



The FSA confirms its new financial penalties regime

This briefing provides commentary on the Enforcement Financial Penalties Policy Statement (10/4), and outlines the key amendments to the Decision Procedure and Penalties Manual (DEPP) and the Enforcement Guide (EG) that were published by the Financial Services Authority (FSA) on 1 March 2010. Financial penalties will now be linked more closely to any income generated by breaches. The FSA has indicated that the effect of the regime is likely to be that its financial penalties will double or treble in size.

The new FSA regime comes after an industry-wide consultation last year. Despite widespread opposition, the new regime is largely unchanged from the proposals the FSA published in its consultation paper (CP09/19) dated 6 July 2009.

The objectives of the new penalty framework, as set out in the FSA's July 2009 consultation paper, largely revolve around the following fundamental principles.

- Disgorgement: to ensure that wrong-doers cannot or do not benefit from any breach.
- Discipline: firms and individuals should be penalised for their wrongful conduct.
- Deterrence: the financial penalty should be sufficient to deter firms and individuals from repeat offending or committing breaches in the first instance.
- Transparency and consistency: to establish a more consistent and transparent approach by the FSA to the calculation and imposition of financial penalties on firms and individuals.

The new regime came into effect on 6 March 2010. It is intended to assist the FSA in its goal of achieving 'credible deterrence' through its enforcement outcomes. The FSA has been concerned that its enforcement methods and philosophy do not have the required deterrent effect or create a compliance-driven culture within the industry. Overall, the new regime is not surprising given the FSA's long-held view that a more aggressive enforcement approach and the imposition of higher financial penalties are necessary to lead to a change in industry behaviour and practice.

The new framework

The fundamental changes to DEPP and EG are that the FSA will now use a five-step framework to determine the level of the financial penalty to be imposed on: (a) firms; (b) individuals; and (c) in market abuse cases. The FSA has also sought to confirm its approach to the imposition of penalties in situations of serious financial hardship.

The assessment of the financial penalty will involve the following.

Step one (disgorgement)

The FSA will determine an appropriate disgorgement figure. Such amount will seek to deprive the firm or individual of any financial benefit derived from the breach, including any profit made or loss avoided, where such benefit can be identified and quantified.

Interest will ordinarily be charged on any benefit identified and quantified by the FSA. The relevant interest rate, and the date from which it will apply, will be determined on a case-by-case basis. The FSA may have regard to the interest rates applied by the Financial Ombudsman Service and the civil courts.

Step two (seriousness and discipline)

The FSA will determine a punitive figure, which will be imposed on top of the disgorgement figure (step one), to reflect the seriousness of the breach and to punish the wrongdoer. This will involve the FSA:

- (a) determining the amount of 'relevant revenue' or 'relevant income' generated from the breach; and

(b) deciding on the percentage of the ‘relevant revenue’ or ‘relevant income’ which should form the basis of the penalty.

In cases against firms, the FSA can select up to 20 per cent of the revenue derived from the products or business areas to which the breach relates (relevant revenue). Depending on the nature, effect and seriousness of the breach, the FSA will categorise it as belonging to one of the following levels: level 1 – 0 per cent; level 2 – 5 per cent; level 3 – 10 per cent; level 4 – 15 per cent; and level 5 – 20 per cent. The FSA has indicated that the meaning of ‘relevant revenue’ will be dependent on the facts of each case, as such it should not be viewed as a ‘term of art’ or reflect a precise accounting definition.

In cases against individuals, the FSA can select up to 40 per cent of the individual’s gross amount of all benefits (salary, bonus, pension, share options and share schemes) received during the period of the breach (relevant income). Again, depending on the nature, effect and seriousness of the breach, the FSA will categorise it as belonging to one of the following levels: level 1 – 0 per cent; level 2 – 10 per cent; level 3 – 20 per cent; level 4 – 30 per cent; and level 5 – 40 per cent.

In market abuse cases referable to the individual’s employment, the FSA will select the greater of: (i) up to 40 per cent of the individual’s relevant income using one of the levels outlined above; (ii) a multiple of up to 40 per cent of the profit made or loss avoided for the individual’s benefit or the benefit of others; and (iii) in the most serious of cases (level 4 or level 5) a penalty of £100,000.

The starting point will be a minimum of 12 months’ relevant revenue or relevant income, or where the conduct continues for longer than a year, then the relevant revenue or relevant income earned during the period of the breach. Where a breach lasts less than 12 months, or is a one-off event, the relevant revenue or relevant income will be derived from the twelve months preceding the end of the breach.

In market abuse cases not referable to the individual’s employment, the FSA will select the greater of: (i) a multiple of up to 40 per cent of the profit made or loss avoided for the individual’s benefit or the benefit of others arising as a direct result of market abuse; and (ii) in the most serious cases (level 4 or 5) £100,000.

The FSA retains discretion to use an ‘appropriate alternative means’ of determining the punitive figure and the assessment of the harm or potential harm, particularly where relevant revenue is not an appropriate measure. Very little guidance has been provided on how this will work in practice. The FSA’s rationale for this is that it is very hard to predict, in advance, what alternative measures they may need to apply in any particular case. This is likely to be a highly contentious area in practice, and we comment further on it below.

Step three (mitigating or aggravating circumstances)

The FSA may increase or decrease the amount of the financial penalty arrived at after step two (but not the disgorged amount determined under step one) as a result of any aggravating or mitigating factors. Any adjustment will be a percentage adjustment. A customer redress exercise, the remedial steps taken to correct or remedy the breach and the degree of co-operation shown to FSA during its investigation are all examples of mitigating factors the FSA may consider.

Step four (deterrence)

The FSA may increase the amount of the financial penalty arrived at after step three if it considers the amount is insufficient to deter the firm or individual who committed the breach, or others, from committing further or similar breaches. An increase may occur if the FSA does not consider that the penalty meets its objectives of credible deterrence or where previous FSA action for similar breaches has failed to improve industry standards.

Step five (settlement discount)

The FSA will apply, as is currently the case, a settlement discount to reflect the stage at which the FSA, the firm or individual reached an agreement. The settlement discount does not impact the disgorgement figure calculated at step one.

Serious financial hardship

The new regime indicates that the FSA will not shy away from imposing financial penalties that could bankrupt firms and individuals, particularly where its regulatory objectives would otherwise be compromised. Any serious financial hardship that may be brought about

through the imposition of the penalty will not result in an automatic reduction of the penalty. Instead, the onus will be on firms and individuals to satisfy the FSA that the payment of the penalty will have serious financial hardship consequences for them.

The FSA will now consider a reduction in a financial penalty only if: (a) verifiable evidence of the firm's or individual's financial situation is produced; and (b) the firm or individual provides full, frank and timely disclosure of all the information the FSA requires, including answering any questions regarding their financial position. In effect, this reverses the burden and forces co-operation.

For individuals, the new regime indicates that the FSA will only consider that they have suffered serious financial hardship if their net annual income falls below £14,000 and their capital falls below £16,000. The FSA will consider as capital anything that could provide the individual with a source of income, including savings, property (including personal possessions), investments and land. There may be cases, however, where the FSA considers the conduct to be so serious that it will impose a penalty despite the financial hardship that will be caused.

For firms, the FSA will consider whether the penalty will render the firm insolvent or threaten its solvency. There may, however, be circumstances where the breach is so serious that it may not be appropriate to reduce the penalty, particularly in circumstances where the FSA is seeking to achieve credible deterrence.

Implications for the industry

As this marks an entirely new approach to the setting of penalties, its practical consequences will take some time to become apparent – and much will depend on how the FSA operates the regime (given the extent of the discretion that it retains). However, it is already possible to foresee some important implications for the industry, which are outlined below.

The regime does not have retrospective effect

The FSA will only impose financial penalties according to the new regime for conduct that takes place on or after 6 March 2010. In situations where the conduct occurs before 6 March 2010 and continues after that date, the

new penalty framework will only apply to that part of the breach which occurs on or after 6 March 2010. The new regime should, therefore, be irrelevant to past conduct.

Transparency and predictability

The new regime attempts to inject greater clarity and transparency into the financial penalties imposed – objectives that are to be welcomed. That said, it still provides the FSA with a high degree of discretion and flexibility. If the FSA considers the penalty is too low or too high, it can adjust it. Such flexibility exists in the current regime, and gives rise to the lack of clarity and predictability upon which the FSA is seeking to improve. It remains to be seen whether in practice the new regime is significantly more predictable.

This is particularly a risk when it comes to the application of the various steps. Given the numerous factors that the FSA can consider at steps two and three, combined with the additional discretion at step four, firms and individuals are unlikely to be able to isolate which factors were considered at each step. The significant scope for subjectivity at steps two, three and four also means there is some potential for 'double counting'.

Relevant revenue

The penalty figure will be determined largely by the figure that is taken for relevant revenue – and that figure will often be contentious. There are a number of interlinked issues. First, there will be the question of which is the relevant business area or product: the regime provides little assistance in defining this. Second, there will be the question of what revenue is generated by that business area or product – which will not necessarily be straightforward to answer. Third, there is the question of whether the amount of revenue generated by that business area or product is 'indicative of the harm or potential harm' that the breach might cause. If the FSA thinks the answer is yes, then that figure will be taken as the base. If the answer is no, then the FSA will use 'an appropriate alternative'. So, the final question is what is an appropriate alternative?

These issues are likely to be particularly difficult to resolve in the context of a large institution, where a simplistic approach to relevant revenue could produce an inappropriately large figure to be used as the base for

a financial penalty. One of the difficulties is that there is no reference point for assessing what is 'indicative of harm' or 'an appropriate alternative'. Given the amounts that could be at stake, it may be that the meaning and application of the new regime will need to be clarified not only with the FSA's Regulatory Decisions Committee but also, in due course, by the Tribunal.

The implication of using a minimum of 12 months' relevant revenue or relevant income to determine the step two calculation is that a one-off breach lasting two weeks will get a penalty broadly the same as one lasting 12 months (assuming both breaches are equally serious, taking all factors into account). Similarly, a less serious breach that lasts several years (for example, because systems were inadequate) could receive a larger fine than a very serious one-off breach. So, it is not surprising that the FSA has reserved for itself considerable discretion as to the practical application of the regime.

This considerable flexibility has the potential to undermine the consistency of treatment by the FSA. Firms and individuals subject to enforcement action should, where possible, seek to obtain as much information as possible from the FSA about the calculation of the penalty and the application of the new regime. This will allow them to highlight any inconsistencies or unfairness about the application of the new regime in their case.

Deterrence

The regime confirms that the FSA will impose higher penalties on firms and individuals who have committed breaches that are similar to those that have been the subject of previous enforcement action. It is likely that the FSA will focus more on using its enforcement decisions against particular firms – and the threat of high penalties – to change the conduct of other firms within the same sector or selling the same product.

Approved persons

The new regime will assist the FSA in its aim of focussing more on the conduct of approved persons, and in particular those holding significant influence functions. The new regime makes clear that this can lead to the imposition of financial penalties which have a significant impact on an approved person. This extends to cases where senior management have failed

to act with reasonable care, particularly in systems and controls-related cases. It seems likely that the FSA will use this – together with the tougher approach to financial hardship – to reinforce its message about the personal responsibility of those carrying out controlled functions. This does not, of course, remove the evidential and practical difficulties for the FSA of bringing enforcement cases against individuals, particularly for alleged failures to supervise or implement systems and controls.

Settlement

Currently a very large proportion of FSA enforcement cases settle at an early stage – with the benefit that this frees up FSA resources reasonably quickly for new cases. There is a possibility that the prospect of significantly higher financial penalties will lead to an increase in challenges to the FSA, which would tie up its resources. Much will depend upon how the FSA seeks to apply the regime in practice, and whether it takes a realistic approach to the financial penalties that it seeks to obtain.

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