

# *Regulatory Investigations Group*

## *Financial Penalties – 5 steps to deterrence*

March 2010

On 1 March 2010, the FSA published in PS10/4 which sets out its final rules on its revised policy in relation to enforcement penalties ([http://www.fsa.gov.uk/pubs/policy/ps10\\_04.pdf](http://www.fsa.gov.uk/pubs/policy/ps10_04.pdf)). This follows CP09/19 which was published in July 2009.

For all the talk in CP09/19 and PS10/4 about introducing more transparency and consistency to the penalty-setting process, the FSA retains for itself a remarkable degree of flexibility. While there are elements of objectivity built into the new framework, many aspects will remain to be assessed at the discretion of the regulator – and the credible deterrence strategy is undoubtedly leading the way. The one thing that is predictable is that penalties will rise – substantially so in cases where the FSA wants to send a strong message to firms and individuals.

The new regime, which involves wholesale changes to the Decision Procedure and Penalties manual ("DEPP"), comes into effect almost immediately and will apply to any enforcement action taken in relation to breaches occurring on or after **6 March 2010**. When a breach begins before 6 March 2010 and continues after that date, the pre-existing penalty regime will apply to conduct before that date and the new penalties regime will apply to conduct from that date onwards.

We set out below a high level summary of the key provisions of the new regime and highlight some of the differences between the proposals contained in CP09/19 and the new policy as implemented.

### **Summary**

As expected, the new regime will be founded upon the five-step framework consulted upon, based on the principles of disgorgement, discipline and deterrence. In outline, the steps are as follows:

- Step 1** Removing any profits made from the misconduct (i.e. disgorgement);
- Step 2** Setting a figure to reflect the seriousness, nature and impact of the breach;
- Step 3** Adjusting the figure arrived at under Step 2 upwards or downwards to take into account any aggravating and mitigating factors;
- Step 4** If appropriate, increasing the amount arrived at in Step 3 to achieve the appropriate deterrent effect; and
- Step 5** Applying any early settlement discount.

In addition, the FSA has (i) set out a new policy relating to the reduction of fines on account of serious financial hardship and (ii) clarified the situations in which it may publicise enforcement action in criminal cases.

### **Step 1 - disgorgement**

The FSA has declined to spell out in more detail how the financial benefit accruing from the misconduct will be calculated, as this will depend on the facts of each case. The amendments to DEPP in relation to disgorgement will therefore be left deliberately vague to leave the FSA with maximum flexibility. The FSA has confirmed in PS10/4 that it will take into account the fact that a firm has implemented a redress programme for customers when quantifying disgorgement but warns that the extent to which it is taken into account will depend on the facts of the case and the nature of the redress programme. However, there is nothing in the DEPP guidance to this effect.

In terms of the interest rate which the FSA may charge, it has again left things open – it says in CP09/19 that it may have regard to the interest rates applied by FOS and the courts, but it is not binding itself to this and in any event this comment is not replicated in the DEPP text itself.

One notable change to the Step 1 guidance in relation to penalties imposed on individuals in non-market abuse cases is that the FSA has decided to copy the approach adopted in relation to firms. This means that where the success of the employing firm's entire business model is dependent upon breaching FSA rules or other regulatory requirements and the individual's breach is central to the firm's regulated activities, the FSA will look to deprive that individual of all the benefit he has derived from those activities. It is

debatable as to whether this actually adds anything to the general principle that the FSA will look to deprive an individual of the financial benefit derived from the breach.

## Step 2 – seriousness of breach

The sliding scales of fixed percentages to be applied depending upon the seriousness of the breach will remain as consulted upon (with different figures for firms, individuals in non-market abuse cases and individuals in market abuse cases respectively).

In partial response to concerns that there should be a clearer distinction between deliberate, reckless, negligent and inadvertent breaches the FSA has included within the list of factors tending to indicate that there has been a level 1, level 2 or level 3 breach whether the breach was committed negligently or inadvertently. In addition, there are additional factors which are likely to show that a breach was deliberate: i.e. seeking to conceal misconduct, being influenced to commit a breach by the belief that it would be difficult to detect and repeating a breach.

CP09/19 had acknowledged the importance of proportionality and stipulated that the FSA would reduce the penalty arrived at as a result of Steps 2-4 if it is disproportionately high: in the final text of DEPP the FSA now provides that it will reduce the penalty arrived at after applying Step 2, this being the stage at which it is most likely that a disproportionate figure may arise (for instance because the firm's revenue is an appropriate "indicator of harm" but gives rise to a disproportionately large penalty sum).

In deciding whether the Step 2 figure is disproportionate the FSA will in addition have regard to whether the firm is also an individual (for example a sole trader) (new wording in DEPP 6.5.3(3)).

### *Cases against firms*

There were objections to the proposal in CP09/19 to use "relevant income" as the basis for setting the penalty – respondents felt that the term could be open to different interpretations depending upon the circumstances. Instead "relevant revenue" will, where appropriate, be used as the indicator of the impact of a firm's breach – this means the revenue derived by the firm during the period of the breach from the products or business area to which the breach relates. The FSA has also confirmed that where revenue is not indicative of the harm or potential harm that a firm's breach may cause, it will still use the 5 step framework, but it will use an appropriate alternative means of arriving at a figure in Step 2.

As established in CP09/19, the Step 2 figure in cases against firms will, depending upon the seriousness of the breach, be: 0% (level 1), 5% (level 2), 10% (level 3), 15% (level 4) or 20% (level 5) of the firm's "relevant revenue" received over the period of the breach from the product or business area to which the breach relates.

### *Cases against individuals (non-market abuse cases)*

Many respondents to CP09/19 felt that taking a maximum of 40% of income was disproportionately high and suggested that the percentage levels should be equivalent to those proposed for firms. Not surprisingly, the FSA has rejected these concerns saying that it considers its approach is justified because action against individuals has a significantly greater impact in terms of deterrence than actions against firms and the focus on individuals forms a key part of the regulator's credible deterrence strategy.

The Step 2 figures in non-market abuse cases against individuals will be 0% (level 1), 10% (level 2), 20% (level 3), 30% (level 4) and 40% (level 5) of the individual's "relevant income", being the gross amount of all benefits received by the individual from the employment in connection with which the breach occurred and for the period of the breach. "Benefits" include, but are not limited to, salary, bonus, pension contributions, share options and share schemes.

### *Cases against individuals (market abuse cases)*

In CP09/19, the FSA proposed that the Step 2 figure in market abuse cases against individuals would be the greater of:

- twice the profit made or loss avoided by the individual as a direct result of the market abuse;
- £100,000; and
- (only where the market abuse was referable to the individual's employment) 40% of the gross amount of all benefits received from the employment in the 12 months preceding the market abuse

Many respondents to CP09/19 felt that a minimum penalty of £100,000, regardless of whether the market abuse was intentional, was too harsh and could be disproportionate. One respondent queried whether the Regulatory Decisions Committee would be more likely to issue a public censure where it thought that a £100,000 would be too harsh on the facts of the particular case (perhaps with the October 2009 decisions relating to the Dresdner bond traders in mind).

The FSA has taken on board these concerns. The minimum £100,000 penalty will now only apply in the most serious of market abuse cases, being cases that fall within levels 4 or 5 (typically where the market abuse was deliberate).

The Step 2 figures in market abuse cases against individuals will now be calculated by reference to the greater of:

- a multiple of the profit made or loss avoided by the individual for his benefit or the benefit of others (zero, one, two, three or four times);

- £100,000 for the most serious of market abuse cases; and
- (only where the market abuse was referable to the individual's employment) a percentage of the individual's relevant income (as to which see above) (0% (level 1), 10% (level 2), 20% (level 3), 30% (level 4) and 40% (level 5)).

### Step 3 – mitigating or aggravating circumstances

The FSA will increase or reduce the Step 2 figure if there are any aggravating or mitigating factors present. However, instead of adjusting the percentage of relevant revenue or income determined in Step 2, any increase or decrease to the Step 2 figure will now be by way of a percentage adjustment to that figure. It is clear that the FSA has absolute flexibility in determining what this percentage adjustment should be. In CP09/19 (but not in the DEPP guidance itself) the FSA says that it is likely to determine, on a case by case basis, the size of the percentage adjustment by deciding the relevant step 3 factors and calculating the overall percentage change needed. The FSA has also confirmed, in response to concerns in this regard, that defending an enforcement action would not be considered to be a form of non-cooperation (being one of the factors deemed to be an aggravating feature). In relation to market abuse cases against individuals, the FSA will now take into account whether the individual assisted the FSA in action taken against other individuals for market abuse and/or in criminal proceedings, thereby allowing the FSA to decrease a penalty where a witness who has engaged in market abuse cooperates with the regulator.

### Step 4 – deterrence

The Step 3 figure will be susceptible to a potentially unlimited increase if the FSA considers that the figure is insufficient to deter the firm or individual who committed the breach, and others, from committing further breaches. While the FSA says in CP09/19 that it will ensure that it uses Step 4 to increase a penalty only where it considers it is justified to do so and that it recognises that the penalty must be proportionate to the misconduct, these comments are not contained in the DEPP guidance. In addition, the specified circumstances in which the FSA may exercise the Step 4 adjustment are clearly non-exhaustive. There remains a concern that the "deterrence factor" could tend to dominate the five-step process disproportionately.

### Step 5 – settlement discount

The existing regime will continue to apply.

### Serious financial hardship

In CP09/19, the FSA proposed two alternative approaches to serious financial hardship. For individuals, option 1 was that the FSA would never reduce a penalty on the grounds of serious financial hardship, and option 2 was that it would consider reducing a penalty on the grounds of serious financial hardship if its payment would result in the person's net annual income falling below £14,000 and capital falling below £16,000. For firms, the proposal was that the FSA would take into consideration its regulatory objectives in deciding whether to reduce the penalty.

As regards individuals, option 1 has (rightly in our view) been jettisoned as being disproportionate and, potentially, in breach of the Human Rights Act 1998. In light of responses received to CP09/19, the FSA has implemented a revised version of option 2.

The FSA's starting point will be that an individual will suffer serious financial hardship only if payment of the proposed penalty would result in the person's net annual income falling below £14,000 and capital falling below £16,000 (the figures are the same as in CP09/19). The FSA now states that it will normally consider as capital the equity that an individual has in the home in which he lives. It will, however, consider any representations by the individual about, for example, the exceptionally severe impact that a sale of the property might have upon other occupants (e.g. family members). Furthermore, the FSA will now take into account any prohibition order or withdrawal of permission affecting the individual's earning capacity when assessing whether the penalty will cause the individual serious financial hardship.

As for firms, in light of responses received, the FSA has amended its approach from that proposed in CP09/19 to make it clear that it will consider reducing the amount of a penalty if a firm will suffer serious financial hardship as a result of having to pay the entire amount. When deciding whether it is appropriate to reduce a penalty, the FSA will consider whether the penalty would threaten the firm's solvency or render it insolvent. The FSA will also take into the impact of a firm paying a penalty on its regulatory objectives. For example, where consumers would be harmed or market confidence would suffer, it may consider it appropriate to reduce the penalty so as to enable the firm to continue in business and/or pay redress.

### Publicising criminal investigations

The FSA will amend the Enforcement Guide (by the addition of a new 6.17A and 6.17 B) to clarify that it may publicise enforcement action in criminal cases where proceedings have not yet commenced. This would involve the FSA "*generally*" considering "*making a public announcement when suspects are arrested, when search warrants are executed and when charges are laid*" and at other stages of the investigation when considered appropriate.

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