



## Disingenuous deterrence: the FSA's "5 step" penalty setting process

**One of the most common questions we are asked when advising clients receiving rather more attention from the FSA than they would like is: "how does the FSA calculate its fines?"**

In March this year, the FSA published a Policy Statement entitled: "Enforcement Financial Penalties" (PS 10/04)<sup>1</sup> containing rules designed to answer this very question.

The Policy Statement was published in response to Consultation Paper 09/19 "Enforcement Financial Penalties" (CP09/19)<sup>2</sup> introduced plans for an apparently more structured "5 step" framework for determining the level of enforcement penalties for regulatory breach.

The new rules constitute the FSA's response to a period of comment and consultation with the industry on the proposed framework. Many respondents during this period expressed significant opposition to the changes on a number of grounds (which are summarised below). It is no surprise that, notwithstanding certain concessions, the FSA all but dismissed the respondents' concerns (many of which it acknowledged as understandable) and decided to implement the rules broadly as proposed.

### The drivers for change

The stated objectives of the rules are twofold: first, to establish a more transparent framework for, and a more consistent approach to, the calculation of financial penalties that the FSA imposes on firms and individuals. Second, to support the FSA's ongoing commitment to the principle of "credible deterrence", and the concomitant improvement of standards within firms. In particular, the FSA has stated that it considers that the new framework will result in trebling the size of fines.<sup>3</sup>

One of the FSA's particular objectives for the new rules is to bring about a significant reduction in instances of market

abuse. To achieve this, the FSA has opted for a framework that focuses on three distinct themes:

- 1 The wrongdoer should be stripped of any benefit or gain deriving from any regulatory breach;
- 2 The wrongdoer should be appropriately punished for any regulatory breach; and
- 3 The financial penalties should reflect the scale of the wrongdoing and, in doing so, act as a deterrent from future breaches.

### The "5 Step" Framework

At the heart of the new rules is the "5 Step" framework which is designed to set out a logical process for the FSA to follow in setting the financial penalty. The steps are as follows:

- Step 1. Disgorgement of any benefit accruing from the breach.
- Step 2. Disciplinary penalty to reflect the nature, impact and seriousness of the breach, incorporating a penalty tariff on a 5 level scale. This figure is in addition to the disgorgement value and will be linked to "relevant income", as follows:
  - Up to 20% of a firm's revenue from the product or business area linked to the breach over the relevant period;
  - Up to 40% of an individual's salary and benefits (including bonuses) from their job relating to the breach in non-market abuse cases; and
  - A minimum starting point of £100,000 for individuals in serious market abuse cases.
- Step 3. Adjustments upwards or downwards to take account of aggravating or mitigating factors (e.g.

<sup>1</sup> [http://www.fsa.gov.uk/pubs/policy/ps10\\_04.pdf](http://www.fsa.gov.uk/pubs/policy/ps10_04.pdf)

<sup>2</sup> [http://www.fsa.gov.uk/pubs/cp/cp09\\_19.pdf](http://www.fsa.gov.uk/pubs/cp/cp09_19.pdf)

<sup>3</sup> <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/036.shtml>

existence of customer detriment; bad faith/wilful default; duration of the breach).

Step 4. An option to increase the level of the penalty agreed in step 1 and 3 in the interests of deterrence to the recipient and to others.

Step 5. A potential discount for early settlement.

In addition, the regulator reserves the right to reduce fines against individuals in instances where payment would inflict serious financial hardship. This applies in situations where income or capital falls below certain specified levels.<sup>4</sup>

## Comment

Despite its apparently straightforward, logical and transparent nature, we do not consider that the framework will assist firms:

- 1 The transparency and structure of the new proposals is, in our view, superficial. This is because, despite the apparent formality and structure of the decision making process, the FSA ultimately enjoys significant discretion at Steps 3 and 4.<sup>5</sup> Essentially, the FSA has given itself significant latitude to adjust and uplift the level of fines according to its taste. We do not, therefore, think that penalties will be significantly more predictable under the new regime.
- 2 Combining higher penalties with the introduction of a five-step framework may see an increase in the number of challenges to penalties. In particular, individuals and firms have now been presented with five “pressure points” at which to attack the legitimacy of the penalty setting. There is a significant risk, in our view, that the FSA will need to divert significant resources to dealing with these challenges.
- 3 The apparently tougher regime may damage firms’ open and cooperative relationship with the FSA, reduce the level of cooperation given by individuals under investigation, deter firms from disclosing their breaches to the FSA, encourage

firms to change their company structure to limit the impact of regulatory sanction, with the cost ultimately passed on to the consumer, and also take evasive measures to limit financial liability in the event of enforcement action.

The FSA in fact recognises these concerns, but has pressed ahead with the rule changes regardless.

## Implementation

The changes instigated by PS10/04 came into effect on 6 March 2010. There is no retrospective effect of the new rules’ application. Accordingly, the new framework will apply to conduct which has taken place on or after 6 March 2010. In relation to continuing breaches occurring before 6 March 2010 and continuing after this date, the new framework will only apply to that part of the conduct constituting the breach occurring after 6 March 2010.

We look forward to working with our clients to ensure that they can hopefully avoid having to deal with this new penalty regime.

## Contact

Please contact us if you would like to discuss any of the issues raised in this briefing.



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<sup>4</sup> Where income is less than £14,000 and capital is less than £16,000

<sup>5</sup> The discretionary nature of the new framework is one aspect that SP10/04 highlighted as an area of concern for many of the respondents to CP09/19. Step 4 in the 5 step process came under particular scrutiny.