market misconduct cases even though the market misconduct rules may not have been broken.

Finally, although the FSA has stated that it is committed to simplifying the Handbook and reducing its size (partially by taking a Principles-based approach), the implementation of the Markets in Financial Instruments Directive (Directive 2004/39/EC) will lead to the creation of a considerable set of new rules [1]. It is unclear whether a Principles-based approach is compatible with MiFID's 'maximum harmonisation' nature in that such an approach may be seen as 'gold-plating'

MiFID by imposing additional requirements on firms.

### Other

Given the disquiet in the retail industry surrounding the role of the Financial Ombudsman Service in mass misselling claims, it is odd that Mr Tiner has not taken the opportunity to address this issue. FOS is not bound by legal principles but decides cases on the basis of what is fair and reasonable in the circumstances of the case.

Despite the fact that FOS was never intended to make decisions that would have a significant financial impact on firms, the fact that FOS determinations act as de facto precedent means that this is not the case in practice. For example, the effect of FOS decisions in lead cases on dual variable rate mortgages reportedly cost one firm alone £90 million.

However, despite the significant impact that FOS determinations can have, there is no effective way of challenging them and failure to comply with them can lead to enforcement action being taken.

### Notes

1. See The MiFID implementing measures: excessive detail or level playing field? in the June 2006 edition of Financial Regulation International ([www.informafinance.com/fri](http://www.informafinance.com/fri)).

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