



ADDLESHAW GODDARD

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2009 – The Year of Enforcement?



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Introduction

In 2008 we saw a significant change in the way the Financial Services Authority (**FSA**) approached enforcement. There has been a noticeable shift in emphasis in that the FSA now have a much sharper focus on enforcement as a strategic tool at the forefront of their drive to achieve 'credible deterrence'.

The FSA's desire to achieve credible deterrence will mean more focus on those cases in which the FSA think they can make a real difference to consumers and markets, using enforcement strategically to change behaviour in the industry. To achieve credible deterrence, the wrongdoers must not only realise that they face a real and tangible risk of being held to account but must also expect a significant penalty.¹

What does this shift in emphasis mean for firms?

The FSA have highlighted three key themes which stem from this change in emphasis:

- ⌚ bringing enough cases of the right sort which result in significant fines;
- ⌚ stressing the importance of senior management responsibility and taking action against them where there have been failings; and
- ⌚ making greater use of criminal sanctions where that is appropriate.

In this note we look at:

- ⌚ the increasing levels of penalty imposed by the FSA;
- ⌚ what the change of emphasis means for senior management;
- ⌚ the consequences of being in enforcement, beyond the imposition of a penalty;
- ⌚ the FSA's increasing use of criminal sanctions, particularly in respect of market abuse and insider dealing cases; and
- ⌚ what you should do if you face the risk of enforcement.

Increased Penalties

It has been repeatedly stated by the FSA that where it sees evidence that standards are not improving despite clear messages to the industry, it will seek tougher penalties to achieve its goals. In many cases, tougher penalties means bigger fines and we have seen evidence of this in relation to PPI, an area of significant focus for the FSA over the last 12 months.

In September 2007, the FSA committed itself to imposing higher fines for firms in the PPI market where standards fell below the required level as it felt that firms had been given due warning of their obligations to treat customers fairly, both generally and on PPI in particular. Whilst the facts of the cases are obviously different, the table below demonstrates a marked shift in the level of fines levied, consistent with the FSA's commitment.

¹ Chief Executive Officer's Overview, FSA Business Plan for 2008/2009



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Pre-September 2007			Post-September 2007		
10/06	Loans.co.uk Limited	£455,000	01/08	HFC Bank Limited	£1,085,000
12/06	Redcats (Brands) Limited	£270,000	05/08	Land of Leather Limited *	£210,000
01/07	GE Capital Bank Limited	£610,000	07/08	Liverpool Victoria	£840,000
02/07	Capital One Bank (Europe) Plc	£175,000	10/08	Alliance & Leicester	£7,000,000
09/07	Hadenglen Home Finance plc*	£133,000	11/08	Egg Banking plc	£721,000

* The Chief Executives were also individually fined in these cases.

What action should firms be taking?

- ⦿ *Firms should be alive to the standards expected by the FSA, particularly through statements in FSA papers, speeches and published enforcement actions. Firms should invest time in benchmarking their activities against the published expectations of the FSA and should seek to remedy any shortcomings it identifies as soon as possible.*
- ⦿ *TCF should now be fully embedded in a firm's business structure. The FSA are likely to take a dim view of non-compliance, particularly now that TCF is no longer viewed as a standalone project but forms part of the FSA's supervisory oversight function.*

Action against senior management

The FSA has made a strategic decision to investigate more individuals. This has implications for all senior management, particularly those who carry out significant influence functions. Whilst the FSA have consistently stressed the importance of senior management responsibility and oversight, that message has not been matched with decisive action, until recently.

It is recognised that action against individuals has a much greater impact in terms of deterrence than action against firms. The FSA sees taking action against individuals as an effective way of achieving credible deterrence. In the past, where action has been taken against individuals, it has tended to focus on cases of dishonesty or lack of integrity. We know that the FSA assesses the competence of holders of significant influence functions and takes action against those who are in breach of the FSA's Principles and the Code of Practice for Approved Persons.

It is worth noting that the FSA's focus on the responsibility of senior management is not limited to the messages coming out of Enforcement Division. The challenges and obligations of senior management have been succinctly summarised in a recent FSA speech where it was said that... "Just as the FSA is adapting, it continues to be crucial that within firms, the boards and senior management actively manage delivery of firms' regulatory responsibilities, and this requires that they demand relevant information and use that information to mitigate these risks. It should come as no surprise to you then that supervisors will be challenging senior managers more intensely about the decisions made and holding them to account. It is crucial that senior management develop business options, that they give robust consideration to the risks and the impact of those risks if they were to crystallise".²

Where individuals do not meet these requirements, the FSA is now demonstrating its willingness to take action. Since October 2008, a total of 16 enforcement actions have been the subject of a press release. Of these, 6 relate to action

² 'The challenge of compliance' Speech by Sally Dewar, Managing Director, Wholesale, FSA at the Securities House Compliance Officer Group conference, 15 October 2008



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against firms only whilst in the remaining 10, action was taken against an individual. It is worth noting in relation to individual action that:

- ⌚ the FSA used various sanctions. Fines were levied in 4 cases, prohibition notices banning individuals from the financial services industry in specified circumstances were issued in 5 cases and public censure (a public statement of the individual's misconduct) was used in one instance;
- ⌚ the regulated activities covered were wide-ranging and include insurance, life assurance, investments, mortgage broking and advisory services; and
- ⌚ the individuals fined included directors, anti-money laundering reporting officers and chief executives.

What action should firms be taking?

- ⌚ *Senior management need to have a clear understanding of their obligations under the regulatory regime, particularly when appointed as an approved person to a significant influence function. Existing approved persons will have received training on their appointment as to their role and responsibilities. This should be refreshed with approved persons being made aware of the FSA's renewed emphasis on their role. For new approved persons, existing training material should be reviewed and updated to ensure that the important messages are received and understood.*
- ⌚ *Renewed focus should be given to ensuring that the board has effective oversight of the business with particular consideration being given to the robustness of the management information used by the board. Where management information identifies failures, this should be acted on in an appropriate and timely manner.*

The consequences of enforcement

The risk of a financial penalty and action against individuals are two of the potential consequences of enforcement action. Others consequences which firms will be aware of are the extensive management time which is involved in dealing with the enforcement process and the adverse publicity which is generated. One consequence which is often overlooked, but in which the FSA are taking a keen interest, is that of rectification for customers who have or may have suffered loss as a result of the failings. In its Enforcement Annual Performance Account 2007/2008, the FSA stated that it had recently refocused its attention on ensuring that firms carry out effective customer contact exercises and the FSA has been using its settlement process to agree with firms the letters they propose to send to customers as a part of the contact exercise. The redress paid to customers, together with the costs of the contact exercise, can often dwarf the fine imposed.

Market abuse and insider dealing

The FSA has identified market abuse and insider dealing as a vital part of the focus on achieving credible deterrence. The FSA has committed to making greater use of the criminal sanctions it has available for breaches in this type of case. In 2008 we saw the FSA impose fines on four individuals for market abuse and a number of criminal insider dealing prosecutions have been commenced with other FSA investigations also currently underway. It is apparent that despite the difficulties in bringing successful market abuse and insider dealing actions, this is a priority area for the Enforcement Division.

One of the ways that the FSA hopes to achieve increased success is through changes to its Enforcement rules. The FSA recently consulted on proposed changes to the Decision Procedure and Penalties Manual and Enforcement Guide and



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now intends to introduce a 'leniency factor' to the non-exhaustive list of factors which it may take into account when considering cases of market abuse. This may have the effect of the FSA taking regulatory (market abuse) rather than criminal (insider dealing) action against individuals as an incentive for them to provide evidence in cases where such co-operation will assist the FSA in securing the conviction of another.

Important Lessons

- ⌚ *Market abuse cases are being upheld on evidence which is not conclusive. It is sufficient to be able to draw inferences and conclusions from the "cogent and compelling" circumstantial evidence in the case. The use of the 'leniency factor' to promote co-operation should, theoretically, make these cases easier to bring.*
- ⌚ *Where the FSA finds market abuse in relation to an approved person, it is likely to increase the level of penalty which it imposes since there is a higher regulatory responsibility and a corresponding higher position of trust.*
- ⌚ *Recent cases have shown that there is no need to demonstrate an intent to use inside information. It is a salutary warning that City professionals need to be able to recognise when information provided during the course of their business is inside information and ensure that they do not misuse this information. Ignorance will not protect an individual against FSA action.*

What you should do if you face the risk of enforcement?

- ⌚ If you become aware that your firm is under investigation, it is important to obtain as much information as possible from the FSA about the nature of its concerns to enable you to prepare appropriately.
- ⌚ Once this information has been obtained, it is essential to identify the legal and regulatory issues underlying the investigation to ensure that you properly understand the context of the investigation and the potential risk of enforcement.
- ⌚ It is important to ensure a consistent position is adopted in relation to any investigation and that any statements made to the FSA are fully informed. Inconsistencies and inaccuracies in information provided, whether through information requested by the FSA or during interviews it conducts, can increase the risk of enforcement action.
- ⌚ Depending on the extent of the work involved, it may be appropriate to nominate a core team of appropriately skilled individuals to collate the information and communicate this to the FSA. It may also be appropriate to undertake an internal review to assess the nature and extent of any legal or regulatory breaches. If such a team is established, particularly where an internal review is being undertaken, the structure of the team should be considered to preserve legal privilege as far as possible.
- ⌚ Once an information request is received from the FSA, processes should be put in place to ensure that no related documentation is destroyed during the course of the investigation. Inadvertent destruction of relevant information, for example, in accordance with the standard retention policy, could result in the loss of key evidence.
- ⌚ Before making statements or providing information to the FSA, it is important to consider the use to which the information may be put by the FSA, or third parties to whom the FSA may disclose the material. So, for example, the possibility of disclosure by the FSA to an overseas or UK Regulator via a Memorandum of Understanding, or to a party in a civil suit via a third party disclosure application or the use of the Freedom of Information Act should be considered.
- ⌚ It is important when responding to a request by the FSA for information to be aware of confidentiality and Data Protection Act restrictions that may apply to the provision of material to the FSA. Such restrictions will preclude disclosure save in circumstances where the FSA's request for disclosure is made pursuant to a statutory power. Once data protection and confidentiality issues have been overcome through a request pursuant to the FSA's information gathering powers, all documents properly falling within that request should be collated, checked for privileged items and then non-privileged items disclosed.



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The underlying theme for all the above is preparation. Spending the time at the outset collating information, understanding the relevant risks and responding accordingly can facilitate the speedy resolution of any investigation and may reduce the risk of enforcement action being taken.

Conclusion

Enforcement will continue to be an FSA priority in 2009. Firms should heed the shift in the FSA's policy and ensure that lessons learnt by firms which are the subject of enforcement action are used to prevent others suffering the same fate.



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