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NEWS ANALYSIS: UK FSA RAMPS UP THE FEAR FACTOR

By Angela Hayes and Susan Rosser

There is a view that people are not frightened of the FSA. I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA," said Hector Sants chief executive of the UK Financial Services Authority (FSA) in a speech in March.

The FSA recently unveiled its plans to increase the fear factor by significantly raising the size of penalties it imposes, particularly in relation to mis-selling and market abuse. In its proposed framework for setting penalties (Consultation Paper 09/19); the regulator plans to introduce a new regime from February 2010.

Both the level and number of fines being levied by the FSA has been steadily increasing. In the year to March 31, 2009, FSA fines totalled a record £27.3 million, up by 514% compared with the same period in 2008. During this period the regulator also prohibited 46 firms and individuals from carrying out regulated activities.

Against that backdrop it would be reasonable to expect hedge funds to have a particular concern about FSA's enforcement efforts. Although hedge fund managers have been periodically publicly in the FSA's sights, most recently in FSA investigation efforts around short selling banks, no fines have been levied against hedge fund management firms since August 2006 with its action against GLG Partners and its former managing director Philippe Jabre, each fined £750,000 for market abuse.

Since then the 'regulatory dividend' for managers with a strong control environment has been clear with the FSA fining individuals rather than the fund manager firm.

In practice the efficacy of risk controls is under greater scrutiny than ever. The FSA's proposals should be seen as a further incentive to hedge fund managers to review systems and controls, update staff training and to supplement limited internal resource by external specialist advice.

The FSA's enforcement division said it intends to focus on individuals, particularly those holding significant influence functions, because it considers that "action against individuals has a significantly greater impact in terms of deterrence than action against firms and this focus on individuals is a key component of [their] credible deterrence philosophy".

The focus on individuals should be seen in the context of the FSA's wider campaign to hold individual senior managers responsible for compliance breaches. This includes a failure by management to implement appropriate systems and controls to prevent breaches by staff.

The FSA is proposing to levy fines of up to 40% of an individual's salary and benefits (including bonuses) from their job relating to the breach. In market abuse cases it could levy a fine of 40% of an individual's salary and benefits (including bonuses) received from the

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individual's employment in the 12 months preceding the abuse minimum fine or twice the profit made (or loss avoided) by the individual as a direct result of the market abuse (whichever is greater), subject to a minimum penalty of £100,000.

The focus on a proportion of income as the starting point for a fine will apply in addition to disgorgement of any profits. The FSA expects the penalties on high-earning individuals may double or even treble from current levels.

The pre-determined minimum penalty of £100,000 for market abuse could apply regardless of a person's financial worth or the level of personal gain (if any) achieved through the activity in question.

In a significant change to its current policy, the FSA is proposing serious financial hardship will not be taken into account when determining the level of the fine to be imposed, even if the effect of the fine is to push the individual into bankruptcy. It appears the FSA is not afraid to bankrupt individuals. Recently it secured a bankruptcy order in the High Court against a former mortgage broker for non-payment of a £129,000 financial penalty levied on her by the FSA for mortgage fraud.

Recognising the serious potential effect of this proposal, the FSA's alternative approach under consultation is that it should only consider reducing a penalty if an individual would be pushed below the threshold of eligibility for means-tested benefits (an income of £14,000 a year and capital resources below £16,000). This is hardly a comfort.

The FSA is not proposing to make changes to its current policy on discounting financial penalties for early settlement as it wants to continue to provide the incentive of a reduced penalty to encourage self-reporting and full co-operation by companies and individuals. The settlement discount is not applied, however, to the amount reflecting the disgorgement of a person's benefit from their wrongdoing.

Hedge funds managers may be nervous about the FSA's proposals, particularly smaller managers who may not have a dedicated in-house compliance team. The FSA's policy against individuals is directed not just against those who show a lack of integrity by market abuse or mis-marking – importantly the FSA wants to hold senior managers responsible for 'mere' compliance failings as well as or instead of their fund manager companies. This makes the level of fines proposed particularly sobering when compared with the FSA's recent performance.

In September 2008, for example, Steven Harrison, a hedge fund portfolio manager, was fined £52,500 for trading on inside information. The total penalty included an early settlement discount of 30% (the fine would otherwise have been £75,000).

The FSA found Harrison's conduct was not deliberate and he made no direct personal profit as a result of the activities for which he was punished. This was a factor in determining the penalty.

If the FSA introduces its proposed pre-determined minimum fines, Harrison would have been facing a penalty of up 40% of his income (before tax) over the previous 12 months.

For a successful hedge fund manager a fine of even 10% of a year's salary and benefits is likely to amount to a considerable sum.

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