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Financial Services Authority
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21 October 2009

Dear Mr. Gordon,

FSA CP 09/19: 'ENFORCEMENT FINANCIAL PENALTIES'

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. The members of the Committee have particular experience in relation to the establishment and regulation of all types of domestic, EU and third country funds and represent firms with international fund establishment practices. Our comments are not therefore made solely from a UK perspective.

This response has been prepared by the CLLS Regulatory Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets.

General comments

We support the FSA's efforts to make its approach to setting financial penalties more transparent and consistent – so that the outcome of an enforcement action becomes more predictable. We also support the FSA's overarching principle that wrongdoers should be punished appropriately.

We note that the FSA's principle of determining which of a finite number of "seriousness" categories applies, and using that to determine the starting point for setting a fine, is similar to the approach used in the sentencing guidelines for criminal cases. The Sentencing Guidelines Council's draft guidelines on fraud offences add further colour to that framework by elaborating on factors that are particularly relevant to fraud offences (albeit in the context of predominantly custodial sentences).

However, we believe there is further work to be done before the FSA is able to achieve its objectives in relation to financial penalty setting. In our view, the FSA's proposals do not take account of its specific statutory obligations and of more general public law duties. This is of particular concern in the proposed treatment of individuals in the context of market abuse cases which we address below.

FSA's legal obligations in formulating policy

Under the Financial Services and Markets Act 2000 (**"FSMA"**), the FSA is obliged to publish a penalties policy that meets certain criteria. One of those criteria is the obligation to ensure that the policy takes account of the seriousness of the misbehaviour. In the context of penalties for market abuse, section 124(2) of FSMA requires the policy to have regard to (among other things) the following factors:

(a) whether there was any adverse impact on the market in question, and, if so, how serious it was; and

(b) the extent to which behaviour was deliberate or reckless.

The other sections of FSMA concerning publication of a penalties policy also require the FSA to have regard to factor (b) above. In addition, in the context of penalties against firms, section 2 of FSMA requires the FSA to have regard to the principle of proportionality when setting policy.

The FSA's proposed approach for individuals facing a penalty for market abuse contrasts markedly from the approach proposed for other contexts. In the latter contexts, the approach is one similar to that published by the Sentencing Guidelines Council – that is, the appropriate category of seriousness is identified, taking account of whether the wrongdoing was deliberate, reckless or "negligent". In the context of an individual facing a penalty, the FSA's proposed approach is to attach the same level of seriousness to <u>all</u> market abuse cases. The only policy justification given in the Consultation Paper is that "market abuse is <u>often</u> a pre-meditated act". We consider that, by setting the base level for a market abuse fine at £100,000, this carries a message by the FSA that every instance of market abuse is very serious and that, in all cases, the individual's behaviour included avoidable elements. This approach contradicts the statement in the Code of Market Conduct (reflecting the position under FSMA) that intention is not a required element of market abuse. Recent market abuse-related cases taken by the FSA also illustrate that the degree of seriousness does vary from intentional to a failure of awareness due to failures of staff training and/or systems. On the face of the FSA's policy, there seems to be no regard had to either of the factors mentioned above as being required by section 124(2) of FSMA, and thus it may be susceptible to attack.

We are also concerned that the Consultation Paper does not contain an adequate justification for the FSA's proposed criteria to determine the income-related "bands", nor why the "bands" are so different as between firms and individuals. For example, the FSA's approach would (absent of any justification for doing so) potentially treat the director of a single-member company differently to a sole trader for the same misbehaviour, so that an earlier decision about business structure may have a considerable impact upon the level of penalty imposed, even if the misbehaviour is identical.

Further, in contrast to the approach adopted in criminal sentencing, the FSA proposes, as a starting point for setting penalties for individuals, to use <u>gross annual</u> income measures. On our assessment, at the levels proposed, the upper end is likely (in many cases) to amount to

the entire post-tax income of the individual concerned. The Sentencing Guidelines Council's approach, by contrast, is to refer to a net weekly income measure – the top end of its scale for the starting point is five times the relevant measure (equivalent to approximately one month's net income). It is also unclear in the Consultation Paper whether the FSA's approach is determined by reference to research about the impact of penalties commissioned by the FSA or by reference to other independent studies.

We consider it to be correct (as stated in the Consultation Paper) that the FSA is not required, explicitly, to have regard to the financial circumstances of an individual or firm when setting its penalty policies. Nonetheless, as we mentioned above, it is required under section 2 of FSMA to have regard to the principle of proportionality. In our view, the FSA's proposal regarding financial hardship does not address the fundamental principle of proportionality. (Whilst we agree that the enforcement process should reflect the FSA's credible deterrence strategy, we believe that it must be balanced with fairness towards the individuals/firms in question and their financial circumstances.)

Finally, we note that the FSA proposes to disregard the possibility that a penalty might cause the insolvency of a wrongdoer. Such action would, inevitably, be a decision by the FSA to put a firm out of business. In view of the statutory prohibition on the FSA from imposing both authorisation cancellation and a financial penalty on a firm, we question the legitimacy of this approach – a question that would not arise if financial circumstances are properly recognised in the policy as a matter of proportionality.

Clarity of approach

Although we support the objective of increased clarity in the FSA's approach to setting financial penalties, as stated above, we do not consider the FSA's proposals to achieve this, particularly in two respects.

First, although the FSA proposes the use of five income "bands" to reflect the seriousness of misbehaviour, the proposals (in contrast to the Sentencing Guidelines Council's paper on seriousness) do not identify the relevant factors for each of those bands. Instead the proposals identify factors relating to two groups of these "bands". If transparency and clarity is to be achieved, we believe that the FSA's policy should follow the Sentencing Guidelines Council's approach by more clearly identifying the factors that will lead to a focus on particular "bands".

Second, we consider that the proposed "step 4" (regarding deterrence) entirely undermines the potential for predictability in appropriate formulations for steps 1 to 3. As currently formulated, step 4 gives no information as to how the FSA will approach the issue of whether the penalty should be adjusted, nor how the FSA will approach the question of the degree of adjustment. In our view, the only "clarity" put forward is that the FSA precludes the possibility at this stage of reducing the penalty. On the face of it this approaches the question of fettering discretion – it contrasts with the parallel matter in criminal sentencing which contemplates the possibility of reducing a fine if it is disproportionate when viewed in the round.

We would be delighted to discuss the above observations and suggestions with you. You may contact me on +44 (0)20 7295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours sincerely

Margaret Chamberlain
Chair CLLS Regulatory Committee

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