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**FSA Enforcement Policies: What's New?****May 18, 2009**

The Financial Services Authority (the "FSA") is undoubtedly in a period of change. Recession and calls for greater regulation of the financial services sector have increased pressure to make significant changes in the way the FSA regulates firms. In a speech on May 6, 2008, the FSA's CEO Hector Sants spoke of a tougher scrutiny of board-level decision-making, and indicated that higher penalties are another way of achieving "credible deterrence." These comments echo recent developments at the FSA:

**BlueCrest – Penalties for Mismarking**

On 28 April 2009, the FSA banned and fined a former portfolio manager at BlueCrest Capital Management Limited ("BlueCrest"), responsible for managing \$60 million of the capital in the BlueCrest Multi Strategy Credit Fund, £35,000 for deliberately mismarking his positions in an attempt to avoid losing his job over losses he was making on his trading book. To disguise the extent of his losses, the former portfolio manager mismarked four equity index options by valuing them at nearly two to three times their actual market price. The mismarking went on for ten days and resulted, at its maximum, in the fund being overvalued by \$8.6 million. On the tenth day, he admitted the overvaluation to the head of his trading desk. The FSA determined that, as a result of the mismarking, BlueCrest was prevented from properly monitoring the trading book. This meant that customers were put at the risk of making investment decisions based on incorrect information. This is the first time the FSA has both banned and fined an individual for mismarking trading positions.

**Winterflood – Financial Services and Markets Tribunal Clarifies That Market Abuse Can Be Found Even When There is No Intention to Mislead The Market**

On 2 April 2009, the Financial Services and Markets Tribunal published its decision in relation to the FSA's market abuse case against an FSA authorised firm, Winterflood, the largest market maker in AIM securities, and two of its traders. The FSA had imposed a fine of £4 million on Winterflood, and further fines on the individual traders, for engaging in market abuse within Section 118 of Financial Services and Markets Act 2000 ("FSMA"). Winterflood and the individuals referred the case to the Tribunal on whether it was necessary for the FSA to prove an intention to mislead or distort the market, relying on the Code of Market Conduct (the "Code"), issued by the FSA.

The Tribunal determined that it is not necessary to have an intention to mislead or distort the market in order to commit market abuse under Section 118 of FSMA and that the Code merely provides non-exhaustive guidance as to the sorts of behaviour that the FSA considers amount to market abuse within the meaning of Section 118 of FSMA. The general approach of the Code is that the statutory definition of market abuse does not require the person engaging in the behaviour to have intended to abuse the market. Accordingly, it is not essential for such an intention or purpose to be present in order for behaviour to fall below the objective standards expected by the FSA. In some circumstances, the determination of whether behaviour falls short of those standards will depend on the purpose of the person in question.

### **Same Strategy, Different Environment**

From the perspective of FSA action, there is a continued emphasis on enforcement as part of the FSA's "credible deterrence" strategy, and certain areas of focus which look, at first glance, not dissimilar to previous years.

However, while the emphasis on effective and credible deterrence is not new, the renewed pressure for regulatory action in the financial services sector has translated into a new determination to make good the tough talking seen so far this year. Indeed, in the *Business Plan for 2009/10* (the "Business Plan") published on 12 February 2009, Hector Sants, states that the FSA "expects to see significant enforcement function in the coming year". He also makes it clear that "wrongdoers must ... expect to suffer meaningful consequences". Furthermore, on 12 March 2009 in a speech outlining the way in which the FSA intends to deliver more intensive supervision and achieve credible deterrence, Sants made the following, much publicised, remark: "people should be very frightened of the FSA".

This emphasis is reflected in three recently published documents: the *Financial Risk Outlook for 2009* (the "Financial Risk Outlook") published on 9 February 2009; the Business Plan referred to above; and the much-publicised *Turner Review – a Regulatory Response to the Global Banking Crisis* published on 18 March 2009 (the "Turner Review").

The Business Plan, the Financial Risk Outlook and the Turner Review state the new focus of the FSA: "outcomes-focused regulation". This focus comprises a new supervisory approach, under which the FSA will judge firms on the outcomes and consequences of their actions rather than on compliance with specific rules.

The Business Plan outlines how this tough talking will be achieved. In the Business Plan, the FSA has indicated that it will use the full range of disciplinary sanctions available to it (that is, criminal, civil and administrative). This means that the FSA may impose civil penalties, seek a court order to restrain the proceeds of a crime, conduct search warrants and arrests with the police or bring a criminal prosecution. The FSA has indicated an increased readiness to make use of the latter sanction.

Finally, in the Business Plan the FSA recognises that a significant aspect of a strategy of credible deterrence is to ensure that there is a genuine expectation on the part of firms and individuals in the financial services sector that they will be held to account and that the consequences of their failures will be meaningful. Therefore, the FSA has indicated that it will seek to ensure that the sanctions it imposes are set at levels which are sufficient to deter potential wrongdoers and that penalties, including financial penalties, are likely to be increased.

In summary, although the "credible deterrence" strategy has not changed, the present environment for the FSA is very different from previous years and is likely to lead to the FSA taking more and more intensive enforcement action.

### **Senior Management: Deeper Look**

The FSA has stated that the focus of enforcement during 2009/10 will continue to be on senior management responsibility and oversight, particularly on those individuals who carry out a Significant Influence Function ("SIF"). The FSA expects that there will be more cases where individuals are held to account for system and control weaknesses. In the Business Plan, the FSA states that a key focus will be on the competence of SIF individuals. The ongoing work to review the competence of SIF individuals and the FSA's strong commitment to pursuing "credible deterrence" "deliver a clear message that those who fail to perform their functions will be held accountable".

The FSA has emphasised senior management responsibility for a number of years. However, **the FSA is making it clear that it expects to take more enforcement action against key individuals, which could potentially include not just a firm's compliance officers and other approved persons but also a firm's key management right up to the very top.**

Under FSMA, the FSA has the power to monitor market activity, investigate suspicious activities and ultimately exercise its disciplinary powers against persons that it has found guilty of misconduct. Cases brought by the FSA against individuals tend to be strongly defended by the individuals concerned and can be referred by them to the

independent Financial Services and Markets Tribunal and ultimately appealed to the courts. Furthermore, proving that the right individual has been targeted in large organisations where responsibilities are shared or not clearly delineated can be difficult. However, the FSA has indicated that it will not be dissuaded from focussing on bringing an increasing number of such cases.

### **Treating Customers Fairly**

Another area of focus is treating customers fairly. This again is a continuation of an existing theme. The FSA expects "to see continued substantial enforcement action against firms, at all levels in the supply chain". In particular, the FSA asserts that, where appropriate, firms will be required to pay compensation to their customers, and that the FSA will also be "bold and resolute in using powers to bring about necessary behavioural change" using a range of disciplinary sanctions at their disposal, including criminal, civil and administrative. The focus therefore remains the same, but **the FSA will now look to the outcome of firms' actions in relation to their customers**. What this will mean in practice is difficult to say. It will not be easy for the FSA to regulate firms' actions in respect of their customers by applying hindsight to an outcome with which it disagrees, and some test cases are likely to be necessary to establish exactly what compensation will be payable and in what circumstances.

### **Market Abuse**

Another area of focus is market abuse and financial crime, which is a significant part of the FSA's credible deterrence strategy. In the Business Plan, the FSA has stated its commitment to bringing about "real changes" in the behaviour of market participants. The Business Plan also states that **the FSA will implement the next phase of its "Sabre II Programme", a market monitoring system designed to increase the FSA's capability to detect insider dealing, with automatic alerts of transactions which may amount to insider dealing**. The system will also enable the FSA to comply with its reporting obligations under the Markets in Financial Instruments Directive.<sup>1</sup>

Generally speaking, as a risk-based and proportionate regulator, the FSA will not use its enforcement powers, whether civil, criminal or administrative, against every violation it identifies. However, the FSA has committed to making greater use of its criminal prosecution powers to deal with market abuse. Margaret Cole, the FSA Director of

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

Enforcement, has made it clear on a number of occasions that, even though the FSA does not expect to win all of the criminal prosecutions it undertakes, it intends to bring a substantial number of cases and not limit itself to those where it feels certain of success. This statement of intent is repeated in the Business Plan. **In March 2009, the FSA completed its first criminal prosecution for insider dealing.**

The FSA considers that grants of immunity from prosecution to potential witnesses are an important part of the market abuse strategy. On 14 January 2009, the FSA published a press release announcing that it welcomed Government proposals to grant it **new statutory powers, including the power to grant immunity to witnesses when investigating criminal cases, such as insider dealing.** The proposed change will be made to the Serious Organised Crime and Police Act 2005, which will be amended by a provision in the Coroners and Justice Bill.

Indications of the willingness to step up the actions against market abuse are contained in The Financial Risk Outlook, which states that financial crime will continue to be a key focus area for the FSA during 2009/10. Firms are expected to focus on improving and maintaining operational risk controls to ensure that such controls are sufficiently robust to prevent or uncover any incidents of market abuse and report any suspicious activity.

### **Summary**

In summary, the Business Plan, Financial Risk Outlook and Turner Review set out the FSA's new supervisory approach under which it will judge companies. The pressure for regulatory action in the financial services sector may mean that the FSA is looking to produce "success stories". How this will impact upon enforcement action remains to be seen but it does seem clear that the FSA intends there to be more and more intensive enforcement action. This is likely to lead to greater use of enforcement as a tool to ensure deterrence, more high profile cases and enforcement actions including cases against individuals, more criminal prosecutions and the FSA pushing for more onerous penalties for both companies and individuals.

It remains to be seen how the "outcomes-focused regulation" approach will be conjugated with the fact that enforcement action by its nature will probably continue to be based on rule (and/or principles) breaches. It is likely that the FSA will find it difficult to bring consistent enforcement actions based upon outcomes which the FSA views as unsatisfactory. By applying hindsight to an unsatisfactory outcome, the FSA may not be able to identify a clear rule or principle breach at a fixed point in time or may not even be able to show that the firm or individual in question could have changed the outcome by acting

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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differently. To mitigate the risk of the Financial Services and Markets Tribunal (or the courts) overturning its decisions, the FSA is likely to continue to base enforcement action on clear rule (and/or principles) breaches.

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