

Financial Institutions Advisory & Financial Regulatory Group | November 19, 2009

Misuse of FSA Powers to Support SEC Investigations

The UK's Financial Services Authority (FSA) has lost a judicial review case concerning use of its information-gathering powers in support of a US Securities and Exchange Commission (SEC) request for documents in the UK.

The case is important because it confirms that the English courts place limits on the ability of the FSA to assist foreign regulators with information-gathering. This is the first time that such cooperation on the part of the FSA has been considered by the English courts.

In *Amro International SA & Creon Management SA v FSA & others*¹ a challenge was made to a decision of the FSA to assist the SEC in obtaining documents by using certain FSA compulsory powers. The Court held that although the FSA had the power to compel the production of documents to assist in a claim brought overseas by a foreign regulator, its use of that power in this case was improper as the SEC's request was "exceedingly wide" and went beyond the issues in the underlying proceedings.

Background facts

Amro and Creon were financing companies based in Panama and the BVI respectively. Rhino, a New York corporation, acted as their investment adviser. Rhino employed Andreas Badian until 2002 and his brother, Thomas, until 2003. In June 2002 the SEC began an investigation into Rhino's short selling activities. The initial outcome of the investigation was a civil claim by the SEC against Rhino and Thomas Badian in respect of a transaction with a Pennsylvania company, Sedona, in March 2001. The action was settled.

However, the SEC continued its investigation and in April 2006, it issued proceedings against Andreas Badian and six others alleging participation in unlawful

short selling arrangements (the New York proceedings). Amro and Creon were not defendants to this action.

On 24 July 2009 the SEC requested assistance from the FSA in obtaining documents from Goodman Jones, a London firm of accountants who acted for Amro and Creon and who were thought to have documents relevant to the SEC's claim. The SEC request effectively covered all documents relating to Creon, Amro or Rhino, dated between January 2000 and July 2009, which may have been in the possession of Goodman Jones.

Initially, the FSA was not satisfied that the SEC request fell within the scope of the New York proceedings or whether it was therefore appropriate to provide the requested assistance. Accordingly, the FSA sought clarification from the SEC on certain matters before resolving to assist the SEC with its request. The FSA initially asked Goodman Jones to produce the documents voluntarily, but Goodman Jones refused to do so in view of client confidentiality. The FSA therefore exercised its powers under the Financial Services and Markets Act 2000, Part XI (the FSMA) and issued a notice on 4 August 2009 requiring Goodman Jones to provide the FSA with the documents requested by the SEC.

¹ [2009] EWHC 2242 (Admin).

Amro and Creon, upon being made aware of the demand, initiated judicial review proceedings against the FSA's decision on the basis that:

- (a) the FSA had acted unlawfully in agreeing to appoint inspectors to obtain the documents through their compulsory powers; and
- (b) the notice was in any event too wide and unspecific and the extent of the requirement was therefore beyond the FSA's powers under the FSMA.

Decision

The Court held that the FSA's exercise of its powers to appoint inspectors and obtain documents was within the scope of the relevant powers. However, the Court held that the FSA had been wrong to accede to the request in its entirety because the request went beyond the scope of the claim in the New York proceedings. The FSA should have decided that "it was not necessary or indeed proportionate for the wide scope of the discovery".

Collins J noted that the SEC made no allegations in the New York proceedings against Amro or Creon. Indeed, Creon was not even mentioned in the claim there. There was also no indication in that claim that Amro or Creon were involved in any illegality nor that they had any knowledge of the short selling arrangements. Information regarding the basis for any such allegations was only provided to the FSA when it sought clarification on the scope of the claim and questioned whether the breadth of disclosure sought was consistent with the claims advanced by the SEC in the New York proceedings. Collins J held that it was "wrong for the FSA to agree to go beyond what is actually covered by the claim" in the New York proceedings.

Collins J was also concerned that no consideration had been given to the potential prejudice that could be caused to Amro and Creon. Given that it might be

alleged that Amro and Creon had acted unlawfully, the Court stressed the importance of ensuring that they were not prejudiced by having no right to defend themselves against such allegations as they were not party to the New York proceedings.

Collins J said that beyond making the initial clarificatory enquiries of the SEC, the FSA was not under any duty to make further enquiries to find out the basis for the allegations against Amro and Creon. To do so would place "an intolerable administrative burden on the FSA".

Comment

Current international proposals on regulatory reforms in light of the financial crisis highlight that increased cooperation between regulators around the world is a significant priority. This decision generally supports such developments in clarifying that there is nothing in the FSMA which prevents the FSA from using its information-gathering powers to cooperate with other regulators (i.e. assistance in obtaining documents to support a civil claim in a foreign jurisdiction). Indeed, the court emphasised that cooperation with overseas regulators is of "vital importance".

Nonetheless, the court's approach is that the FSA must consider the scope of the request of the foreign regulator against the underlying matter to which it relates. If there is a mismatch between the two, the exercise of the FSA's powers to compel document production will be open to challenge.

Collins J gave permission to appeal his decision and the FSA has confirmed that it will launch an appeal. In the meantime, regulators must consider carefully their decisions to cooperate with a foreign regulator, particularly the extent to which such cooperation is necessary and proportionate, taking into account the possible effect on all parties involved.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Josanne Rickard
London
+44.20.7655.5781
josanne.rickard@shearman.com

Robert Evans
New York
+1.212.848.8830
revans@shearman.com

Tobia Croff
Rome
+39.06.697.679.209
tobia.croff@shearman.com

Abigail Arms
Washington
+1.202.508.8025
aarms@shearman.com

Pierre-Nicolas Ferrand
Paris
+33.1.53.89.71.77
pferrand@shearman.com

Lorna Xin Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Katja Kaulamo
Frankfurt
+49.69.9711.1719
katja.kaulamo@shearman.com

Brian Polovoy
New York
+1.212.8484703
bpolovoy@shearman.com

Azad Ali
London
+44.20.7655.5659
azad.ali@shearman.com

Thomas A. Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Richard Kelly
London
+44.20.7655.5788
richard.kelly@shearman.com

Russel Sacks
New York
+1.212.848.7585
rsacks@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com

James Brilliant
London
+44.20.7655.5612
james.brilliant@shearman.com

Aatif Ahmad
London
+44.20.7655.5120
aatif.ahmad@shearman.com

BROADGATE WEST | 9 APPOLD STREET | LONDON | EC2A 2AP | WWW.SHEARMAN.COM

©2009 Shearman & Sterling LLP. As used herein, "Shearman & Sterling" refers to Shearman & Sterling LLP, a limited liability partnership organized under the laws of the State of Delaware.