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News flash

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The FSA gets Tough!

On 24 August 2004, the FSA imposed the largest financial penalty in its history – SHELL GROUP OF COMPANIES ("Shell") was fined £17m for the first market abuse case based on false and misleading impressions given. The fine arises in connection with what the FSA has termed "*unprecedented misconduct.*"

Back in July 2003, our publication entitled *"FSA Investigations (everything you wanted to know but were too afraid to ask)"* set the scene for an increasingly aggressive and invasive regulatory regime. Now Misha Nateghi **and** Nilam Sharma **ask whether the FSA has finally come of age?**

Market Abuse Regime

Part XVIII of the Financial Services and Markets Act 2000 ("FSMA") introduced a new regime relating to market abuse to sit alongside the existing provisions relating to insider dealing pursuant to Part V of the Criminal Justice Act 1993. The market abuse regime applies to all persons, whether or not authorised, and market abuse is a criminal offence punishable by unlimited fine or public censure.

Market abuse is defined as at Section 118(2) of FSMA as one of three types of behaviour:

(a) Misuse of information;
(b) Misleading statements and impressions; and/or
(c) Market distortion.

In Shell's case, the market conduct amounted to behaviour likely to give a regular user of the market a false or misleading impression (Section 118(2)(b) FSMA). The behaviour must satisfy the regular user test, which is defined as "*A reasonable person who regularly deals on that market in the investments of the kind in question" (Section 118(10) FSMA).*

As a listed company, Shell also has responsibilities by virtue of the Listing Rules, which provides all listed issuers:

"Must take all reasonable care to ensure that any statement or forecast or any other information…is not misleading, false or deceptive…." (Listing Rules 9.3(a))

Where the FSA is satisfied that a person (which includes a corporate entity) has been engaged in market abuse, pursuant to Section 123(1) of FSMA, the FSA may impose a financial penalty of such amount as it considers appropriate. Further, Section 91(1) of FSMA allows the FSA to impose a penalty where an issuer of UK listed securities has contravened a provision of the Listing Rules.

FSA Investigation into Shell

The FSA investigation began on 23 April 2004, and culminated in a Final Notice on 24 August 2004, which concluded that Shell had committed market abuse and breached the Listing Rules by way of the following behaviour:

1. Shell announced false and misleading reserves for the period 1998 to 2003;

2. Shell were reckless or ignored or simply did not respond to the

indications or warnings, which were given from January 2000 regarding the overstated reserves;

3. Shell did not take any steps to address this issue until at least December 2003, and did not notify the market of the mis-statements until 9 January 2004.

SEC Investigation

The parallel investigation in the US by the SEC has also concluded, and Shell have paid US$120m to settle the allegations of massive overstatement of reserves, in violation of anti-fraud and securities laws.

Lessons learnt the hard way

This is a significant marker in the history of the FSA. For some time, the FSA have been criticised for being slow to respond to conduct which compromised the integrity of the financial markets, for failing to use their statutory powers effectively, and generally not commanding the same kudos as the SEC. That is now a thing of the past. It is now time to sit up and listen to the FSA. The level of this penalty underlines how seriously the FSA view regulatory breaches, and that it is determined to punish Shell and deter others from engaging in similar conduct. The FSA is making it clear that it will not tolerate this type of market behaviour by corporate entities, and any individuals who may be "knowingly concerned."

"It is now time to sit up and listen to the FSA."

Following a review by the FSA of its enforcement procedures, the FSA now aims to act more quickly in misconduct cases. This has resulted in setting shorter target times for each stage of an investigation, disclosure of far more details of whom the FSA is investigating and why, disclosing key evidence earlier and ensuring meetings are held with senior management of firms under investigation. These recommendations are expected to lead to a reduction in the time taken to complete investigations. In this case, the FSA commenced its investigation in April, and 4 months later, in August, published its Final Notice. This is pretty remarkable.

For Shell, whilst the investigation of the company is now closed, FSA and SEC investigations into other aspects of the scandal and into the role of senior executives will continue. Enforcement action will undoubtedly be taken against individual senior executives. Interestingly, the SEC always investigates the company first, and the individuals afterwards. This has not been the case with the FSA. To date, there have only been two instances where individual directors have been found to be knowingly concerned for breach of the listing rules and market abuse, and subsequently fined in their personal capacity.

In the meantime, Shell could face lengthy litigation arising from the Class Actions on behalf of individual investors and derivative shareholder lawsuits, which have been filed in the US seeking some US$5billion from Shell and former and current senior executives, charged with breach of fiduciary duty, abuse of control, management, fraud and unjust enrichment. In addition, KPMG and PWC have been accused of professional negligence and accounting malpractice as auditors.

The future of FSA investigations

Investigations into market abuse are on the up. This will have a direct impact on the Directors and Officers Liability Insurance market. In the usual case the FSA investigation will focus on the company, and not the individual directors and officers, although it is likely that senior management of the entity under investigation, will be called to attend interviews at the FSA, in relation to the affairs of the company.

Insurers should be aware of the FSA's increasing focus on individual responsibility. It will not be surprising to see more individual directors and officers coming under the spotlight. If investigation times are reduced, companies and their management will have to be ready and prepared at an early stage, to respond to the enquiries of the FSA. Companies also have the additional concern that the FSA may publicly announce who they are investigating and why, much sooner. Therefore, systems will have to be put in place to deal with potentially adverse publicity and crisis management issues.

As a starting point, when faced with an FSA investigation, there are a number of issues for Insurers, which require consideration:

1. Is the FSA investigation a "claim" as defined?
2. Are wrongful acts alleged by the FSA against an "Insured" as defined?
3. Erosion of policy limits by defence costs.
4. Allocation of costs issues vis-à-vis the uninsured entity.
5. Application of fraud/dishonesty exclusion.
6. Application of exclusions concerning fines and penalties.
7. Advancement of costs issues.
8. Policy limits, sub limits and endorsements.
9. Is the FSA investigation part of an industry wide enquiry?

In the meantime, co-operation with the FSA is always advisable. The FSA made the point that Shell had co-operated fully with the investigation. This is (apparently) reflected in the size of the penalty, which would have been significantly higher otherwise.

Perhaps it is fair to say that the FSA is now standing up to its critics and becoming a force to be reckoned with, akin to the SEC. All companies and persons authorised and regulated by the FSA must understand their responsibilities and comply, if not, the FSA will make them pay!

Should you require any further information regarding issues concerning FSA investigations, please contact any member of the Financial Institutions Team at Robin Simon LLP.

Should you require any further information regarding issues concerning Financial Institutions and/or Directors and Officers Liabilities, please contact any member of the Financial Institutions Team at Robin Simon LLP.

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