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Client briefing
October 2011

FSA Update

At the FSA in the past few weeks:

- **Keydata: FSA held to have acted unlawfully in using material subject to joint legal advice privilege - *R (on the application of Ford) v Financial Services Authority* [2011] EWHC 2583**

The FSA appears to have encountered a significant obstacle in its pursuit of former directors of the defunct investment services firm Keydata Investment Services Limited ("Keydata"), which entered administration (in 2009 on the application of the FSA), reportedly owing approximately 30,000 investors almost £450 million.

The Administrative Court's judgment, handed down on 11th October, will force the FSA to reconsider not only whether and/or how it seeks to pursue those former directors, but also how it requests and manages privileged material in future investigations.

The proceedings arose from an investigation by the FSA (the "investigation"). Mr Ford and a number of other former directors of Keydata (the "directors") were made subjects of the investigation in their individual capacities during the course of the FSA's investigation into the firm. Importantly, the investigation was regulatory (rather than criminal) in nature, examining suspected breaches of relevant FSA Principles and other regulatory requirements. There is no indication that the FSA has, to date, been (or indeed is at this stage) pursuing parallel civil or criminal action.

In 2010, during the course of the investigation, the FSA requested documents including communications between Irwin Mitchell, (who acted for both Keydata and the directors in connection with the investigation) and the directors. Keydata's administrators were asked by the FSA to waive privilege in respect of the documents requested. Having taken advice, they did so and provided the documents to the FSA.

These documents were then read by investigators and used to prepare an investigation report, which was sent first to Keydata's administrators and, some weeks later, to Mr Ford and the other individual subjects of the investigation. Realising that the report was partially based upon these documents, Mr Ford, supported by other directors, mounted a challenge by way of judicial review to the FSA's decision to access and use the documents, arguing that the documents were subject to joint legal advice privilege and that he had not waived that privilege.

During the currency of the judicial review proceedings, the FSA pressed on with regulatory action arising out of the investigation against the directors, proceeding to the Regulatory Decisions Committee which subsequently issued Warning Notices in September 2010 (despite requests that the Committee postpone its consideration until issues relating to privilege were determined by the Administrative Court). The regulatory process, for now, remains ongoing.

Key Issues

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On 11th October, Burnett J, agreeing with Mr Ford, held that the FSA, by accessing and using the documents in the course of the investigation (and the associated regulatory process), acted unlawfully. The case turned on whether advice given to the firm regarding the individual directors by Irwin Mitchell, before the firm of solicitors had been engaged by the directors, could nonetheless be subject to privilege as between them. The judge held that in certain circumstances it could. The judgment raises a number of serious issues, principally, although not exclusively, in relation to the examination of privileged material, and recommends that the FSA look to processes adopted by the SFO and the police to prevent investigators from accessing privileged material in analogous investigations in the criminal jurisdiction.

The nature and extent of redress which will be awarded to Mr Ford, and the impact of the judgment on the proposed regulatory action (both those which are extant and any others which may be contemplated) against him and others of the directors, remain to be decided. However, the FSA has invested significant levels of time and resources into an investigation which commenced in 2007 and which has already, amongst other complexities, required investigators to make a separate trip to the High Court to secure possession of other material held by a third party electronic data storage provider (see *Fieldglen Limited v Financial Services Authority* [2009] UKHC 1939).

Although it is not yet clear as to whether any appeal will be pursued, the FSA will now no doubt be considering how best to proceed.

It is improbable that the FSA will be satisfied with simply taking action against those on the periphery, or that it will consider the end of such an important, long running and high profile investigation in such circumstances to send a message of credible deterrence. Indeed, its website confirms that it "remains committed to pursuing this case" (see http://www.fsa.gov.uk/pages/consumerinformation/firmnews/2010/keydata_faq.shtml#14).

Proceeding with enforcement action is not likely to be straightforward however, not made easier by the historic involvement of the Serious Fraud Office and Insolvency Service, both of which have opted to discontinue their criminal and regulatory investigations respectively, and the ongoing involvement of HM Revenue & Customs.

Mr Ford has won a battle and underlined the importance of handling potentially privileged information. However, he is unlikely to have won the war.

Particularly given the Court's direct recommendation that safeguards from the criminal jurisdiction be imported into the regulatory sphere, the ruling is likely to have wider repercussions in relation to the safeguards which FSA investigators are required to apply when seeking to review and use privileged and other sensitive material (although the FSA do not appear to have yet published any guidance in this regard or amended its Enforcement Guide).

- **FSA not required to give cross-undertakings for damages when seeking injunctions under s. 380 FSMA – *Financial Services Authority v Sinoloa Gold plc* [2011] EWCA Civ 1158**

It seems that all injunctions are equal, but some are more equal than others.

The Court of Appeal has held that the FSA, when seeking freezing injunctions under s. 380 FSMA, is not required to give the normal cross-undertaking in damages to either defendants or third parties who may incur loss as the result of the injunction.

In arriving at this decision, the Court extended the scope of previous decisions in *Hoffman La-Roche & Co AG v Secretary of State for Trade and Industry* [1975] AC 295 and *United States Securities and Exchange Commission v Masterfield* [2009] EWCA Civ 27, in which it was held that cross-undertakings in damages were not required to be given to defendants made subject to such injunctions, to innocent third parties (in this case Barclays).

Although the FSA was still required to provide an undertaking to pay Barclays' costs of complying with the injunction in respect of its customer (and did not seek to argue against doing so), a clear distinction was drawn by Patten LJ (who gave the leading judgment) between those costs and the potential "blank cheque" which he perceived would be licensed by a traditional cross-undertaking.

This distinction was based upon the character of the FSA as a claimant seeking to use statutory restitutionary powers to exercise its law enforcement function. In particular, the Court relied upon the absence of express provision requiring cross-undertakings in damages to be provided to third parties (or defendants), coupled with the immunity afforded to it under Schedule 1, paragraph 19 FSMA as a "strong pointer" (per Patten LJ at paragraph 54) towards the FSA's ability to seek relief in aid of its law enforcement function without being required to compensate third parties for the effect of such steps.

The case is clearly intended to create a binding precedent, with Patten LJ stating:

"*Once one recognises the grant of the injunctions in the present case as part of a law enforcement process the principle that no cross-undertaking should be required ought to apply without exception*".

The case highlights the continuing increase in the latitude allowed to the FSA by the Courts in the exercise of its enforcement function. In injecting such a dose of public policy and pragmatism into its construction of the provisions of FSMA (both those which are present and those which are not) in this case and others, the Court has applied to the FSA an approach previously taken with other statutory regulators (see, for example, *Hoffman La-Roche* (above) in relation to analogous competition proceedings).

As the FSA has increased in assertiveness over recent years, it has sought to test and expand the boundaries of the many and various civil, criminal and regulatory enforcement tools at its disposal. This trend has developed particularly visibly recently through, for example, the FSA's hard fought and ultimately successful campaign to defend its right to prosecute offences not expressly provided for by FSMA (see *R v Rollins* [2010] UKSC 39).

One further thread may be drawn from this case, and from others such as Rollins which have featured in this progression. There is a developing dichotomy between the FSA's position as a body which receives income from firms rather than from the public purse (in which respect it differs markedly from other investigative and prosecutorial or regulatory enforcement authorities) and its position as a public authority with perhaps the widest and most flexible options open to any UK regulatory enforcement authority. This position will not change with the coming of the FCA.

The regulated community (including those who are not subjects of enforcement action but who are affected by it, such as Barclays in this instance) may consider that the FSA is seeking to take an excessively "commercial" approach to the exercise of its significant powers whilst, successfully in this instance, seeking to opt out of the normal safeguards afforded to subjects of action and third parties affected by it. It is clear from Patten LJ's comments above that, were a party to make a similar application seeking to dispense with the need for a cross-undertaking in damages in connection with a freezing injunction sought in the course of litigation involving individuals or companies other than the FSA, the Courts would be unlikely to entertain it.

- **Lord Turner calls for greater powers for FCA**

In what will be, if the timetable for structural change remains on track, his penultimate Mansion House speech as FSA Chairman (on 20th October), Lord Turner has called for the FCA to be provided with new, more robust powers to regulate retail activity to tackle consumer detriment before it occurs. Referring to the new more proactive and interventionist approach which it is intended the FCA will take, he urged those involved in shaping the Financial Services Bill which will ultimately govern the break-up of the FSA, to "give the new approach [to be adopted by the FCA] effective teeth" by providing it with new and/or stronger powers to demand changes to the terms of and/or ban products or misleading financial advertisements.

Lord Turner referred to the significant challenges currently facing both regulators and regulated, and suggested that legislators should recognise the competing imperatives of, for example, more intense supervision versus higher costs of regulation and the need to preserve customer choice and preventative intervention versus after the event compensation.

The full version of Lord Turner's speech can be found at
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/1020_at.shtml.

- **FSA and SEC host round table discussions on market structures**

On 14th October, Martin Wheatley, Managing Director of the FSA's Conduct Business Unit and CEO Designate of the FCA and Mary L Schapiro, Chairman of the US Securities and Exchange Commission, jointly hosted a round table discussion with other national markets and securities regulators.

Key issues discussed included developments in market structures, particularly automated trading strategies such as high frequency trading, market fragmentation and undisplayed liquidity, and how regulators may respond to them.

It is intended that further multilateral meetings are proposed in future to seek to allow regulators to collaborate and formulate approaches to effectively deal with technological developments and changing trading strategies.

http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/085.shtml

- **FSA and SEC hold strategic bilateral talks**

These discussions followed bilateral talks between the FSA (Hector Sants) and SEC (Mary Schapiro) the previous day under the ongoing Strategic Dialogue programme, at which, in addition to the issues above, other areas of discussion included regulatory reform, oversight of over-the-counter derivatives trading and clearing and market surveillance and short selling.

http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/084.shtml

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- **FSA gives guidance on Retail Distribution Review implementation considerations and confirms review of outsourcing relationship between advisers and discretionary managers**

In a speech to the Personal Finance Society on 13th October, Linda Woodall, the FSA's Head of Investments, has outlined the FSA's view of firms' progress with making changes in readiness for the implementation of the Retail Distribution Review.

In addition to identifying key questions for firms to address as part of the implementation process, she confirmed that the FSA's proposed supervisory approach, which is currently focused through a thematic review of RDR readiness, will place significant emphasis on centralised investment propositions.

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/1013_lw.shtml

- **FSA invites dialogue with applicants for recognition as Recognised Auction Platforms**

In advance of the implementation of the EU Emissions Trading Scheme in January 2013, and further to the FSA's consultation paper CP 11/14 (http://www.fsa.gov.uk/pages/Library/Policy/CP/2011/11_14.shtml) earlier this year, the FSA has invited applicants to discuss their proposals for compliance and submit draft applications if appropriate.

http://www.fsa.gov.uk/pages/Library/Communication/Statements/2011/rap.shtml

- **Finalised guidance on selling of general insurance through price comparison websites (FG11/17)**

The FSA has given guidance arising from its thematic review in 2010 in relation to the online sale of regulated insurance products and services and "white labelling", focusing in particular on steps which may be taken to avoid breaches of the general prohibition under section 19 FSMA, Insurance: Conduct of Business sourcebook or senior management arrangements of the Systems and Controls sourcebook (SYSC).

http://www.fsa.gov.uk/pubs/guidance/fg11_17.pdf

- **Finalised guidance on "Buy out" awards to new staff (FG11/18)**

The FSA has given guidance in relation to the provisions of SYSC19A.3 as they relate to situations where a firm hires a new member of staff and seeks to "buy out" and existing award of deferred variable remuneration offered by the employee's previous employer.

http://www.fsa.gov.uk/pubs/guidance/fg11_18.pdf

This guidance follows on from that provided earlier in October in "Dear CEO" letters clarifying how the FSA intends to implement the Remuneration Code.

http://www.fsa.gov.uk/pages/Library/Policy/final_guides/2011/fg11_16.shtml

- **Proposed guidance on "payment order flow" (GCP11/23)**

The FSA has requested the provision of information and set out its understanding of and views on "payment order flow" – i.e. the practice whereby a broker receives payment from market makers in return for sending order flow to them. The proposed guidance sets out the FSA's approach to relevant provisions of SYSC and the Conduct of Business sourcebook.

Responses are requested by the FSA to be submitted by 9th November, with a view to the publication of finalised guidance by the FSA in early 2012.

http://www.fsa.gov.uk/pubs/guidance/gc11_23.pdf

- **Cancellation of permissions**

  - Health & General Limited's Part IV permission was cancelled on 17th October 2011 as the firm had not conducted any regulated activity since 27th January 2005

  - Commercial Insurance Services (M/CR) Limited's Part IV permission was cancelled on 18th October , further to the previous variation by way of a First Supervisory Notice dated 27th July, which had already removed all regulated activities from the firm's permission.

- **Further afield:**
  - Market Abuse: European Commission proposes new EU regime

The European Commission, on 20th October, published its formal legislative proposals for a new Market Abuse Regulation and a new Market Abuse Directive to replace the 2003 Market Abuse Directive.

For our full briefing note, please go to
http://www.cliffordchance.com/publicationviews/publications/2011/10/market_abuse_europeancommissionproposesnewe.html

- **Rajaratnam sentenced to 11 years for Galleon insider dealing offences**

On 13th October, Raj Rajaratnam was sentenced by a court in New York to eleven years' imprisonment following his conviction in May of insider dealing offences committed during his time as CEO of Galleon Group. The sentence is the longest in respect of insider dealing offences in recent times. It dwarfs those handed down in the UK, where the ten convictions secured to date have resulted in total periods of imprisonment of approximately fifteen years for the individuals concerned.

http://www.ft.com/cms/s/0/3fd28f6c-f5c4-11e0-bcc2-00144feab49a.html#axzz1bKGvE9jK