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Recent Developments in Securities Enforcement Investigations Involving the United Kingdom's Financial Services Authority

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Two recent developments regarding the U.K. Financial Services Authority ("FSA") appear likely to lead to more burdensome FSA information requests and to more severe financial penalties, respectively.

First, the Court of Appeal of England and Wales recently held that the FSA may issue document requests in the UK on behalf of foreign regulatory authorities without first analyzing the scope of or basis for the foreign regulator's request, beyond a minimal determination of "relevance."[1]

Second, the FSA announced that, effective March 6, 2010, it will begin to employ a new framework to determine financial penalties in enforcement cases.[2] The FSA's new framework is intended to advance the three principles of the FSA's enforcement program—disgorgement, discipline, and deterrence—by imposing enhanced penalties in enforcement actions.[3]

British High Court Confirms Broad Investigative Reach of FSA's Authority in Overseas SEC Investigations

Background to the FSA Investigation

In April 2006, the SEC filed a civil enforcement action in the Southern District of New York (the "New York litigation") alleging that the defendants (an investment adviser, a registered broker-dealer, and several registered representatives of the broker-dealer) had fraudulently traded Sedona Corporation's shares between 1999 and 2002.[4] Approximately one month before the discovery deadline in that action, the SEC requested the FSA's assistance in obtaining documents and information from a UK accounting firm, pursuant to two Memoranda of Understanding ("MOU") between the SEC and FSA.[5] In particular, the SEC sought the FSA's assistance in obtaining from the London-based accounting firm ownership records, correspondence, and bank information for several entities that the SEC suspected were related to the defendants in the New York litigation. The scope of the requests went substantially beyond the particular transactions at issue in the New York litigation, to which the accounting firm was not a party.

In order to request documents and information on behalf of a foreign regulator pursuant to an MOU, the FSA is required to open its own enforcement investigation and to appoint its own investigators. Following discussions and correspondence between the SEC and the FSA, the FSA agreed to assist the SEC with its request. The FSA consequently opened its own matter and appointed two investigators to conduct the investigation.[6] In assessing the SEC's request and in evaluating whether to open an investigation, the FSA did not conduct an independent assessment of the relevance of the SEC request to the New York litigation.[7] Rather, the FSA accepted the SEC's rationales for seeking the information and documents and opened its own inquiry on the basis of its obligations under the MOUs and because of the strong public interest in assisting foreign counterparts, among other factors.[8]

FSA Investigation and Court of Appeal Decision

As part of its investigation, the FSA issued a notice to the London accounting firm, requesting the production of certain documents and information.[9] The original request for documents in the FSA notice mirrored the SEC's request to the FSA. After learning of the FSA's notice from the accounting firm, clients of the accounting firm sought judicial review in the Administrative Court of England and Wales.

The FSA issued its document requests pursuant to Sections 171(2) and 172(2) of the Financial Services and Markets Act ("FSMA"). Section 171(2) authorizes investigators to require any person to produce specified documents[10] so long as the documents are "relevant to the purposes of the investigation" as required by Section 171(3).[11] Section 172(2)(b) authorizes investigators to require a person who is neither the subject of the investigation nor a person connected with the person under investigation to provide information to the FSA,[12] so long as the information is "necessary or expedient for the purposes of the investigation," as defined by Section 172(3).[13]

The Administrative Court evaluated the FSA request according to the standard in Section 172(3) and held that much of the information sought by the FSA's notice was not "necessary or expedient for the purposes of [the FSA's] investigation."[14] As a consequence, the Judge quashed the appointment of the investigators and limited the scope of the investigators' notice to information regarding the specific transaction pled in the SEC's complaint in the New York litigation.[15] The Administrative Court reasoned that, when the FSA elected to cooperate with the SEC's request for assistance, it was required to evaluate the scope of the SEC's request in light of the New York litigation to ensure that the request was narrowly tailored

to the claims asserted in that litigation. The FSA appealed to the Court of Appeal of England and Wales.

The Court of Appeal held in favor of the FSA, agreeing with the authority on three key points[16] :

1. The FSA need not independently verify either (i) the factual bases for the foreign regulator's request or (ii) the foreign regulator's actual need for the documents sought. The Court held that, when opening an inquiry in response to a request from a foreign regulator, the FSA is acting pursuant to Section 169(4) of the FSMA, which does not require the FSA "to form a judgment as to the necessity or desirability, from the point of view of the foreign regulator, of its obtaining the information or documents it seeks."[17]

2. When the FSA issues a notice for documents or information as part of an investigation prompted by a request for assistance by a foreign regulator that is already involved in foreign litigation, the FSA is not limited to requesting material related to the particular facts pled in the foreign litigation. Because the FSA investigators are appointed to exercise their *investigatory* powers alone and are not themselves party to any litigation, the scope of the FSA document requests are not limited by the UK's civil discovery norms.[18]

3. Before issuing a notice for documents or information in response to a foreign regulator's request, the FSA must satisfy only the "relatively low hurdle"[19] of whether the information or documents sought are "relevant to the purposes of the investigation."[20] The FSA need not evaluate whether the request was "necessary or expedient," as would be required for a document request issued pursuant to Section 172 of the FSMA.

As a result, the FSA may issue domestic notices for documents or information on behalf of foreign regulators under Section 171 of the FSMA so long as the information is "relevant" to the FSA investigation. Moreover, the FSA may simply reiterate the foreign regulator's explanation for its request to satisfy the FSMA's relevance standard, as the FSA is merely acting as a conduit for the foreign regulator, and the FSA's investigation is simply executing the foreign regulator's request. While the FSA retains discretion over whether to exercise its own judgment in defining the scope of the notice for documents or information, it is under no obligation to exercise that discretion. As a consequence, UK entities and individuals who are subject to the FSA's jurisdiction will have little recourse to challenge the FSA requests issued at the behest of foreign regulators.

FSA Strengthens Penalty Scheme in Securities Enforcement Investigations

On March 1, the FSA published a new five-step framework for calculating the financial penalties that may be imposed against regulated entities and others subject to FSA securities enforcement investigations.[21] The new framework appears intended to increase the size of FSA penalties and

replaces a regime that the FSA viewed as weak.

According to the FSA, its new penalty regime will not only enhance deterrence but also provide greater structure and predictability to enforcement penalties. While the prior penalty regime was simply a non-exhaustive list of factors that the FSA could consider, such as deterrence, nature and seriousness of the breach, conduct following the breach, and compliance history, the new policy outlines five specific steps that the FSA must consider when levying penalties.

The new framework requires:

1) disgorgement of any profits derived as a result of the misconduct;

2) determination of a penalty amount designed to reflect the seriousness of the breach;

3) adjustment to the penalty amount determined in Step 2 in light of any aggravating or mitigating factors;

4) increasing the adjusted penalty amount from Step 3 if the FSA determines the Step 3 amount insufficient to have appropriate deterrent effect; and

5) applying a settlement discount, if applicable.

After applying the above five-step framework, the new policy permits the FSA to consider reducing the proposed penalty if the individual or firm would suffer "serious financial hardship" as a result of repaying the penalty.[22] For individuals, the FSA will consider serious financial hardship to be demonstrated if her net annual income would fall below £14,000 *and* her capital would fall below £16,000 as a result of payment of the penalty.[23] For firms, the FSA will consider serious financial hardship to be shown if payment of the penalty would render the firm insolvent or threaten the firm's solvency.[24] Even if "serious financial hardship" is established, the FSA will reduce the penalty only after considering the circumstances of each case.

The FSA claims that this new framework establishes a "consistent and more transparent framework for the calculation of financial penalties."[25] The bases for penalty calculations in the new framework, however, continue to appear highly discretionary. For example, substantial discretion remains with respect to both baseline penalty amounts under Step 2 and the calculation of discounts and enhancements under Step 3. Moreover, the framework does not state whether consideration of aggravating and mitigating factors in Step 3 is mandatory and will be applied in each case. While the new policy lists a number of qualitative factors to be considered in Step 3, such as the "degree of [the firm's] cooperation" and "the conduct of the firm in bringing...quickly, effectively and completely the *breach* to the FSA's attention," it offers very little guidance regarding how the FSA will interpret these factors.[26] Thus, until the FSA has applied its new framework in a meaningful number of cases, respondents in FSA actions will potentially continue to have trouble predicting the FSA's likely

reaction to potential misconduct.

Despite uncertainty in how the factors will be used, it is clear that the quantum of penalties will likely increase. In adopting its new framework, the FSA expressed a desire to "'amplif[y] the deterrent effect'"[27] of financial penalties and noted that "harder hitting financial penalties...will become a feature of enforcement activity in the future."[28] Indeed, the FSA estimates that the new framework may, in some cases, cause fines to treble.[29] Whereas the prior FSA policy did not specify penalty amounts, the new guidelines permit fines up to 20 percent of a firm's revenue from the product or business area linked to the breach or up to 40 percent of an individual's salary and benefits in non-market abuse cases. For individuals involved in serious market abuse cases,[30] fines will be a minimum of £100,000.

The new penalty framework reflects the FSA's current philosophy that deterrence can best be achieved through steep penalties. As the FSA anticipates, however, higher penalties will likely lead to more litigation before the Financial Services and Market Tribunal.[31] It may therefore take some time to appreciate the full effect of the FSA's new penalty framework.

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[1] *R. (on the application of Amro Int'l SA) v. Fin. Servs. Auth.*, [2010] EWCA (Civ) 123, [46]-[48] (Eng.).

[2] Press Release, Financial Services Authority, FSA Finalises New Framework for Financial Penalty-Setting (Mar. 1, 2010), *available here*.

[3] *See id.*

[4] Complaint, *Sec. & Exch. Comm'n v. Badian*, No. 06-CV-2621 (S.D.N.Y. Apr. 3, 2006).

[5] *R. (on the application of Amro Int'l SA) v. Fin. Servs. Auth.*, [2010] EWCA (Civ) at [10]; *see also* Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, May 2002, *available here*; Memorandum of Understanding Regarding Mutual Assistance and the Exchange of Information, U.S.-U.K., Sept. 25, 1991, *available here*.

[6] *R. (on the application of Amro Int'l SA) v. Fin. Servs. Auth.*, [2010] EWCA (Civ) at [19].

[7] *See id.* at [18].

[8] *See id.*

[9] *See id.* at [20].

[10] Financial Services and Markets Act, 2000, c. 8, §171(2) (U.K.).

[11] *Id.* § 171(3).

[12]*Id.* § 172(2)(b).

[13]*Id.* § 172(3).

[14]*R. (on the application of Amro Int'l SA) v. Fin. Servs. Auth.*, [2009] EWHC (Admin) 2242, [15] (Eng.); *see also* Financial Services and Markets Act § 172(3).

[15]*R. (on the application of Amro Int'l SA) v. Fin. Servs. Auth*., [2009] EWHC (Admin) at [103].

[16] The Court of Appeal also held that FSA need only comply with the requirements of the FSMA and not the MOUs when deciding whether to accept a request for assistance from a foreign regulator and that the notice provisions contained in Section 170(2) are inapplicable when investigators are appointed under Section 168(3) and (5). *See R. (on the application of Amro Int'l SA) v. Fin. Servs. Auth*., [2010] EWCA (Civ) at [43]-[44].

[17]*Id.* at [39].

[18]*Id.* at [46]-[48].

[19]*Id.* at [52].

[20]*Id.*

[21] Financial Services Authority, Policy Statement 10/4: Enforcement Financial Penalties (Mar. 2010), *available here*.

[22] Financial Services Authority, Decision Procedure and Penalties Manual (Financial Penalties) Instrument 2010 ("DEPP"), § 6.5D.

[23]*Id.* § 6.5D.2 (G)(1).

[24]*Id.* § 6.5.D.4 (G)(1).

[25] Press Release, Financial Services Authority, *supra* note 2.

[26] DEPP, *supra* note 22, § 6.5A.3.

[27] Press Release, Financial Services Authority, *supra* note 2 (quoting Margaret Cole, FSA Director of Enforcement and Financial Crime).

[28]*Id.*

[29] *Id.*

[30] "Market abuse" refers generally to misuse of inside information, insider trading, market manipulation, and improper public disclosure. *See* Financial Services Authority, Policy Statement 05/3: Implementation of the Market Abuse Directive (Mar. 2005), *available here*.

[31] Policy Statement 10/4: Enforcement Financial Penalties, *supra* note 21, at ¶ 1.7.

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