

## Article

### Soft guidance: tool or weapon in a principles-based world?

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No one can fail to notice the mass of material that the Financial Services Authority has generated. As well as the usual consultation papers, policy statements and Handbook material, there are "Dear CEO" letters, sector newsletters, fact-sheets, cluster reports and case studies, not to mention web site pages that suddenly appear reporting on thematic work. This supplementary material, in this article referred to as "soft guidance", is not formal FSA guidance; indeed, such material often expressly states that it is not FSA guidance<sup>1</sup>. Firms must, however, take note: keeping up to date with soft guidance is not optional. Although the FSA has observed that soft guidance is intended to be a tool for firms rather than a weapon<sup>2</sup>, the regulator will use soft guidance against firms in enforcement, for example, to provide regulatory context and inform the seriousness of breaches<sup>3</sup>.

The use of soft guidance in enforcement is not a new concept. For [example](#), in *Legal & General Assurance Society Limited v FSA* (January 19 2005), the Financial Services and Markets Tribunal stated that Personal Investment Authority regulatory updates, while not mandatory, served as a useful indication of the standards expected to be applied at that time.

In the move away from detailed rules in favour of high-level principles, however, soft guidance has become increasingly important. Although soft guidance clearly has a useful role to play in principles-based regulation, providing firms with a steer on compliant conduct, the FSA must take care when citing it against firms in enforcement actions. Failure to do so may result in allegations of unfairness and retrospective action; in this context, the fact that soft guidance, unlike formal FSA guidance, is not consulted on will be of concern.

There are, of course, many examples of soft guidance being referred to in an appropriate way<sup>4</sup>. Several recent enforcement actions have, however, highlighted the need for the FSA to be careful not to give soft guidance a bad name. Of particular concern are: the citing of material that does not appear to instruct firms or be of clear relevance to breaches; the reference to material that firms may not have been given a sufficient opportunity to review; and the analogous use of soft guidance (that is, where material cited was directed at a sector other than the one in which the relevant firm carries on business).

#### Does the material cited instruct firms and is it relevant?

##### *Nationwide Building Society*

In February 2007, Nationwide Building Society was [fined](#) £980,000 for failing to take reasonable care to ensure that it had effective systems and controls to manage risks relating to information security. Nationwide's breaches, which occurred between December 2004 and December 2006, came to light when a laptop was stolen from an employee's home.

The FSA found that Nationwide's failings were particularly serious as they occurred following and during a period of "heightened awareness of information security issues", said to involve several FSA publications, numerous high-profile press articles, FSA speeches, and government and industry guidance. Variations of this wording appeared several times in the final notice and in the accompanying [press release](#).

An initial concern with this is the apparent extension of soft guidance to include material that would not generally be considered as such, for example, articles in the national and trade press. Are firms expected to divine the "mood" on various regulatory issues by carrying out a wide-ranging and ongoing review of speeches, press articles, miscellaneous papers and so forth? If so, the usefulness of soft guidance to firms will be significantly diminished; small firms, in particular, will find it near impossible to carry out this type of exercise.

It is also arguable that some of this material should not constitute soft guidance, for example, articles in the national and trade press may not necessarily reflect the views and policy of the FSA (i.e., due to editorial spin).

A cause of particular concern, however, is the emphasis placed on a November 2004 FSA [report](#), "Countering financial crime and risks in information security". The report itself stated that it did not constitute formal FSA guidance. Perhaps, however, we are expected to consider whether it may still be informal guidance? It explained that the findings of its review were intended to assist firms and "help them compare the nature of their risks and risk management practices with those of their peers".

The report is not, furthermore, prescriptive in the way that the final notice suggests. For example, the final notice stated that the report "specifically highlighted the danger of reliance on an annual requirement to sign acceptance of corporate policies whose size made their effectiveness questionable". This appears to be an overstatement, as this was just one of several findings on employee education, with the report concluding that "staff should be provided with education of the firm's policies and procedures on joining". Other FSA publications that have been cited in final notices contained a much greater level of instruction, for example, the "Dear CEO" [letter](#) on payment protection insurance.

The report is not clearly on point, either. It focuses mainly on external IT threats, such as phishing and viruses, and although it

does consider the risks relating to portable devices such as USBs, diskettes and CD-ROMs, it does not mention laptops in this context. It is worth noting that although Nationwide reviewed the report and took steps to enhance information security in the light of the report's conclusions, the FSA did not consider this to be sufficient.

Expecting firms to respond to isolated findings set out in a report which does not set out to instruct or direct firms, however, appears both unrealistic and unfair. The wider context should also be kept in mind; the last few years have seen significant developments in financial services regulation (notably, the implementation of the [Markets in Financial Instruments Directive](#) and the Capital Requirements Directive, not to mention the treating customers fairly initiative). Firms may not have had the resources to scrutinise the full range of the FSA's soft guidance.

The wording used in the Nationwide final notice also implied that there was an intense period of FSA activity on information security and fraud. A review of relevant FSA publications<sup>5</sup>, however, reveals somewhat less than expected. Since the November 2004 report, only one other FSA paper has been published: "Firms' high-level management of fraud risk" (February 2006). Although the February 2006 report was more prescriptive than the November 2004 report, stating that firms could do more to manage fraud risk, it was published after the relevant period for Nationwide's breaches. Presumably, this was why it was not referred to in the final notice.

There were a few speeches on fraud and information security, for example, just before the publication of the November 2004 report. Several financial crime newsletters were also published during the relevant period. These speeches and newsletters were general and informative, however, rather than instructive to firms. The real thrust of the FSA's drive on financial crime emerged in February 2007, and in a [speech](#) by John Tiner<sup>6</sup> shortly beforehand; however, as discussed above, this all happened after the conduct for which Nationwide was sanctioned occurred.

#### *BNP Paribas Private Bank SA London Branch*

In May 2007, BNP Paribas Private Bank SA London Branch was [fined](#) £350,000 for weak anti-fraud systems and controls. BNP Paribas' breaches, which occurred between September 1 2002 and July 28 2006, allowed a senior employee fraudulently to transfer £1.4m out of client accounts.

The FSA's approach to soft guidance in the BNP Paribas decision is very similar to the approach taken in Nationwide. In particular, the final notice referred to BNP Paribas' breaches being serious. This was because BNP failed to enhance procedures to an adequate standard during a "period of heightened FSA and industry awareness of fraud and client money risks" involving several FSA publications, press articles, speeches and so forth.

The specific example given was [discussion paper 26](#), "Developing our policy on fraud and dishonesty" (December 2003). DP26's stated aim was, however, to stimulate debate and obtain views on the FSA's role in reducing fraud and dishonesty affecting the financial services industry. It is therefore highly unlikely that firms would have considered this paper to require action on their part.

As discussed above, a February 2006 report stated that firms could do more to manage the risk of fraud; however, this report was not cited in the BNP Paribas final notice (perhaps because a skilled person's report, which reviewed the firm's anti-fraud controls between March and May 2006, found no significant weaknesses).

The FSA's approach to soft guidance in this case is very similar to, and raises the same concerns as, the approach taken in the Nationwide decision. There is also a sense that the FSA may have acted too quickly in taking enforcement action in this case, without first allowing firms to take on board its more prescriptive publication on fraud issued in February 2006.

The [press release](#) that announced the BNP Paribas final notice warned firms that the FSA was "raising its game" in this area and would "not hesitate to take action against any firm found wanting". This added to the impression that the FSA was making an example of BNP Paribas (and, indeed, Nationwide).

To avoid allegations of unfairness and retrospective action going forward, the FSA would do well to ensure that soft guidance material cited in support of alleged breaches is expressed in instructive language, and that it is relevant to the breaches in question.

#### **Have firms been given a sufficient opportunity to review material?**

##### *Cathedral Motor Company Limited*

In February 2007, Cathedral Motor Company Limited was publicly [censured](#) for failures between January 14 2005 and May 23 2006 relating to the sale of payment protection insurance in connection with vehicle financing agreements. The final notice referred to three FSA publications on PPI: a November 2005 [report](#), "The sale of payment protection insurance — results of thematic work"; a November 2005 "Dear CEO" letter on the sale of PPI; and a December 2005 PPI fact-sheet directed at smaller firms. While none of these publications constituted formal FSA guidance, they required firms to take urgent action to improve PPI sales practices and warned of enforcement action. The "Dear CEO" letter and the fact-sheet also set out specific actions for firms to take, as well as examples of good and bad practice.

The citing of these publications in the Cathedral final notice is a more appropriate use of soft guidance than the approach taken in the Nationwide and BNP Paribas decisions: the PPI publications, unlike the report and discussion paper on fraud, required urgent action and provided details of what was expected.

The [press release](#) accompanying the November 2005 PPI report reiterated this message, speaking in terms of firms being "on notice" of the need to improve sales practices. The FSA was also more restrained in the way it cited soft guidance in the Cathedral final notice. It kept it within a background section, rather than used it as evidence of serious failings.

The main concern with Cathedral was the accompanying [press release](#), which appeared to have overstated the position with regard to the soft guidance material available for review. It referred to the FSA having taken "a number of enforcement actions relating to PPI" and stated that the Cathedral action followed two phases of PPI work. In fact, the other PPI enforcement actions related to similar time periods as Cathedral — the first PPI final notice was not published until September 2006.

Cathedral was, furthermore, only aware of the first phase of the FSA's PPI work: it was visited by the FSA in early 2006, to establish its response to the November 2005 report, and was subsequently referred to enforcement. The mismatch between the Cathedral press release and final notice, in the references to soft guidance, is of concern; press releases communicate the FSA's view of breaches and some firms may not read beyond the press release.

To prevent confusion and allegations of unfairness, the FSA should avoid overstating the position on soft guidance when publicising final notices and firms should be given the opportunity to review guidance referred to.

#### *Regency Mortgage Corporation Limited*

In the Regency Mortgage Corporation Limited [decision](#), the accompanying press release raised similar concerns. Regency's breaches took place between January and November 22 2005. The overlap of Regency's breaches with the PPI November 2005 report and "Dear CEO" letter was, therefore, minimal. The press release, however, reported that the FSA had warned firms of enforcement action following its thematic review; in Regency's case, though, this warning came too late.

The press release also stated that the FSA had highlighted PPI as an area of high potential risk to consumers; however, prior to the November 2005 report, the main FSA publication cited as highlighting PPI as a priority was the FSA's Business Plan for [2005/2006](#), which contained one bullet point on the subject.

There is also the sense in the Regency action that the FSA may be leaping in too early with enforcement, before firms have been given a sufficient opportunity to digest soft guidance. This is apparent in other PPI cases. Although Regency commenced a review of its past sales and systems and controls following receipt of the "Dear CEO" letter, it appears that this was too late: the FSA had already referred Regency to enforcement following a supervisory visit in August 2005. The soft guidance referred to in the final notice was cited to demonstrate mitigating steps taken by Regency rather than breaches, but it is arguable that Regency was not given a proper opportunity to review and respond to the guidance to begin with<sup>7</sup>.

#### **Analogous use of soft guidance**

In April 2007, Sesame Limited was [fined](#) £330,000 for inadequate procedures for the handling of complaints regarding structured capital at risk products. The final notice stated that Sesame's failings were particularly serious as they occurred during a period when there was a "high level of industry awareness of the importance of fair and adequate complaint handling" and a number of regulatory publications detailing the risks associated with SCARPs.

The only publication cited in the final notice in relation to complaint handling was, however, a "Dear CEO" [letter](#) on mortgage endowment complaints. Although this letter outlined the FSA's concerns and asked firms to review complaint-handling procedures, it was clearly directed at the mortgage endowment market. It is unlikely, therefore, that Sesame received this letter.

Nonetheless, the final notice stated that although the letter was aimed at mortgage endowment complaints, it made points relevant to SCARPs complaints as well as other types of complaints. Apparently, the FSA expects firms to read across material and consider, by way of analogy, whether it applies to them — even when it expressly states that it applies to another sector.

The other material referred to in the final notice and the accompanying [press release](#) related to the marketing and mis-selling of SCARPs, rather than complaint handling procedures. One example, given in the press release, is a Financial Ombudsman Service newsletter; this raises the question, again, of the boundaries of soft guidance.

The FSA's use of soft guidance in the Sesame final notice was of particular concern, raising issues of unfairness and the potential for retrospective interpretation. Firms already have a substantial amount of FSA material to trawl through; to expect them to carry out the type of exercise contemplated by the Sesame decision seems unduly onerous, in particular for small firms. A more compelling argument for this could be made where the FSA specifically draws firms' attention to a publication not expressly directed at them; however, this was not the case in Sesame.

A more appropriate use of the mortgage endowments complaint handling "Dear CEO" letter was made in the Guardian Assurance plc [final notice](#) (January 9 2006). Unlike Sesame, Guardian carried out mortgage endowment business; it also received the letter.

#### **Questionable guidance?**

The use of soft guidance in enforcement is not a new development. When used prudently, it can be helpful in terms of providing regulatory context. There are several enforcement actions where the FSA has used soft guidance in an appropriate way, for example, in The Ancient Order of Foresters Friendly Society Limited [final notice](#) (August 23 2006) and in the Kings [final notice](#) (November 8 2005). In Foresters and Kings, the soft guidance material referred to in the final notices was directly relevant to the breaches and contained instruction as well as warnings of enforcement action.

Several recent enforcement actions, however, demonstrate a more questionable use of soft guidance material. The implication in Sesame, that firms should consider guidance directed at other sectors, is of particular concern. Although soft guidance has a useful role to play in principles-based regulation, providing a steer to firms on compliant conduct, the FSA must take care when citing it against firms in enforcement.

In particular, material relied on should be instructive and of relevance to the breaches and the firm, the position on soft guidance should not be overstated and firms should be given a sufficient opportunity to review material referred to. It would also be helpful if

the FSA clarified the boundaries of soft guidance, for example, should such material properly include articles in the national and trade press?

The use of soft guidance in enforcement is a delicate exercise, in particular, where breaches of principles rather than rules are concerned. Soft guidance also raises wider issues, beyond the scope of this article, such as whether it introduces prescription by the back door and whether it is appropriate to impose standards on firms which are not consulted on. As far as soft guidance in enforcement is concerned, it is crucial that the FSA treads carefully in this area; otherwise, firms may consider soft guidance to be an unfair weapon, rather than the useful tool that the FSA intends it to be.

## Footnotes

<sup>1</sup> Formal FSA guidance (indicated by "G" in the FSA Handbook) is given under section 157 of the Financial Services and Markets Act 2000. As such, it must be consulted on (it may also be subjected to cost benefit analysis). Soft guidance is not given under section 157 of FSMA.

<sup>2</sup> Jamie Symington, FSA head of wholesale enforcement, at the inaugural meeting of the Financial Services Lawyers Association on June 7 2007; Margaret Cole, FSA director of enforcement, at a seminar of the Association of Regulatory & Disciplinary Lawyers on July 9 2007.

<sup>3</sup> "Principles-based regulation; Focusing on outcomes that matter", p. 14. This approach is amplified in the draft Enforcement Guide (see paragraph 2.21), which was consulted on in FSA Consultation Paper 07/2: "Review of the Enforcement and Decision making manuals". The guide sets out ways in which soft guidance can be relevant to an enforcement case, including illuminating the FSA's view of the application of a principle, explaining the regulatory context, informing the overall seriousness of the breaches and informing the consideration of a firm's defence.

<sup>4</sup> See the final notices for The Ancient Order of Foresters Friendly Society Limited (August 23 2006) and Kings (November 8 2005), discussed further below.

<sup>5</sup> See the FSA fraud library webpage.

<sup>6</sup> Speech by John Tiner at the Annual Financial Crime Conference, January 22 2007.

<sup>7</sup> Of course, guidance may reflect existing standards; however, if the FSA intends guidance to be an effective tool, firms should be given a reasonable opportunity to consider and act on it.

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### Financial Services and Markets Act 2000

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### FSA Consultation Papers and Source Material

- . [DP26 — Developing our policy on fraud and dishonesty](#)
- . [Countering Financial Crime Risks in Information Security](#)
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