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Assessing U.K. Watchdog

FSA's Regulatory Model Gets Some Raves in U.S.; A Lapdog at Home?


By ALISTAIR MACDONALD
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LONDON -- Politicians and some corporate executives in the U.S. often praise Britain's approach to regulation as a model for an effective but not onerous system to oversee banks, brokers and investment funds, and one that could improve the competitive position of U.S. financial markets globally.

Yet even as Britain's market watchdog, the Financial Services Authority, is lauded across the Atlantic, it and its new chief executive, a former investment banker, face tough questions at home about whether it does enough to protect individual investors.

The equivalent of the U.S. Securities and Exchange Commission and various other U.S. federal and state regulators combined, the FSA regulates everything from global banks trading derivatives and hedge funds to door-to-door sellers of insurance in rural Britain. But rather than relying on rules prescribing how people should act, as U.S. regulators do, the FSA sets broader principles for the behavior it expects.

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A member of the United Kingdom Parliament recently described the FSA's approach to a financial scandal that cost ordinary investors millions of pounds as "extremely feeble." In some corners of the City of London, equivalent to Wall Street, and elsewhere in the U.K., the FSA is often looked on as a toothless tiger with little appetite for the harsh enforcement tactics often employed by U.S. regulators.

Hector Sants, who took over last week as chief executive of the FSA, is a former head of Credit Suisse Group's European investment-banking operations and was head of wholesale and institutional

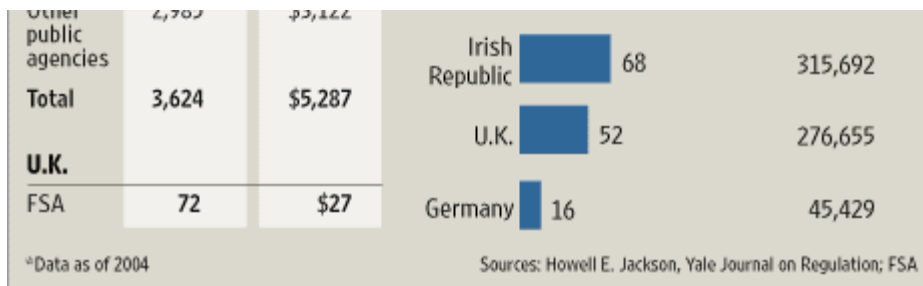


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In an interview, Financial Services Authority Chairman **Callum McCarthy** (left) said that creating an "efficient and orderly" market for retail investors will be the chief long-term priority of the agency and its new chief executive, Hector Sants.

FSA's Lighter Touch The U.S. spreads more and takes a more active stance on



markets at the FSA. His appointment is likely to please London's booming financial-services industry and possibly disappoint some small investors.

Unlike the U.S. Securities and Exchange Commission, which plays cop on the Wall Street beat and may file civil charges or refer cases for criminal prosecution, the FSA typically looks to resolve cases through compromise and negotiation. Much of its sanctioning happens behind closed doors, an approach the FSA says can encourage offenders to look for a quicker settlement. To shape new regulations or call attention to market risks, the FSA puts out "consultation papers," to get feedback on a subject from market participants, the results of which help mold policy.

The SEC champions itself as "the investor's advocate," while the FSA has, as part of its mission, an objective to promote London as a place to do business.

The FSA is looking at relaxing the rules for investment funds listing on **London Stock Exchange PLC's** main market after the exchange and London-based bankers told the FSA that the U.K. had lost out on listing several hedge and private-equity funds to Euronext Amsterdam, a division of recently merged **NYSE Euronext**. The FSA withdrew its earlier attempt to relax requirements after consumer groups complained that it watered down investor protection.

"The FSA know the professional investment market well and are aware of the commercial context that we all live in and don't want to stifle that commerce," says Michael Hintze, chief executive of London hedge fund CQS.

That approach appeals to those in the U.S. who think regulatory overkill is stifling innovation and driving business to other markets. "Repeatedly, the U.S. Congress has instructed the Securities and Exchange Commission to examine a principles-based system and report back to Congress on how quickly such a system might be implemented," SEC Chairman Christopher Cox told reporters when he visited London in April.

The U.K. regulator says it needs to turn its attention to retail markets, where investors often have low levels of financial education and can be offered complicated products by professionals with poor standards. A low level of savings and investing in the U.K. encouraged the agency to act. Creating an "efficient and orderly" market for retail, or individual, investors will be Mr. Sants's and the FSA's biggest long-term priority, FSA Chairman Callum McCarthy said in an interview.

For "retail investors and smaller financial firms, everyone is aware of the FSA, but they are not quite sure what they do, which is not a great reflection on them," says Richard Grossman, head of the London office of Redmayne Bentley Stockbrokers, based in Leeds, which mainly caters to retail investors. Mr. Grossman says the FSA has often acted too late to protect smaller investors.

Last month, the FSA wound up its nearly five-year investigation into the improper marketing and trading of shares in public funds called split-capital investment trusts. Retail investors lost millions of pounds when the values of these funds -- which often had been sold by banks and funds as low-risk when they actually took on a lot of debt and invested in technology stocks -- plummeted when stock markets collapsed after 2000.

Under a deal with the FSA, the banks and funds involved, without admitting blame, agreed to set up a

£195 million (\$400.8 million) compensation fund. The FSA originally demanded a £350 million fund.

Five people involved in selling the funds agreed to either retire or be temporarily barred from working in financial markets, but the FSA didn't say they had breached regulations, under terms of the deal. The banks included units of **ABN Amro Holding** NV and British broker Brewin Dolphin Securities Ltd., and funds such as Gartmore Investment Ltd. and Jupiter Asset Management Ltd.

"The SEC would not have accepted such an outcome, indicating the generally weaker processes of enforcement in the British system," Jim Cousins, a member of Parliament, said in an interview, calling the FSA's response "extremely feeble."

An FSA spokesman says it was a "pragmatic approach to settling a very complex case that resulted in the return of £195 million to investors."

The FSA's approach stems from the tradition of self-regulation that characterized finance in the U.K. In 1997, as one of the first acts of former Prime Minister Tony Blair's government, Mr. Blair created the FSA, which eventually combined nine regulatory bodies under one roof. The FSA employs about 2,700 people, less than a 15th of the work force of U.S. regulatory bodies, including the SEC, the Commodity Futures Trading Commission and U.S. insurance regulators, calculates Howell Jackson, a business professor specializing in regulation at Harvard University.

Between 2002 and 2006, the FSA completed a yearly average of 77 enforcement cases that resulted in action. Between 2002 and 2004, U.S. regulators notched an average of 3,624, according to Mr. Jackson. Forty percent of the SEC's staff works on enforcement, compared with 10% of the FSA's, the U.K. regulator says.

In its own study, issued in March, the FSA found that nearly a quarter of U.K. takeover deals in 2005 were preceded by "abnormal price activity," or possible insider trading. This number was little improved from 2001, when the FSA toughened sanctions to stop insider trading. The SEC also has come under fire over a perceived increase in insider trading ahead of announcements on mergers and acquisitions, which have boomed in recent years.

"We clearly believe that we need to improve the quality of markets in the U.K.," Mr. Sants, the new chief executive, told journalists last week. Still, he added, "there is no evidence that London is a less clean market than others; in fact it could be the very opposite." The SEC has been stepping up its efforts on insider trading, although with less-prominent targets than in the past.

In a high-profile case last year, the FSA fined hedge-fund trader Philippe Jabre £750,000 for market abuse for what the FSA calls "misusing" confidential information about a coming sale of convertible preference shares. The FSA said that Mr. Jabre had violated two of its principles by conducting business without "due skill, care and diligence" and failing to "observe proper standards of market conduct."

A year later, Mr. Jabre started a hedge fund in Geneva, Switzerland. A spokesman for Mr. Jabre declined to comment.

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