No more Mr Nice Guy

The UK FSA can no longer be accused of taking a softly, softly approach to enforcement. In the harsh new world of City regulation, credible deterrence is the main theme, and the FSA is hitting banks and individuals where it hurts with larger fines than ever before. Nick Kochan reports

The record-breaking fine of £33 million levied against JP Morgan by the UK Financial Services Authority (FSA) last year for failing to properly segregate client money sent out a clear message: the FSA's Enforcement Division was determined to clamp down on regulatory breaches and market abuse, and to intensify changes in the City's self-regulation.

The figures speak for themselves. FSA fines rose from £35 million in 2009 to a total of £89.3 million in 2010. Fines for 2011 by March had already reached £13.9 million. Observers say a new slew of fines will shortly to be announced by the FSA and many City players are set to be hit hard.

The FSA message to the City is one of 'credible deterrence'. Ian Mason, a former FSA department head and now partner at law firm Baker & McKenzie, said: "The FSA has been criticised in the past for being soft on firms, and succumbing to regulatory capture, that it is falling excessively under the sway of the powerful institutions in the industry. The financial crisis has triggered a reaction. The FSA is being much tougher now, generally in regulation, but particularly in enforcement. A revised fining policy, introduced last year, assumes fines will be two or three times higher than under the previous policy and this is symptomatic of the FSA's goal to toughen up."

Hector Sants, chief executive of the FSA and chief executive designate of the future Prudential Regulation Authority, is driving the campaign for credible deterrence forward. He has said markets cannot be relied upon to "be rational and self-corrective". He went on to say that a weak regulatory framework had created a vacuum that gave rise to the crisis. "We had a set of economic drivers; a set of social and cultural drivers; and a set of regulatory drivers but also a set of market participant drivers – notably a failure of market discipline: markets did not self-correct."

Margaret Cole, the FSA's director of enforcement, has spoken elsewhere of the need to clean up the markets. "The fight is directly relevant to our statutory objective to promote clean, orderly and fair markets." High-impact sanctions are integral to the FSA's new policy of regulating behaviour rather than structure, says Cole. In the new harsh world of City regulation, the byword is punishment not tolerance. Both businesses and individuals can be expected to be hit hard and in proportion to their misconduct. Cole has stated: "Credible deterrence is all about delivering outcomes that make a real difference to consumers and to markets. It means delivering results that make people sit up and pay attention. It's about making people realise they can suffer meaningful consequences if they break the law and if they don't improve their standards of behaviour." While this might appear to some as 'gesture politics', as far as the FSA is concerned this is a way of broadcasting a message that misconduct is simply not acceptable.

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As the deterrence culture is embedded, fines will rise, says Mason. "This is just the start. Each fine sets a new level, so the FSA will say, 'Look we have publicised this case, we have said we are very worried about these things, and things must be improved.' But firms generally haven't learnt the lessons, so the fines have got to be higher next time round. It is a self-escalating mechanism."

Mason has seen weaker forms of sanctions fall out of favour in recent years. He says the administering of a public censure with no consequent fine is used less as instead individual culpability is met with a fine. Mason says, "There is a perception that fining a firm just doesn't drive home the credible deterrence message; whereas if you fine an individual you are hitting people personally. And if you are fining a compliance officer, you are making compliance officers sit up, worry and take notice. It is a question of deterrence value, and obviously if you are fining a large firm, unless it is a very large fine, there is a perception that firms will just pay it and move on. It is a bit like a traffic violation really. Whereas if you are fining an individual that is going to hit them in the pocket." The pain is exacerbated by the fact individuals must pay the fine from their own resources and cannot be bailed out by their firms.

Individuals who cannot pay fines and plead hardship face some tough tests. For example, they will not be allowed more than three years to defer or spread the fine. Worse than that, they have to be down to their last thousands before the 'serious financial hardship' allowance kicks in. Carlos Conceicao, a partner at Clifford Chance, says: 'The rules around 'serious financial hardship' are tight. The new rules say you only suffer serious financial hardship if your net income is under £14k and it reduces your capital to £16k. You're only going to count as suffering serious financial hardship if you qualify for benefits. People were quite shocked that they would only reduce the fine on the grounds of hardship."

As the fines grow more painful, the process for deciding and administering them gets tighter. A

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policy that appeared subjective has now been replaced with some objective criteria such as the profit made from the illicit transaction and the individual's salary over the past year or the period of breach, if longer. Further to that, the FSA can ramp up the fine with a monetary component designed to send out a deterrent message. Conceicao says: "The decision to ramp up fines has been going on for a while and it was driven by the idea that what might seem like a large fine to some people is not large to people who are very wealthy and earn a lot of money through their job. Philippe Jabre, in 2006, was fined £750,000 for market abuse, when he earned millions from his employment. So a £750,000 fine was seen as loose change. If you could link the fine to his remuneration, it might be more of a deterrence."

Jabre was an immensely wealthy hedge fund manager and former managing director of hedge fund GLG. Margaret Cole said at the time: "Jabre traded on information he had received as a result of the position he enjoyed as a leading hedge fund manager. The stability and fair operation of the markets through legitimate pre-marketing activities is jeopardised if those who are wall-crossed do not respect the restrictions imposed on them. GLG is also responsible for Jabre's market abuse. Firms are accountable for the behaviour of their employees, particularly if they are at a senior level." GLG was similarly fined £750,000, a figure that did little to boost the credibility of the FSA's fining regime.

The FSA's five-step process, introduced last April for offences committed subsequently, is expected to raise the fining stakes. Mason describes the stages. "Stage one, you look at what benefit has been made by the firm. If it has made a profit, that has to be disgorged. That would be a basis for calculating the fine, it is a starting point. Step two enables the penalty to reflect the impact and seriousness of the breach: how serious was the contravention? Did you deliberately breach the rules, or were you just incompetent? That is a sort of 'seriousness test'. There is then an adjustment for mitigating and aggravating factors. An aggravating factor might be that you knew there was a breach but you didn't notify the FSA, you tried to cover it up but the FSA discovered it. A mitigation would be an early admission."

Step four of the process is perhaps the most problematic. Some argue it risks being less transparent and possibly arbitrary. It allows the FSA to "adjust the fine upwards for deterrence". Insider dealing and market abuse, for example, which is an FSA priority, would potentially carry with it a higher index of adjustment. Conceicao says: "Deterrence is a completely arbitrary concept. It allows the FSA to raise the fine if it doesn't think the science has produced the right figure. In fact, the FSA won't need the deterrence stage. It will just use the individual's income to raise the fine." The new rules allow the FSA to fine an individual up to 40% of his or her annual income.

The system remains subjective and opaque, says Mason. "One reason for introducing the new fining policy was precisely that, because people said it was all rather arbitrary and discretionary, and the idea of this five-stage process was to make it more 'scientific'. In fact, it is still pretty subjective, and I am finding it an art rather than a science." Mason says the FSA can say "'Well, we're not very happy with this figure we have come out with so we think it should go up'. That is not terribly transparent really."

He cites the case of Mark Lockwood, who was

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fined £20,000 in 2009 for being wilfully ignorant of certain hints a client dropped to him that the client himself was in possession of certain inside information. Lockwood did not deal on the information but failed to report the event to his compliance officer. Mason says: "In this case, the view was he should have known, and he really was closing his eyes and ears to it and he should have known better." The FSA's Final Notice referred to deterrence as a factor in its fining decision. "The penalty is intended to have a deterrent effect on those who may consider acting in this way. In determining the financial penalty the FSA has considered the need to ensure you and others observe proper standards of market conduct."

While this deterrence factor might trigger resentment, it is unlikely to lead to any flexibility from the regulator. Indeed, the FSA claims to have produced an objective approach to levying a fine and it is not expected to haggle or budge from it.

The fifth step in the FSA fining structure allows fines to be reduced for early settlement. If a firm settles in the early stages of investigation, a maximum of 30% can be discounted. This is a tapered discount, however, and the final figure will decrease according to the length of time taken to settle the amount of the fine.

Fines can be reduced when the firm or individual supports the investigation and makes an early admission of guilt. Mason advises firms to "emphasise the level of co-operation the firm has afforded in the investigation, [and] the immediate action it has taken. It is not just about the original contravention. It is also what the firm has done since then, to respond, to clear up the mess. And if the firm has been proactive in clearing up the mess, it has compensated consumers and it has overhauled its systems and controls, it will want all of that to be known in the publicity, and it should get it some sort of credit." The FSA will be less amenable to individuals trying to haggle down their fine under the new system, says Conceicao. "You can't start derogating from your wonderful framework with its stages, just for the sake of achieving a result."

Individuals and firms have the option of having fines reviewed by the Regulatory Decisions Committee (RDC), an internal body staffed by FSA officials. If the complainant is still unhappy, they can go to a Tribunal, a public entity staffed by non-FSA officials. It will review the entire process from its beginning, assess its outcome and has the power to increase as well as reduce a fine. Such an appeal is expensive for complainants, who typically hire lawyers to lead their appeal. According to one former regulator: "You might have more cases being challenged. If there are higher fines, the logic is that more people will challenge them. Quite a lot of people are challenging cases in front of the RDC anyway. This is because a prohibition usually accompanies a fine, and that is what individuals don't want. There are quite a lot of challenges at the RDC. To go further to the Tribunal is an expensive and time-consuming process."

Mason says sanctions on firms are generally settled early to keep the fine low and save embarrassment. They just want "to get it over with", he says. Breaches involving individuals however, tend to be fought, if only because they do not have such deep pockets and professional reputations are at stake. The total of prosecutions of individuals has leapt from less than £1 million in 2009 to more than £4.5 million in the first half of 2010 alone. Mason, who formerly worked for the FSA and saw the impact of an investigation, says: "It is worrying for an individual to be under investigation. Even if it only results in a small fine, that is still quite disastrous and they might have difficulty working again in the industry. It could be career limiting. If you have been fined for committing market abuse that is a serious contravention, and I think unless you are a really, really good dealer, you are going to have trouble moving to another firm. If it is more of a technical breach, down to lack of diligence for example, that would be recoverable."

The imposition of fines on compliance officers and money-laundering reporting officers has brought a number of careers to premature ends, said one former regulator. "When when the guys who are supposed to be guarding the system break it either knowingly or inadvertently, the penalties are inevitably that much heavier."

The avoidance of fines can raise as many eyebrows as their imposition. One observer commented: "No chief executive of a FTSE 100 company has been fined. Barclay's Bank was fined about £7 million earlier this year for mis-telling of funds, but no individual cases arose from that. Top managers and directors in other banks, in particular those that have failed, have likewise escaped fines. We haven't had a fine against a really well-known individual at a top firm. And that is because those cases are difficult to bring and difficult to prove."

Conceicao says the full force of the FSA's credible deterrence policy has yet to be fully felt by the City. He believes the FSA is set to announce a series of fines that will shock the industry by their magnitude. He expects more fines to be challenged as their size increases.

The FSA's reputation has grown as a result of the new tougher fining regime, says Mason. "People are probably more scared of the FSA than they were before, particularly in areas such as insider dealing. People who are determined criminals will always be determined criminals, but people who are perhaps somewhere in between, who might have thought 'Is it worth a punt here?', might now think twice about it. You are never going to get a nil failure regime; it is not a zero-sum game. But I think the FSA has upped its game quite a bit."

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