Linklaters

August 2011

Regulatory Investigations Update.

The last month has been dominated by the FSA's decision to levy its largest fine to date for anti-bribery systems and controls failings. The decision comes shortly after the Bribery Act 2010 came into force and is accompanied by a significant civil recovery action by the SFO. These factors combine to create a regulatory climate in which the mitigation of bribery and corruption risks must be given the highest priority. Elsewhere, the FSA's focus on consumers continues with further fines against both individuals and firms for failing to demonstrate the suitability of their advice, in particular, in respect of high risk financial products.

Contents

UK News

Joint Committee of the House of Lords and Commons calls for evidence on the draft Financial Services Bill

The Joint Committee of the House of Lords and House of Commons formed to carry out pre-legislative scrutiny of the draft Financial Services Bill has issued a call for evidence. This contains 22 questions about the Bill and the proposed reforms to the UK regulatory structure. The Committee has also asked respondents to consider whether the Bill will enable the UK to avoid, or better handle, another financial crisis. The deadline for submissions is 2 September 2011. The Committee, which was approved by Parliament in July, is due to report on the draft Bill by 1 December 2011.

UK Policy and Practice

FSA publishes document outlining FCA approach to regulation: 27 June 2011

The FSA recently published a paper on the proposed regulatory approach of the FCA (the "Paper"), which was launched at a day-long conference in London. This sets out some initial thinking on the approach the new FCA, which is due to replace the FSA towards the end of 2012, will take to financial regulation. The Paper is underpinned by the HM Treasury White Paper entitled "A new approach to financial regulation", which contains the draft

Financial Services Bill and upon which we reported in the June edition of this Update.

Although the Paper adds little to what has already been published concerning the likely approach of the FCA, its wide classification of "consumer" has attracted attention. Firms have voiced concern that the new regulator intends to class non-retail customers as "consumers", suggesting a more "hands-on" approach will be taken to the oversight of wholesale markets. The Paper argues that wholesale markets do not operate in isolation. Certain wholesale activities may impact directly upon retail markets, for example, the sale of mortgage-backed securities which played a significant part in the recent financial crisis. It remains to be seen how effectively the FCA can balance sufficient protective oversight of wholesale firms with the freedom their better informed participants may demand.

UK: Decisions

Insurance broker given record fine for failings in anti-bribery and corruption systems and controls: 21 July 2011

Insurance broking firm Willis Limited ("Willis") has been fined £6,895,000 for breaches of Principle 3 (management and control) and SYSC 3.2.6R (systems and controls for countering the risk of financial crime). This is the largest fine imposed by the FSA to date for failings in anti-bribery and corruption systems and controls. The FSA found that the firm was, for a period of almost five years, unable to provide evidence to demonstrate that it had taken reasonable care to establish and maintain effective systems and controls for countering the risks of bribery and corruption associated with payments it made to non-FSA authorised overseas third parties ("OTPs"). The OTPs assisted Willis in winning business from overseas clients, in particular, in high-risk jurisdictions. Willis benefited from a 30% reduction for early settlement, without which the fine would have been £9,850,000.

The fine was imposed notwithstanding the fact that there was no finding that Willis had actually paid bribes (although a small number of suspicious payments uncovered during the FSA investigation were subsequently reported to SOCA). It was sufficient for the FSA, however, that the failures identified resulted in a weak control environment which created an unacceptable risk that the relevant payments could have been used for criminal purposes. This suggests that action by the FSA in respect of financial crime systems and controls failings may pose a greater threat to regulated firms than proceedings by the SFO under the recently enacted Bribery Act 2010. The FSA has a far simpler task in putting a case together, and need not prove that any bribe has actually been offered or taken.

The decision emphasises the importance that the FSA now attaches to the role of senior management in ensuring regulatory compliance. Consultation paper 11/12 Financial Crime: A guide for firms (published in June 2011) indicates that "senior management should take clear responsibility for managing financial crime risks". The Willis board was criticised as having received insufficient information to enable it to assess whether bribery and corruption risks were being managed effectively. In mitigation, the FSA recognised that Willis was now committed “from its CEOs down” to ensure best practice in its approach to anti-bribery and corruption issues.

Ensuring that firms take sufficient steps to combat the risk of financial crime is a key current concern for the FSA. A two-year thematic review resulted in the publication in May 2010 of the FSA’s report on Anti-Bribery and Corruption in Commercial Insurance Broking, which set out good and bad practice in this area. A £5,250,000 fine was levied upon Aon Limited in January 2009 for similar breaches of Principle 3 and SYSC 3.2.6R, and the FSA has most recently published CP 11/12 on Financial Crime (referred to above). This decision underlines the perils of taking insufficient account of the FSA’s expectations of firms in respect of particular compliance failings, as expressed in its own publications and decisions.

FSA issues further fines and bans directors in respect of UCIS advice failings: 8 and 20 July 2011

The FSA has recently issued four final notices against individuals concerning compliance failings which exposed customers to a risk of unsuitable investment advice. In the first case, Andrew Ruff and Richard Lindley, former directors of independent financial adviser network Alpha to Omega (UK) Ltd (A2O), were fined £28,000 and £14,000 respectively for failing effectively to manage and control the firm’s compliance risk. This resulted in a risk that customers received unsuitable investment advice, which was a particular concern where they had been recommended high risk investments, such as unregulated collective investment schemes (“UCIS”). Andrew Ruff, the director primarily responsible for professional standards and compliance oversight, was also banned from performing any significant influence function relating to regulated activities.

The FSA recognises that fines are likely to have a greater impact upon an individual than a firm. In this case, it considered that fines representing a third and over half of the directors’ respective gross annual incomes during the relevant period (before the application of the settlement discount) were proportionate, given their position as approved persons performing a significant influence functions.

In a separate decision, Anthony Moss and Paul Banfield, former directors of Best Advice Planning Ltd, have been banned from performing any significant influence function at an authorised firm following failures which exposed their clients to the risk of receiving unsuitable advice on UCIS. The FSA found that they had breached APER Principle 7, in particular, that there was no evidence that either director understood the restrictions and risks concerning the promotion of UCIS to small investors. Mr Banfield also breached APER Principle 2 in failing to act with due skill and care in performing his controlled functions. He has been banned from acting as an investment advisor and fined £15,000. Mr Moss escaped a fine of £20,000 by providing evidence that this would cause him serious financial hardship, instead receiving a public censure.

The FSA highlighted UCIS as an emerging risk in its 2011 Retail Conduct Risk Outlook. It also has a particular focus on the suitability of advice given, in particular, to retail customers. Firms involved in promoting UCIS should ensure that staff fully understand the statutory restrictions on their promotion under s.238 FSMA and are clear that financial promotions can include both written and verbal communications.

IFA firm and partner receive public censure for systems and controls failings concerning suitability of advice: 29 June 2011

The FSA has issued a public censure of independent financial advisory firm Wheatcroft Fox & Company ("Wheatcroft") in respect of systems and controls failings which rendered the firm unable to demonstrate the suitability of its advice. Wheatcroft was found to have breached Principles 3 (management and control) and 9 (customers: relationship of trust) between June 2004 and May 2009. The FSA also found the firm in breach of Principle 11 (relations with regulators) from August 2010, when it failed to provide the FSA with information about a past business review. Were it not for the financial position of Wheatcroft's partners, the FSA would have fined the firm £45,000.

Peter Fox, who acted as an approved person at Wheatfield, has also received a public censure for breaching Principles 2 and 7 of the FSA's Statements of Principle and Code of Practice for Approved Persons, in respect of the same failings. He has also been banned from carrying on any significant influence function in relation to any regulated activity carried on by a firm. Mr Fox would have been fined £15,000, had he not been able to provide evidence that this would have caused him serious financial hardship. In both cases the failings were regarded as serious as they related to pension products, which the FSA has publicly classified as high risk. As the FSA increases its emphasis upon consumer protection, we are seeing growing number of decisions against both firms and individuals concerning a failure to demonstrate suitability of advice, for example, the significant fines levied earlier this year upon Barclays Bank plc and the Norwich and Peterborough Building Society. Although Mr Fox and Wheatcroft were able to demonstrate knowledge of their customers' financial situations, this information had not been recorded on individual files. This decision underlines the importance of ensuring that clients' files contain sufficient evidence to demonstrate that any advice given was suitable for their particular circumstances.

ECtHR dismisses challenge to FOS procedure and decision: 14 June 2011

The European Court of Human Rights ("ECtHR") has recently considered the compatibility of the Financial Ombudsman Scheme ("FOS") with the right to a fair trial. In *Heather Moor & Edgecomb Ltd v UK* 1550/09 [2011] ECtHR 1019, it was held that the FOS procedure in upholding a complaint against the applicant firm of independent financial advisers had not breached its right to a fair and independent hearing set out at Article 6 ECHR. In 2006, the FOS issued a final decision against Heather Moor & Edgecomb Ltd ("HME"), upholding a complaint brought by a client concerning advice given to him about exiting his occupational pension scheme. The firm sought judicial review of the decision, which was refused both on the papers and following an oral hearing. Permission to appeal was granted and the Court of Appeal dismissed the claim following a three day hearing in June 2008.

In the application to the ECtHR, HME sought to challenge the FOS's refusal to hold an oral hearing, the fact it did not deliver its decision in public and that it is not bound to take decisions based upon the law. These grounds had all been considered during the Court of Appeal hearing. The ECtHR found that the right to an oral hearing was not absolute. It would not be necessary for the fair resolution of a claim in all cases and could give way to considerations of efficiency and economy. In addition, a FOS decision did not preclude a party from subsequently accessing the court, either by a private action against the relevant regulated firm or judicial review of the FOS's decision. In this particular case, the need for publication had been met in the Court of Appeal's judgment, which quoted at length from the FOS decision in question. Finally, endorsing the conclusions of the Court of Appeal, the ECtHR held that Parliament had intended that the FOS should not be limited to the rules of common law when taking decisions, but should be able to make a subjective assessment of what is "fair and reasonable" in the circumstances of any particular case.

Firms have long found the subjective basis of the FOS's decision making to sit uncomfortably with the requirement of legal certainty. The Court of Appeal decision indicated that a firm could comply with all relevant law, rules and regulation and still find itself liable to a client where an "exceptional" factor existed; the ECtHR did not contradict this reasoning. On a more positive note, both the Court of Appeal and ECtHR decision suggest that the FOS should consider allowing an oral hearing where there is a significant factual dispute between a firm and consumer. There was also a suggestion in both the Court of Appeal and ECtHR that there was no reason, in general, why a FOS decision should not be made public. This may become common practice if proposals in the Government's White Paper on Financial Reform to clarify the FOS's ability to publish individual determinations become law. This would go some way towards assisting firms in assessing the standards against which the FOS will hold them to account.

Financial Crime

Investment banker and associates charged with insider dealing: 4 August 2011

An investment banker and two of his associates have been charged with insider dealing offences under s.52 Criminal Justice Act 1993. Thomas Ammann, who lives in Germany, has been charged with two counts of insider dealing and one count of money laundering under s.327 Proceeds of Crime Act, in respect of trading in the shares of Océ NV which took place between February and November 2009. He has also been charged with two counts of encouraging insider dealing. His associates, Christina Weckwerth and Jessica Mang were charged with insider dealing, with Ms Weckwerth also accused of money laundering. All three have been bailed to attend City and Westminster Magistrates Court on 23 August 2011.

Alstom arrests - Judicial review denied: 13 July 2011

As reported in the May 2010 edition of this Update, on 24 March 2010 three members of the board of Alstom, the French transport and infrastructure group, in the UK, were arrested on suspicion of bribery and corruption, conspiracy to pay bribes, money laundering and false accounting following an SFO investigation.

Applications brought by two of the executives, Robert Purcell and Stephen Burgin, for permission to bring judicial review proceedings to challenge the legality of the searches of their homes by the SFO, have now been dismissed by the High Court, and the order preventing the SFO examining search material from these locations, lifted. The third executive arrested died last year.

Permission to challenge the legitimacy of the arrests themselves was previously granted on 26 November 2010 and will be heard in full at a later date. Burgin and Purcell have argued that "[t]he mere fact that an individual is a member, or president, of the board of a company or group of companies which is or may have been involved in criminal offences provides no objective basis to suspect that individual personally knew of wrongdoing". The liability of directors for acts of a company is currently under review by the Law Commission.

Civil recovery order obtained against Macmillan Publishers Limited: 22 July 2011

The SFO has obtained a further civil recovery order ("CRO") under Part 5 POCA 2002 in the High Court. Macmillan Publishers Limited (MPL) was ordered to pay over £11m in recognition of sums it received which were generated through unlawful conduct relating to its Education Division. Following parallel investigations by the SFO and World Bank, it became apparent that public tender processes relating to the supply of educational material in certain East and West African states were susceptible to corruption and it was impossible to be sure that the awards of tenders to MPL in those jurisdictions were not the result of corruption.

As well as the CRO and the costs of the various investigations, MPL will be subject to review by an independent monitor reporting to the SFO and World Bank within twelve months. It has also been debarred from participating in World Bank-funded tender business for at least three years.

This is the fifth and largest civil settlement obtained by the SFO. The level of the order may be of concern to businesses since the SFO acknowledged that MPL had cooperated with the SFO and World Bank throughout the process, having itself approached the SFO. On learning of the allegations of bribery and corruption, MPL had taken appropriate measures to review its internal policies and procedures and appoint external consultants to advise. There was no suggestion that MPL's products were over-priced or of anything but good quality. In addition, MPL's subsequent decision to withdraw from the sector has lost it significant future revenue.

SFO brings actions against alleged Ponzi scheme operators: 27 July 2011

Five people have been charged with offences including money laundering, conspiracy to defraud and making misleading statements contrary to s.397(2)

FSMA 2000, in relation to the Gilher Inc Ponzi scheme that targeted UK based investors and expatriates living in Spain. Richard Pollett, who was extradited from Spain to face the charges, John Hirst, Daniel Hirst, Linda Hirst and Zoe Waite appeared at Bradford Magistrates Court in April, June and July and have all been granted conditional bail pending further investigation. The scheme is alleged to have obtained over £10m from investors, with losses believed to be around £6m. Convictions on the charges could result in substantial fines and/or imprisonment for the alleged fraudsters.

U.S.: News

U.S. and Chinese regulators plan discussions regarding cross-border audits

Since 2007, U.S. regulators, including the Public Company Accounting Oversight Board ("PCAOB") and the Securities and Exchange Commission ("SEC"), have been in discussions with their Chinese counterparts regarding a bilateral agreement that would allow U.S. authorities to inspect auditing firms in China. With an eye to bringing an end to these long-standing talks, representatives form China's Ministry of Finance and the China Securities Regulatory Commission have agreed to meet with a delegation from the PCAOB and the SEC.

The U.S. delegation will be led by PCAOB member Lewis H. Ferguson, who explained that "the purpose of this meeting is to provide an opportunity to exchange information about how each country conducts inspections of auditing firms and to move toward a bilateral agreement providing for joint inspections of China based auditing firms registered with the PCAOB. All companies whose securities trade on a U.S. exchange are required to use an audit firm that is registered with the PCAOB. To date, however, the PCAOB has not been allowed to inspect Chinese audit firms due to sovereignty concerns.

Cooperation regarding cross-border audits may be particularly important, in light of the SEC's recent scrutiny of Chinese companies employing so-called reverse mergers to gain access to the U.S. markets, and their auditors. In the June edition of this Update, we described recent investigations into not only the companies utilizing reverse mergers, but also their auditors. A new era of cooperation between U.S. and Chinese authorities could be an important step in addressing the ongoing concerns regarding the auditing of Chinese companies.

Hong Kong: News

SFC unable to obtain permanent injunctions from Hong Kong courts

In earlier Updates we have noted the fact that the Hong Kong Securities and Futures Commission has started to use the full array of powers available to it under the Securities and Futures Ordinance. This has included the regular use of injunctions, including freezing of assets, pending the outcome of investigations into alleged market misconduct. Recently, the SFC has sought permanent injunctions under the same statutory scheme. However, in two recent decisions, the Hong Kong Court has upheld challenges by a hedge fund to the court's jurisdiction to issue permanent relief where this would involve a determination that insider dealing or other market misconduct had been committed. The SFC sought final orders against Tiger Asia Management LLC ("Tiger Asia"), a New York based hedge fund, and three of its officers (together, the "Defendants") freezing Tiger Asia's assets and banning the Defendants from trading in Hong Kong listed securities.

The Defendants argued that the relevant finding of a contravention could only be made by the Market Misconduct Tribunal ("MMT") or in criminal proceedings under the market misconduct regime of the Securities and Futures Ordinance ("SFO").

The court rejected the suggestion that the Hong Kong legislature intended for final orders to be made on the basis of prima facie evidence of a contravention (the touchstone for jurisdiction to issue these kinds of injunctions). Having rejected the basic premise of the SFC's action in the first decision, the court struck out the proceedings against the Defendants altogether in the second. The SFC has indicated that it will appeal both decisions.

The judgments may have a significant impact on other cases that are currently pending, such as the proceedings initiated by the SFC to return the proceeds from the IPO of Hontex International Holdings Company Ltd to subscribers. The same judge who dealt with the Tiger Asia matters has placed the Hontex proceedings on hold pending appellate review of his interpretation of the scope of the relevant powers. If the appellate decision confirms the view of the first instance court, this could substantially curb the SFC's appetite for bypassing the existing procedures for establishing contraventions of the market misconduct regime which are lengthier (MMT) or more difficult (criminal) for the SFC to pursue.

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