



Client Advisory

FSA Chief Executive Signals Regulatory Sea Change: Intensive Supervision

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On March 12 Hector Sants, the FSA's chief executive, delivered an important speech which sounds certain key notes for short- and medium-term changes in the style and substance of FSA regulation.

Mr Sants declared that the philosophy of principles-based regulation, generally characterised as "light touch," is to be replaced by a more "intrusive and direct style of supervision."

The reasons for the change are based on lessons learned from recent market events as well as a change in the FSA approach. Further, "to suggest that we can operate on principles alone is illusory, particularly because the policy-making framework does not allow it. Europe, in particular, has a particular penchant for rules and in any case in a number of key areas such as prudential they are indeed necessary."

Mr Sants characterised the future direction of the FSA as "outcomes-focused." He explained this to mean that the regulator would "seek to make judgments on the judgments of senior management and take actions if in our view those actions will lead to risks to our statutory objectives. This is a fundamental change. It is moving from regulation based only on observable facts to regulation based on judgments about the future."

He emphasised that this would be an "intrusive" and "direct" style of supervision (which he called "the intensive supervisory model") and stated that this would be allied with a more proactive approach to enforcement termed "our credible deterrence philosophy."

Finally, Mr Sants issued a stark warning: "There is a view that people are not frightened of the FSA. I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA."

Further key extracts from the speech are set out below.

"The key feature of this programme is greater supervisory resource of a higher quality. We are on course to hire, by the end of 2009, 280 extra specialist and supervisory staff which will represent a 30% increase in our supervisory capacity. To ensure these individuals are properly equipped to do this job we have introduced a new Training & Competence scheme which involves a regulatory testing regime for existing supervisors. We have also ensured that we have the right mix between professional regulators and market practitioners.

"Historically, the FSA characterised its approach as evidence-based, risk-based and principles-based. We remain, and must remain, evidence- and risk-based but the phrase 'principles-based' has, I think, been misunderstood. To suggest that we can operate on principles alone is illusory particularly because the policy-making framework does not allow it. Europe, in particular, has a particular penchant for rules and in any case in a number of key areas such as prudential they are indeed necessary.

"Furthermore, the limitations of a pure principles-based regime have to be recognised. I continue to believe the majority of market participants are decent people; however, a principles-based approach does not work with individuals who have no principles.

"What principles-based regulation does mean and should mean, is moving away from prescriptive rules to a higher level articulation of what the FSA expects firms to do. In other words, it helps emphasise that what really matters is not that

any particular box has been ticked but rather that when making decisions, executives know they will be judged on the consequences—the results of those actions.

“Similarly, the FSA, when it supervises, needs to supervise to a philosophy that says 'It will judge firms on the outcomes and consequences of their actions not on the compliance with any given individual rule'. Given this philosophy, a better strapline is 'outcomes-focused regulation'.

“This more ‘intrusive’ and ‘direct’ style of supervision we call ‘the intensive Supervisory Model’. To see the full picture it is important to ally this with our more proactive approach to enforcement—‘our credible deterrence philosophy.’ Since we set out this philosophy, last year, we have demonstrated by our actions that we will use all our powers including criminal prosecutions to deliver our mandate and we are not ducking that responsibility. This week the first of our insider dealing criminal prosecutions has come to trial and we have several more in the pipeline.

“It is also very important to be clear what our mandate is and what it is not. There has been some media commentary of late criticising the financial crime and fraud enforcement architecture in the UK and the effectiveness of the FSA has been included in this criticism. This set of observations demonstrates a lack of understanding of the FSA’s role. The FSA focuses on delivering credible deterrence in respect of its Financial Services & Markets Act (FSMA) mandate. We focus in particular on market-related offences and issues relating to unauthorised activities such as boiler rooms. We are not and do not seek to be the responsible agency for prosecuting financial fraud in its ‘conventional’ or wider sense. It may well be that responsibility is shared elsewhere and it may well be that historically this was not taken seriously enough but we are clear about our responsibilities and are delivering on them.

“[O]n conduct issues I believe a better use of resources is ‘mystery shopping’ and ‘branch visits’ rather than detailed reviews of high-level management information. This switch to outcomes testing is also central to the delivery of ‘credible deterrence’.

“[D]elivery of supervision has to be done in partnership with responsible firms, shareholders and auditors. The supervisors cannot operate alone. All involved in oversight must ensure the right business strategies and behaviours are being pursued. This will require greater engagement by all of us and in particular by shareholders and the non-executive community. The greater engagement of shareholders and non-executives will be central to this improved regulatory proposition.

“Non-executives will need to commit more time and raise their technical skills to exercise rigorous oversight. These changes will no doubt warrant more support and indeed compensation for these individuals. They will also however, need to be more willing to challenge executives. All of this suggests that non-executive directors, as others have already observed, will need to become more like full-time ‘Independent Directors’.

“[T]he principal responsibility for managing firms responsibly lies with the management themselves. It also needs to be recognised that the ultimate responsibility for what has happened rests with firms’ senior management. In reviewing the recent litany of firm failures in many cases, albeit with hindsight, specific decisions and strategies can be seen to be at the root of those firms’ demise.

“The managers of the future must acknowledge and fight against the ‘herd mentality’; ‘the collective wisdom’. To be helpful may I suggest a few simple rules which I am sure we are all aware of but it is worth reminding ourselves of:

- ‘Do not take risks you do not understand.’
- ‘Ensure the focus is on the long run franchise and profitability of the institution not the short term.’
- ‘Ensure a healthy and ethical culture in your organisation!’
- ‘Recognise the future is not predictable and ensure at all times you understand the circumstances under which your firm will fail and that you are happy with the degree of risk mitigation you have.’
- ‘Ensure a healthy and thoughtful culture of challenge from the independent directors.’

“These rules may seem simple but they are regularly ignored. The recognition that financial markets are not rational but rather they are a behavioural system built around personal aspirations is critical to us effectively changing this time round.

“My central message is that when I took on the CEO role in the summer of 2007 my intention was to radically change the supervision practices of the FSA. I set out to ensure the FSA is seen as a regulator which delivers ‘intensive supervision’ and ‘credible deterrence’. The programme to achieve that goal was commenced 18 months ago and we are well on track to achieve that goal by the end of this year. The FSA is already a radically different organisation. The FSA has been seared by recent events but it is tougher and better as a result. The FSA has grown up.”

The full text of the speech is available at:

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml

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