

## Contentious issues for the financial sector

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### Introduction

There are a host of contentious issues that financial firms need to be aware of and know how to deal with, some of which have arisen from, or have received greater emphasis following, the financial crisis.

This document summarises some of the key contentious issues, developments and regulatory agenda and sets out how we can help firms to be ready for them.

If you would like to speak to anyone about any of the issues outlined in this document or any other contentious issues that you may have at the moment, please contact any of our senior colleagues in the financial services department's contentious team: Simon Morris, Maxine Cupitt or Alison McHaffie (contact details appear at the end of this document).

### Tougher FSA enforcement

The FSA is getting "tough" with regulated firms in light of the financial crisis and no more so than in relation to investigations and enforcement actions. The FSA's Enforcement division is pushing hard its strategy of "credible deterrence" through greater financial penalties, the increased use of criminal prosecutions, and greater personal sanctions being taken against senior management, including non-executive directors.

The FSA's financial penalties regime details a new five-step process for setting financial penalties, aimed at achieving a more consistent and transparent process for firms. It takes account of the financial benefits obtained from the relevant failings, the level of fine required to deter further failings, and any mitigating or aggravating factors affecting the level of the fine.

The process's method of calculating fines allows the FSA to order fines of up to 20% of the firm's relevant business income and/or up to 40% of the relevant individual's income. These levels are intended to be sufficiently high to focus senior management's attention, "hurt" the business where it matters, and make clear to individuals the financial risk of personal misconduct.

The FSA also intends to level greater personal sanctions against firms' senior management, including non-executive directors and those personnel in parent companies with regulatory responsibility for their subsidiaries. Such sanctions may arise out of personal failings in relation to the running and management of businesses, but they can also be imposed where senior management fail to prevent failings by junior or subsidiary company personnel through effective systems and controls.

For further information on FSA enforcement, please see our page "[FSA investigations and enforcement](#)" on our online information service on financial regulatory issues, "Regzone", which can be accessed [here](#).

### Key enforcement focus in the retail and wholesale markets

The FSA is committed to reducing mis-selling in the retail market and reducing financial crime in the wholesale market, with the underlying aims of cleaning up financial markets and practices and improving public confidence in the financial sector.

On the retail side, there has been significant enforcement action by the FSA in relation to PPI sales and there may be more to follow. The failure of Lehman Brothers saw the FSA review sales of Lehman-backed structured products and so far it has brought several enforcement actions against advisor firms – again there may be more to follow.

Recent years have seen significant enforcement action against mortgage advisers following the FSA's review of the mortgage market, both in relation to unsuitable sales and inadequate systems and controls to ensure proper sales processes. The FSA has also taken an amount of action against unauthorised share selling firms known as "boiler rooms" which promote and sell shares illegally in the UK and the FSA reports that this has seen a slight decrease in such activity in the past year. The FSA temporarily banned short selling for several months in 2008 and 2009 following the distortion of HSBC's share price and it continues to monitor such practices closely.

On the wholesale side, the FSA is cranking up its pursuit of financial crime, most notably in the market abuse and insider dealing areas. It recently levelled its highest ever civil enforcement fine for market abuse of nearly £1,000,000 against the senior management of an oil exploration company and the fine would have been still higher if the senior management individuals involved had not co-operated with the FSA and identified and informed the FSA of the problem, and if the misconduct had been carried out deliberately.

2010 saw the FSA using its criminal prosecution powers to a far greater extent to reduce, and demonstrate to the industry that it is serious about reducing, financial crime. Most notably this has been seen recently in the custodial sentence secured against Mr Calvert, an ex-employee of Cazenove, for insider dealing offences, and the recent arrest of two insider-dealing groups comprising of individuals working for the investment banks, UBS and JP Morgan.

## Other potential triggers for enforcement

The FSA's enforcement strategy is very much twinned with its new approach of more intensive, and more intrusive, supervision, which includes more frequent and detailed ARROW visits and an increase in significant influence function interviews where these are deemed necessary. The FSA has made clear that its supervision focus will extend to the whole life-cycle of products, including the product development and design stages which it has, until now, left firms to manage themselves; this is an important development for firms given that it goes to the core of their business and profit-making activities.

The FSA is also placing renewed focus on its well-established treating customers fairly initiative, as well as bringing in a new regulatory regime in relation to retail distribution following its thematic work and consultation with the industry in this area.

Both the FSA's new supervisory approach and thematic focuses may well generate a greater amount of FSA investigation and enforcement work where bad practice and inadequate standards are identified. The FSA is certainly cranking up its internal resources to respond to this.

For further information in relation to [ARROW visits](#) and the [Retail Distribution Review](#), please see our pages on both on Regzone via the links above.

Furthermore, the FSA's serious emphasis on senior management responsibility and personal accountability, including in relation to non-executive directors and parent management responsibility for subsidiaries, may well see a rise in investigations and enforcement, including against senior management personally.

Such action may relate to senior management's personal responsibilities in relation to the corporate governance systems, business strategies and models, and risk management in place within firms, as well as their personal responsibility through effective systems and controls for the failings of junior personnel. The FSA is moving away from accepting senior management's judgements and simply reviewing firms' systems and controls to ensure compliance, and instead is increasingly focussing on and challenging senior management's judgement in relation to decisions made about the running of businesses and making its own judgements on those of senior personnel.

The FSA's recent consultation and new proposals in relation to its controlled and significant influence functions, the approval process for these functions, and its new proposed approved persons categorisation, will need to be carefully understood and adhered to, so as to avoid falling foul of the FSA's requirements.

For further information on corporate governance and senior management responsibility, please see our pages on [corporate governance](#) on Regzone.

## Pre-emptive action assistance

We can help firms with reviews of their corporate governance, with their business strategy, and business model structures to ensure these are robust and meet the necessary requirements. We can carry out health-checks, training and internal reviews, and can provide feedback on these.

We can also assist with firms' preparation for ARROW visits, including significant influence function interviews, and help firms understand the new corporate governance regime being proposed and what it will mean for them, as well as assist with approval applications and any interviews that the FSA may require.

We can help firms avoid FSA investigations and enforcement as much as possible and prepare for these if firms are faced with them. Please see our page "[FSA investigations and enforcement](#)" and, in particular, our guide "[Handling a regulatory crisis](#)", on Regzone for further information.

## FSA's renewed focus on complaints and firms' complaints - handling processes

The FSA is placing focus on the level of complaints firms receive in relation to particular products and renewed focus on firms' complaints-handling processes. In relation to the level of complaints, the FSA has recently proposed the use and analysis of complaints as part of its initiative to identify and remedy conduct risks and systemic failures much earlier in the product life-cycle process and before serious customer detriment is caused and large mis-selling issues arise.

Its proposals include placing greater emphasis on firms' requirement to monitor the nature and level of complaints in relation to particular products, and the formation of a "coordinated committee" of FSA, Financial Ombudsman Service ("FOS") and OFT members to identify conduct risks arising out of complaints. This will undoubtedly mean more involvement of these identities in the development and design of products, and in liaison with the FSA's supervision and, possibly, enforcement arms. The FSA's requirement, now in place, for certain firms to publish their complaints data, and FOS's recent move to do the same, will no doubt also be used in this process.

In addition, the FSA is placing renewed focus on firms' complaints-handling processes, both specifically and as part of its now well-established treating customers fairly initiative. The FSA still considers that complaints are being poorly handled by many firms. It has recently proposed a number of additions to the rules governing firms' complaints-handling processes.

The FSA's focus has particularly been seen in the PPI, structured products, and banking sectors. The industry has seen over the last few years, and is still seeing, a high volume of PPI sales' complaints and, after a long period of consultation, the FSA has now published requirements as to how these should be handled, assessed and redressed. A number of PPI providers have already begun a challenge of these requirements by way of Judicial Review led by the BBA. It seems that the hoped for end to the discussions surrounding PPI that the FSA's requirements may have brought is still some way off.

In relation to structured products, including those backed by Lehman Brothers, the FSA is requiring past business reviews in order to identify where potential redress may be required and has produced a template for the assessment of complaints going forward.

In addition, the FSA is keeping a close eye on the treatment by mortgage lenders and banks of their customers, particularly in relation to mortgage arrears and bank fees and charges respectively, and on the activities of unauthorised share sale firms which cause consumer losses by illegal practices. The FSA recently concluded a review of Banks complaints-handling processes which has seen a number of Banks implement improvements to their processes and two Banks being further investigated by the FSA

## The likely focus of FOS complaints

The FOS provides a free service for financial consumers to bring complaints they may have in relation to the sale or marketing of products from authorised firms where the firms themselves have been unable to resolve these complaints.

Over the last few years, as mortgage endowment complaints have decreased, the FOS has seen a rise in PPI and bank charges complaints received from consumers (the latter being settled, in part, by a recent OFT Court test case), a significant amount of which are still being processed.

Now, as a result of the financial crisis, the FOS predicts a rise in complaints both where consumers are struggling financially and where investment returns have been affected by the economic and market conditions. As well as potentially further complaints about PPI and at-risk structured products, these are predicted to include complaints arising out of the treatment received by complainants from mortgage lenders and banks, as well as in relation to investment products, including with-profit bonds and capital guaranteed structured products.

As a result of recent economic conditions, with-profit bond bonuses have typically had to be reduced or not awarded at all, as well as market value reductions being applied to their surrender values. Capital guaranteed structured products remain popular among an increasingly risk averse financial consumer population, and while these are less risky than capital-at-risk structured products, they still contain risks, notably in relation to counterparty risk, which consumers may still not properly understand.

## The Financial Services Compensation Scheme (the "FSCS") and its power to bring Court proceedings against firms

Firms should also be aware of the action that can, and may, be taken by the FSCS against firms. It is responsible for assessing firms' liability and consumer compensation in relation to consumer claims against insolvent firms (the FOS deals with complaints in relation to solvent firms) but it also has the power to bring Court proceedings against any other firm which may have been involved and incurred liability in relation to those claims, and recoup via such proceedings compensation it has paid out to consumers.

The FSCS is currently dealing with consumer claims brought against a number of insolvent adviser firms in relation to the sale of Lehman-backed structured products. On the back of any compensation it pays out to consumers in relation to those sales, it may seek to recover compensation against the advisers' insurers and liquidators, and against the product providers in relation to the design, issue and marketing of the product. Firms should also be alive to contribution proceedings which could be brought by any other firm pursued by the FSCS in this way against any additional firm that that firm considers may be contributorily liable.

## Collective actions

Currently, financial consumers can pursue a group action through the Courts if certain criteria are met. Historically, this option has not been taken up by financial consumers, largely due to the alternative routes in the financial sector to seek redress, because of redress settlements agreed between the FSA and the industry, and, in part, because of the nature of the group litigation procedure itself.

The Financial Services Bill, enacted in April 2010, did originally contain provisions providing consumers with a specific right to pursue collective actions as another option to seek redress. These provisions were removed at the last minute by the government in order to get the Bill passed before Parliament's dissolution prior to the general election. This was largely due to the strong concern voiced by the industry and other bodies as to the operation and effect of the provisions and the new style of group action they would potentially introduce in the UK. For our Law-Now article on the Financial Services Act and paper on the Financial Services Bill, please see our page "[Consumer protection: FOS, complaints-handling, compensation, and collective action](#)" on Regzone.

Importantly, the Bill's provisions to allow the FSA to order consumer redress across the industry have remained in the Bill as enacted. The industry and other bodies also expressed concern over these provisions, given that they would allow the FSA to order redress across the industry without having investigated individual firms. However, it remains to be seen how actively FSA uses its new power, which would require a cost benefit analysis and formal consultation beforehand, or whether it prefers to deal with firm-specific failings through the current supervision and enforcement processes.

It also remains to be seen how the FSA will use this power in the future. It will need to use it, and demonstrate it is using it, reasonably, proportionately, with proper justification and on a sound basis, to allay the industry's fears about the potential nature and scope of such redress orders, and its concern that they may be used despite there being insufficient basis on which to do so.

## Assistance

We can help firms ensure that their complaints-handling processes are compliant, in relation to past business reviews and/or customer redress required by the FSA, in dealing with FOS complaints and wider-implications issues, understanding the impact of the FSCS's powers to bring claims, and the current collective actions regime in the UK. For further information, please see our page "[Consumer protection: FOS, complaints-handling and collective action](#)" on Regzone.

## Other potential "hot" topics

We can also provide assistance, training, analysis and further information on the following areas:

- Investigations by other authorities, including the Serious Fraud Office and the Competition Commission – please see our guide "[An inspector calls – raids and inspections by regulatory authorities](#)" on Regzone;
- The FSA's proposals in relation to client assets – please see our page on [client assets](#) on Regzone;
- The new Bribery Act and the FSA's work in the bribery and corruption areas – please see our dedicated online information service on these areas, the "[Anti-Corruption Zone](#)".

## Contacts

As we have stated above, please feel free to contact any of our senior contentious team if you would like to discuss any of the issues raised in this document or any contentious issue you may have: To view our brochure, "Regulatory Actions and Disputes", please click [here](#).



**Simon Morris**  
Partner, Financial Services  
T +44 (0) 20 7367 2702  
E [simon.morris@cms-cmck.com](mailto:simon.morris@cms-cmck.com)



**Maxine Cupitt**  
Partner, Financial Services (Insurance)  
T +44 (0) 20 7367 2865  
E: [maxine.cupitt@cms-cmck.com](mailto:maxine.cupitt@cms-cmck.com)



**Alison McHaffie**  
Partner, Financial Services  
T +44 (0) 20 7367 2785  
E: [alison.mchaffie@cms-cmck.com](mailto:alison.mchaffie@cms-cmck.com)