KAYE SCHOLER LLP
INVESTMENT FUNDS GROUP

Five Steps to Heaven? FSA Proposes Increased Financial Penalties in Enforcement Cases

On 6 July 2009, the Financial Services Authority ("FSA") issued Consultation Paper ("CP") 09/19, "Enforcement financial penalties", which seeks views on proposals to change the FSA's current policy on the level of financial penalties it imposes in enforcement cases.

The FSA gives three reasons for proposing the change to its policy:

1. to be more transparent in the way it sets penalties;
2. to aid consistency in penalty-setting; and
3. to increase the level of penalties it imposes.

The last — probably of greatest interest to firms and individuals who come within the FSA's purview — is seen by the FSA as in keeping with its recently-articulated enforcement philosophy of achieving "credible deterrence". The FSA believes that penalties need to be increased to act as a sufficient deterrent to prevent wrongdoing.

The FSA proposes to apply a common framework to all cases, whether involving firms or individuals, based on three objectives (Disgorgement, Discipline and Deterrence) and five steps:

1. disgorgement of any direct benefit;
2. determining a figure that reflects the nature, impact and seriousness of the breach;
3. an adjustment to that figure to reflect any aggravating or mitigating factors;
4. a further upward adjustment, if necessary, to ensure the penalty has the appropriate deterrent effect; and
5. applying any discount for early settlement with the FSA.

For cases against firms, the FSA proposes that the Step 2 figure will be a maximum of 20% of the firm's pre-tax income from the profit or business area to which the breach relates. For cases against individuals, the penalties will be larger. In non-market abuse cases, the figure rises to a maximum of 40% of their gross salary and benefits for the period of the breach. In market abuse cases, the penalty would be the greater of 40% of all benefits received from employment in the previous twelve months, twice the profit made or loss avoided as a result of the market abuse, or £100,000. The FSA estimates that these proposals will often double or treble penalties compared to their current levels.

The FSA is also reviewing its policy as regards serious financial hardship resulting from the imposition of a penalty. In keeping with the tougher stance apparent elsewhere in CP09/19, the FSA is proposing to delete the statement in its enforcement guide that the purpose of a penalty is not to render a person insolvent or to threaten insolvency, on the grounds that this might suggest that the FSA would not levy a penalty in cases where insolvency would result. The FSA clearly — and rightly — regards the prospect of insolvency, particularly in the cases of individuals, as strengthening the deterrent factor. In that regard, it is interesting to note that one of the alternatives for treating claims of serious financial hardship on which the FSA is consulting would apply to firms only; there would be no reduction in cases against individuals, which suggests that the FSA believes that concentrating its enforcement action on individuals is the best way of reducing the scope for wrongdoers. And although the FSA's other option would apply to individuals, basing any reduction on capital thresholds of £14,000 for income and £16,000 for capital, the example that the FSA uses shows that any reduction may be minor, and only temporary.

The consultation period for CP09/19 runs until 21 October 2009. The FSA aims to publish feedback on responses, along with the final handbook text, in the first quarter of 2010.

The FSA's proposals in CP09/19 do not, as such, require firms to revise their procedures. But they are further evidence of a more assertive approach by the FSA towards exercising its enforcement powers. Fund managers and brokers should therefore be in no doubt that the FSA means business in this area, and may wish to satisfy themselves that they have robust systems and controls in place so that these proposals are, in their cases, purely academic.

Chicago Office
+1 312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1 310.788.1000

New York Office
+1 212.836.8000

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1 202.682.3500

West Palm Beach Office
+1 561.802.3230