THE CITY LIBRARY

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COMPLIANCE OFFICER BULLETIN

The **Travers Smith Regulatory Investigations Group** comprises members of the firm's Financial Services and Markets and Dispute Resolution teams, all of whom are leading experts in regulatory investigations and disciplinary and enforcement proceedings. The Group has extensive experience in advising individuals and companies in relation to both internal and external investigations and enforcement proceedings by the FCA (and before that, the FSA), the Serious Fraud Office, the London Stock Exchange, HMRC and various non-UK regulators (including the SEC). The Group provides advice on a wide range of issues in this area including: manipulation of trading records, client money failings, mismarking, market abuse, systems and controls failings, loss of customer details, mis-selling, money laundering failings and breaches of the requirements regarding the marketing of unregulated collective investment schemes and other non-mainstream pooled investments.

The co-heads of the Regulatory Investigations Group are Jane Tuckley and Stephen Paget-Brown.

FCA AND PRA ENFORCEMENT: A YEAR IN REVIEW

1. Introduction

In Shakespeare's *Julius Caesar*, the character Cassius famously observes that "the fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings". Much academic ink has been spilled analysing these words in the years since the play was first written in around 1599, but the common consensus is that Cassius's words emphasise that individuals are responsible for their own choices, rather than being at the mercy of larger, unavoidable events which determine their fate. Fast forward 400 years and one might be forgiven for thinking that these words are also an accurate description of the FCA's continued supervisory focus (although perhaps without the murderous intent behind them): that is to say, the regulator has sustained its emphasis on the importance of individual accountability amongst senior managers and staff within regulated firms and has sought to disabuse them of the notion that regulatory failings of the business are somehow an independent result that is unconnected with the choices made by individuals within the organisation. This emphasis upon the actions of the firm's human agents is complemented by the extension of the Senior Managers and Certification Regime ("SMCR") to all FCA firms, which is now expected to occur in December 2019. It remains to be seen whether the SMCR will lead to an increase in enforcement levels and whether actions against senior executives will become more prevalent, given that one purpose of the new regime is to clarify the specific areas of regulated businesses for which individual senior managers are

CONTENTS

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responsible. The SMCR will also provide a broader foundation for the FCA to take action against other staff within a firm below senior management level, by virtue of the wide application of the new, principles-based, Conduct Rules. Ultimately, it will not only be the Caesars at the top of firms that will need to recognise when the fault may lie in themselves, but increasingly, the underlings too.

There was some speculation that 2016 might have been something of an anomaly in enforcement terms, given the very low aggregate level of financial penalties imposed by the FCA, amounting to only £22 million, and the reduced number of enforcement cases. In the event, 2017 continued in a broadly similar vein, with only 13 cases resulting in a financial penalty, although the total value of fines imposed did increase significantly to almost £230 million. Nonetheless, within that amount, over two thirds of the value is represented by a single penalty imposed on Deutsche Bank back in January 2017 in connection with financial crime failings, with relatively low fines in most of the remaining cases. The pace of enforcement may have accelerated slightly during the first half of 2018, but the aggregate value of fines remains relatively low, at approximately £4.7 million. To date, it is clear that there has been no return to the frenetic levels of enforcement activity seen back in 2014 and 2015. Part of the reason for the decrease in the value of penalties may be the increase in enforcement actions against individuals, rather than against regulated firms. This has been a noticeable trend for the last few years and fits with the FCA's increasing focus on culture and individual accountability: given the obvious implications for individuals and their careers, it should make sobering reading for those working within the financial services industry.

The PRA continues to take a fairly enigmatic approach to enforcement, given the few instances of PRA enforcement action to date. The only example during the relevant period under review in this issue (covering June 2017 to June 2018) was a joint action with the FCA against Jes Staley, the chief executive of Barclays Bank, following his decision to attempt to identify a potential whistleblower back in 2016. As is typical for joint actions, the final notice issued by each regulator is drafted in substantially similar terms so it is clear that there was little opportunity for the PRA to demonstrate its own approach to enforcement. Nonetheless, the absence of other PRA-led enforcement cases confirms the established trend of the PRA using its enforcement powers far less frequently than the FCA, in part reflecting its narrower remit and the fact that the imposition of financial penalties may serve to exacerbate certain declining prudential situations. This may also reflect the PRA's closer ongoing dialogue with many of the prudentially significant firms that it regulates, allowing concerns to be addressed on an ongoing basis before the enforcement stage is reached.

As regards emerging enforcement themes, it is clear that "culture" is the FCA's current watchword, with enforcement actions against Jes Staley (referenced above), Paul Flowers, former chair of the Co-operative Bank, and Charles Palmer, former *de facto* chief executive of Standard Financial Group, each referencing that concept. The FCA is increasingly arguing that it is the responsibility of senior executives to set and maintain the culture within the firm and that their individual misconduct or failure to ensure proper standards of behaviour may contribute to wider failings by other members of staff. As such, the focus is no longer only on the immediate impact of a senior executive's behaviour, but on its wider potential effect in encouraging others to engage in improper behaviour or to disregard applicable regulatory standards. Senior individuals should therefore recognise that they are likely to be viewed as role models by the regulator and that their actions must support, and be seen to support, compliance with the letter and spirit of regulatory requirements.

The broad issue of culture sits alongside the FCA's continued pursuit of individuals whom it considers have failed to act with integrity and who may therefore represent a risk to customers or the financial markets more generally. Many of the cases during the period under review have been manifest examples of extreme dishonesty, including John and Colette Chiesa, who took extensive steps to conceal their personal assets to minimise payments to clients with personal claims against them, and Alexander Stuart and Darren Cummings, both of whom falsified professional qualifications in the financial services industry. The issue of integrity is often a relevant consideration in many other enforcement actions which do not necessarily involve clear dishonesty; although the FCA's guidance in relation to the requirement to act with integrity gives a number of non-exhaustive examples of deliberate acts, relatively recent case law has made it clear that a person can lack integrity by being reckless as to the risk that his or her conduct will breach applicable regulatory standards. Increasingly, the FCA is relying on this approach when bringing enforcement actions. Individuals should therefore be aware that deliberately closing their minds to potential breaches of regulation still involves the risk that they may find themselves banned from the financial services industry.

As usual, systems and controls failures featured prominently during the period, with familiar examples of deficiencies in AML procedures, reporting systems and market abuse surveillance processes. Recent regulatory developments have placed increasing importance on accurate data collection, particularly in relation to transaction reporting and trade reporting under MiFID II and derivatives reporting under EMIR, risk-based customer assessments under the Fourth Money Laundering Directive and transaction surveillance under the EU Market Abuse Regulation. Firms that have failed to implement robust systems to accommodate these (or similar) requirements are at risk of enforcement proceedings, as evidenced by the FCA's actions against Canara Bank, Merrill Lynch International and Interactive Brokers (UK) Ltd.

The importance of clear and fair communications with customers was also underlined during the period, with significant penalties imposed on Vanquis Bank for its failure to explain the true cost of certain credit payment protection products to customers, and Bluefin Insurance for holding itself out as an independent insurance broker despite being (at that time) owned by the insurer AXA. The Bluefin case also emphasises the importance of firms giving clear guidance to their staff about how to address potential conflicts of interest in order to ensure that the firm's regulatory obligations to its customers are prioritised over its commercial objectives.

In this issue, we consider a selection of the more significant or interesting FCA and PRA enforcement actions published between 1 June 2017 and 30 June 2018 in order to identify common themes and lessons that can be learnt by firms and individuals.

2. Criminal enforcement actions

Alongside the FCA's extensive civil enforcement powers, the regulator has demonstrated that it is prepared to prosecute serious misconduct under the criminal law and to push for significant penalties. There have been a number of successful criminal prosecutions (and related ancillary criminal proceedings, such as confiscation applications) by the FCA during the period under review, although the overall level remains relatively subdued when compared with some previous years.

In December 2017, the FCA announced that six defendants had pleaded guilty to various fraud offences and, in certain cases, breach of the UK rules on financial promotions, following their roles in a series of "boiler room" scams which led to investors losing more than £2.7 million. However, limited information is available about the case as two of the defendants were facing additional criminal trials in 2018 and the court ordered a reporting restriction to remain in place in order to avoid prejudicing the outcome of those proceedings. The FCA confirmed that confiscation proceedings will follow against the individuals in due course.

2.1 Muhammad Aleem Mirza, Samrat Bhandari, Michael Moore and Paul Moore: December 2017

In addition, also in December 2017, three individuals were sentenced at Southwark Crown Court for their role in operating an investment scheme which led to over 300 investors losing approximately £1.4 million. The scheme involved one of the defendants, Dr Muhammad Aleem Mirza, establishing a company, Symbiosis Healthcare Plc, which purported to offer healthcare solutions through a network of medical clinics. His co-defendant, Samrat Bhandari, was director of a firm, William Albert Securities Ltd, which acted as corporate finance adviser to Symbiosis and marketed its shares to investors. Both men published misleading statements about Symbiosis's business and made exaggerated claims in promotional materials about the value of the shares being sold. Investors were also cold-called by a number of brokers, including brothers Michael and Paul Moore, who were also co-defendants in the case. Dr Mirza and Mr Bhandari were convicted by a jury in November 2017, while the Moore brothers had each pleaded guilty at an earlier date. Dr Mirza was sentenced to 15 months' imprisonment for two counts of creating a false or misleading impression about the value of the shares and one count of publishing false or misleading statements while acting as a company director. Mr Bhandari, who had been identified by the trial judge as the "prime mover" in the scam and as being "entirely self-centred and devious", had originally offered to reimburse investors but subsequently withdrew that offer prior to sentencing. He was convicted of two counts of creating a false impression in relation to the shares and one count of carrying on a regulated activity without permission, in breach of the general prohibition, resulting in him being sentenced to a total of three and a half years' imprisonment in January 2018. Michael Moore was sentenced to a total of 15 months' imprisonment for two counts of creating a false impression and one count of carrying on a regulated activity without authorisation. Paul Moore was sentenced to 9 months' imprisonment for one count of creating a false impression in relation to the shares and one count of carrying on a regulated activity without authorisation. Both of the Moore brothers were already serving seven year prison sentences for previous offences; the new sentences were added to that original punishment, to run consecutively. Confiscation proceedings are expected to follow against all the defendants in the future.

2.2 Dharam Gopee: February 2018

In February 2018, Dharam Prakash Gopee was convicted at Southwark Crown Court of two breaches of the Consumer Credit Act 1974 and two offences of carrying on a regulated activity in relation to regulated credit agreements without authorisation, following the transfer of responsibility for consumer credit regulation to the FCA in April 2014. Mr Gopee marketed himself as a "lender of last resort" to customers who were often vulnerable individuals in difficult financial circumstances. Between August 2012 and December 2016, he entered into over 140 credit agreements with customers which had a total value of over £1 million and in connection with which he received at least £2 million in payments. In an attempt to avoid the scope of consumer credit regulation, Mr Gopee devised a form of agreement where customers would supposedly sell their homes to a company (Company A) that he controlled for the value of the relevant loan (which was often worth considerably less than the value of the home, for example, between £2,000 and £5,000). A separate company (Company B), which was also controlled by Mr Gopee, would then loan the purchase money for the property to Company A, which had advanced the customer loan. The customers were permitted to remain resident at their properties on the condition that they paid the amounts due from Company A to Company B under the intercompany loan. The purpose of these elaborate arrangements was to support the argument that Mr Gopee was not entering into regulated consumer credit agreements directly with the relevant customers, but the jury was satisfied that in substance, Mr Gopee was in fact providing regulated credit to consumers. The judge found that Mr Gopee knew that the agreements were not enforceable, but continued to pressurise individuals for repayment and charged very high rates of monthly compound interest. Mr Gopee was sentenced to three and a half years' imprisonment, as well as being made subject to a five-year serious crime prevention order, prohibiting him from conducting any consumer credit business and requiring him to disclose information about his banking facilities to the FCA. At the time of sentencing, Mr Gopee was already in prison serving a 15 month sentence for contempt of court, following repeated breaches of a previous restraint order obtained by the FCA in June 2015.

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2.3 Martyn Dodgson and Andrew Hind: May 2018

In May 2018, the Crown Court made confiscation orders against Martyn Dodgson and Andrew Hind, for £1,074,236 and £624,521 respectively, following their conviction for conspiracy to engage in insider dealing in May 2016. Although the insider dealing offences were originally proven in relation to five stocks, the FCA was able to rely on the Proceeds of Crime Act to bring successful confiscation proceedings in relation to trading in a further 23 stocks on the basis that Mr Dodgson and Mr Hind had a criminal lifestyle. The case is a powerful illustration of the FCA's determination to ensure that individuals are not permitted to retain the benefits arising from their misconduct.

3. Market conduct

Market conduct issues, including market manipulation and benchmark manipulation, continued to be high on the list of the FCA's enforcement priorities throughout the review period as part of its broader strategic objective of ensuring the integrity of UK financial markets.

The enforcement action against Paul Walter in November 2017 has echoes of familiar previous examples of manipulative trading, but with a modern twist relating to the deliberate "baiting" of trading algorithms in an anonymous marketplace. While the case is not revolutionary in nature, it provides a useful example of key elements of the civil market abuse regime, including the fact that it is not necessary for individuals to intend to commit market abuse, provided that their actions are such that they have an abusive effect.

Enforcement actions for LIBOR manipulation continued to take place throughout the period, although they have become something of a slow, residual trickle following the flood of cases in 2015 and 2016. Many of these are relatively unexceptional, with what appear to be clear examples of individuals becoming actively involved in misleading submissions in order to benefit themselves, their colleagues or their firms. However, the Upper Tribunal took a more nuanced approach in the case of Arif Hussein, a relatively junior trader within UBS, even going as far as to express some criticism of the FCA for its failure to take action against more senior managers implicated in the LIBOR scandal.

The FCA has also taken action for failure to operate adequate market abuse detection systems; see the case against Interactive Brokers (UK) Ltd in section 5 below.

3.1 Market manipulation

3.1.1 Paul Walter – November 2017

3.1.1.1 Facts

Mr Walter was fined £60,090 in November 2017 for engaging in market abuse by giving a false or misleading impression as to the price and supply or demand of Dutch state loans ("DSLs") and securing the price of DSLs at an artificial level. Since Mr Walter's abusive trading occurred between July and August 2014, the FCA brought the enforcement action under the previous market abuse provisions in the Financial Services and Markets Act, rather than the current EU Market Abuse Regulation rules which replaced them, although many of the same considerations are likely to remain relevant under the new regime.

The DSLs were listed liquid bonds issued by the Dutch government. Mr Walter was an experienced senior trader employed by Bank of America Merrill Lynch ("BAML") who specialised in government bond trading. BAML was a participant on BrokerTec, an electronic inter-dealer multilateral trading facility that operated as a platform for trading fixed income instruments and which allowed participants to trade manually or using algorithms. All trading that occurred on BrokerTec was anonymous.

While Mr Walter also engaged in legitimate trading throughout the relevant period, his abusive trading consisted of him using an "algo-baiting" strategy to manipulate the price of DSLs in a manner that was favourable to his trading positions. First, Mr Walter would enter a high bid (or a low offer) in order to give the impression of wanting to buy (or sell) DSLs, when in fact this was the opposite of what he intended. The high bid (or low offer) would represent the best bid or offer price for the DSLs on BrokerTec, but Mr Walter would always ensure that these bids were in the minimum permitted size so that if other market participants executed against them, his resulting exposure would be limited.

Mr Walter would then wait until other market participants began to adjust their bids or offers as a result of his quote, knowing that many participants on BrokerTec used algorithms to trade and that those algorithms would automatically respond to his bid or offer. Once he knew that the algorithms were tracking his bid or offer, he would incrementally raise the bid (or lower the offer) until the tracking algorithms posted quotes that reached a price at which he wanted to sell (if he had placed a series of high bids) or buy (if he had placed a series of low offers). The buy or sell orders that Mr Walter subsequently executed would almost invariably be larger in size than his prevailing bid or offer that was designed to manipulate the price of the DSLs. Once he had executed his desired trade, he would then cancel his bid or offer quote in order to avoid other market participants executing against it at a price which was unfavourable to him. The fact that trading on BrokerTec was anonymous on both a pre- and post-trade basis meant that it was very difficult for other market participants to identify that Mr Walter had adopted this manipulative algo-baiting strategy. The FCA identified 12 instances of abusive trading in the DSLs by Mr Walter, which resulted in an overall profit of €22,000.

In July 2014, an employee at BrokerTec telephoned Mr Walter to inform him that there had been a complaint about his trading through the platform and that he had been accused of manipulating the prevailing prices. Mr Walter refused to answer any of the questions, later telling the FCA that he did not consider that the call was genuine and that it was BAML's policy not to provide any information in relation to calls of that nature. However, the FCA noted that this call had correctly identified his trading strategy and should at least have prompted him to consider if it was legitimate, and yet he carried out similar abusive trading in the following month.

When he was initially interviewed by BAML, Mr Walter said that the trading could have been the result of entering erroneous quotes on BrokerTec, but later changed his explanation to argue that he was using the minimum size orders to try to round up or round down his trading positions. In response to questions from the FCA, Mr Walter maintained that the orders were genuine transactions and that he was trying to incrementally build up large positions without causing undue disruption in the market. The FCA rejected that explanation, concluding that he had no intention of buying or selling when he placed the smaller manipulating orders and that his behaviour had given a false or misleading impression as to price and trading volume. The result was to fix the price of the DSLs at an artificial level, allowing Mr Walter to execute trades at a price that was more advantageous to him than he could otherwise have obtained.

When determining the applicable penalty, the FCA took a range of factors into account, including the following:

- Mr Walter himself made no direct profits from the abusive trading, since he was trading on behalf of BAML;
- the trading had no effect on the overall orderliness of the market;
- the conduct was repeated on 12 separate occasions and continued even after BrokerTec had raised concerns with him;
- Mr Walter's behaviour only ceased after he was suspended from his role by BAML;
- he had over 20 years' experience in trading government bonds; and
- he did not intend to commit market abuse and had not foreseen that his actions would constitute abusive trading, but should have realised that his behaviour would do so.

3.1.1.2 Comment

Mr Walter's case is another illustration of the fact that individuals do not need to intend to commit market abuse in order to breach the relevant rules; it is only necessary that a person's actions have an abusive effect. Although his trading involved getting algorithms to follow his quotes, in many ways it is simply a more modern version of a manipulation strategy involving the use of incremental small quotes to drive prices in a particular direction before executing a more substantial trade at a favourable artificial price. Nonetheless, it is clear that the faster responsiveness of trading algorithms and the fact that they may generate quotes without human intervention broadens the risk that individuals may be able to manipulate them into posting favourable bids or offers. The FCA's enforcement action against Mr Walter is a reminder that the regulator will investigate and pursue any such attempted manipulation, even if the individual does not make a personal profit as a result.

3.2 LIBOR cases

The FCA has continued to address the consequences of the LIBOR-fixing scandal, with three separate cases against Arif Hussein, a former derivatives trader at UBS; Guillaume Adolph, a former derivatives trader at Deutsche Bank; and Neil Danziger, a former derivatives trader and LIBOR submitter at Royal Bank of Scotland.

3.2.1 Guillaume Adolph: February 2018

Mr Adolph's case, which led to him receiving a £180,000 penalty and a prohibition order in February 2018, appears to have been a relatively clear example of a broker making inappropriate LIBOR submissions in order to benefit his own trading positions and the trading positions of third parties. The FCA noted that: (1) Deutsche Bank had failed to give him formal training on the LIBOR submission process; and (2) taking into account the trading positions of the bank when making submissions was a widespread practice during the relevant period (which in Mr Adolph's case, lasted from July 2008 until March 2010). However, despite this, Mr Adolph was an experienced derivatives trader and knew that the definition of LIBOR required a genuine assessment of the rate at which Deutsche could borrow funds in the market. As a result, the FCA concluded that he had deliberately closed his mind to the risk that his behaviour fell below the required standards of market conduct and was knowingly concerned in Deutsche's breach of the relevant standards.

3.2.2 Neil Danziger: January 2018

Mr Danziger was fined £250,000 and made subject to a prohibition order in January 2018, after the FCA found that he was knowingly concerned in RBS's failure to uphold proper standards of market conduct between February 2007 and November 2010. In order to benefit his own trading positions and those of other individuals within the bank, the FCA found that Mr Danziger made requests to RBS's main LIBOR submitters in order to influence their submissions and facilitated requests from other traders when he was acting as a substitute LIBOR submitter. In addition, he also entered into a number of "wash trades" (i.e. risk-free trades that offset each other) with brokers in order to facilitate brokerage payments to them in return for personal hospitality provided to him.

The FCA concluded that Mr Danziger's extensive involvement in attempted LIBOR manipulation and use of wash trades for personal gain showed a serious lack of integrity and justified the imposition of the significant personal fine. The regulator had no sympathy for the representations put forward by Mr Danziger that the enforcement action was inappropriate because some of the events had taken place a decade ago and that RBS had not breached the FCA's market conduct principle because influencing LIBOR submissions was "typical" practice at the time. It noted that the Court of Appeal had on a number of occasions clearly upheld the view that the LIBOR definition meant that banks were not entitled to take their own commercial advantage into account when making submissions and that simply because a practice is widespread in financial markets does mean that such behaviour constitutes a *proper* standard of market conduct. The FCA conceded that Mr Danziger had not been given any formal training in relation to the LIBOR submissions process, but nonetheless concluded that he was aware of the definition of LIBOR and of the fact that it precluded taking into account RBS's proprietary positions. It is clear from the FCA's response to the various representations that individuals are unlikely to be able to rely on a lack of training as a defence where a reasonable person would nonetheless have appreciated that the relevant conduct could be considered to be improper.

3.2.3 Arif Hussein: June 2018

The case against Mr Hussein was somewhat more complex than the above cases, but underlines the critical importance of being open and truthful with the FCA and the Tribunal in order to avoid adverse findings about an individual's integrity.

3.2.3.1 Summary

In his capacity as a derivatives trader at UBS, Mr Hussein had a number of conversations between April 2007 and March 2008 via an internal messaging system with other traders at UBS who had responsibility for UBS's LIBOR submissions. Mr Hussein provided information on his trading positions to those trader-submitters, but did not request them to take this into account when providing UBS's submissions. After considering the facts of the case, as presented by the FCA's Enforcement Division, the Regulatory Decisions Committee ("RDC") within the FCA concluded that Mr Hussein had not acted dishonestly, but had nonetheless closed his mind to the possibility that the information he provided through the messenger system would be used to influence UBS's LIBOR submissions for the bank's own benefit. As a result, the RDC concluded that Mr Hussein had acted recklessly and therefore lacked integrity, such that it was justified in imposing a prohibition order on him.

Mr Hussein referred the case to the Upper Tribunal for a rehearing. The Tribunal found that during the relevant period, it was a widely accepted practice within UBS to take into account the bank's own derivatives positions when setting LIBOR and that this had been sanctioned by certain senior managers. It concluded that Mr Hussein had not improperly closed his mind to the risks so as to act recklessly, particularly in light of the fact that he had asked his manager whether the conversations were appropriate. However, the Tribunal also found that Mr Hussein had misled the FCA through the answers he had provided at interview, which were partly inconsistent with the case he later advanced before the Tribunal. As a result of his failure to be open and honest with the regulator, he lacked integrity. Given that a failure to be candid and truthful with the FCA was a very serious matter, the Tribunal concluded that there was no basis on which it could properly interfere with the FCA's decision to impose a prohibition order on Mr Hussein, although it did note that it would be open to the FCA to vary or revoke the order in the future.

3.2.3.2 Facts

Mr Hussein engaged in a number of conversations with different LIBOR submitters where he provided information on his trading positions. His explanation for the conversations was that he had been instructed by his superiors to disclose his trading positions to the submitters because the submitters were also derivatives traders and UBS wanted to explore the possibility of internal hedging (i.e. offsetting opposite positions taken by different UBS traders) in order to reduce the costs of unnecessary hedging with external counterparties. The FCA disputed that account and argued that the content of the conversations contained no express reference to the idea of hedging positions, which it found strange if hedging had in fact been intended. In any case, there was no evidence that any internal hedging ever occurred as a result of the relevant conversations.

On one occasion, after a submitter informed Mr Hussein that the submitter would aim to make a submission for three-month LIBOR at a higher rate to suit Mr Hussein's trading positions, Mr Hussein informed his line manager that he was concerned that this could be improper. His recollection was that the line manager confirmed that the conversation did not give rise to any concerns.

In July 2013, Mr Hussein was interviewed by the FCA and asked to explain the nature of the conversations with the LIBOR submitters. He said that the information he provided about his trading positions was given to the submitters in good faith and in their separate capacity as traders, and that he had always assumed that UBS had proper compliance systems in place to prevent the submitters misusing that information. He reiterated that he understood that his communications only ever related to internal hedging.

In October 2013, the FCA published its Preliminary Investigation Report, where it concluded that Mr Hussein had been knowingly concerned in UBS's breach of market conduct requirements and had given a false or misleading account at the July 2013 interview. In his response to that report, Mr Hussein again emphasised that he had never realised that the information he provided to the submitters might be used for the purposes of UBS's LIBOR submissions, although with the benefit of hindsight, he conceded that he could have appreciated that the submitters were not only derivatives traders, but also had responsibility for making the submissions. Mr Hussein also stated that he had felt increasingly uncomfortable with being instructed to participate in the internal chats when there was no obvious benefit, but there was a corresponding risk in terms of the purpose of the conversations being misinterpreted. The Tribunal noted that that statement was effectively an admission that he knew that there was a risk that the submitters would use the information he provided for an improper purpose.

In May 2014, Mr Hussein made a number of written submissions to the RDC, in which he stated that he did not know that the derivatives traders with whom he was conversing were also LIBOR submitters and that it was therefore reasonable for him to assume that the information he provided would only be used for the purposes of internal hedging. In December 2014, he made a number of oral representations before the RDC which essentially made the same point, although he conceded that he believed that one individual was also a LIBOR submitter. The RDC subsequently rejected the FCA Enforcement Division's case that Mr Hussein had acted dishonestly, but concluded that his approach to the relevant conversations was consistent with the idea that he had closed his mind to their possible purpose and that he therefore lacked integrity through being reckless.

In the subsequent rehearing before the Tribunal, Mr Hussein conceded that the wording of at least one of the instant messenger conversations would have made it clear to him that the relevant submitter was taking into account Mr Hussein's trading positions when making the LIBOR submission. Mr Hussein then sought to maintain that despite knowing that the submitters might have been using his trading information for that purpose, he now recalled that he understood at the time that it was permissible within UBS to take into account internal trading positions for the purposes of LIBOR submissions.

The Tribunal found that Mr Hussein had acted neither dishonestly nor recklessly. It accepted that on the basis of the discussion with his line manager and the fact that other senior managers within UBS had sanctioned using trading information for the purposes of the LIBOR submission process, he believed that it was proper for his information to be used in that way. The conversations had not taken place at Mr Hussein's instigation, but because his superiors had instructed him to provide the relevant information. There was no evidence that he had made a specific request for the submitters to make a particular LIBOR submission to suit his own trading position. On this basis, the Tribunal found that his behaviour had not fallen below the ordinary standards of honest behaviour and that he had not improperly closed his mind to the risks so as to act recklessly.

However, the Tribunal concluded that Mr Hussein had misled the FCA through the answers he had provided at interview, albeit by being "deliberately economical with the truth" rather than making obviously false statements. He had failed to disclose that he knew that the information he provided through the messenger system would be taken into account by the submitters for the purposes of setting LIBOR and therefore that the conversations had a dual purpose. His explanation that he did not reveal this at his original interview with the FCA because the conversations had taken place many years before and he had had little time to prepare was plausible, but he had ample time to reflect and take advice from his lawyers before subsequently responding to the FCA's Preliminary Investigation Report or before he made representations to the RDC. It was therefore undeniable that by advancing a case before the Tribunal which was inconsistent with answers provided to the FCA, Mr Hussein had misled the FCA. It seemed that his evidence before the Tribunal differed from his earlier statements because he realised that his original case (i.e. that he did not know that the conversations had a dual purpose) lacked credibility and that this would become clear at the rehearing. Providing misleading information to the regulator was a very serious matter, as was failing to give truthful evidence before the Tribunal when under oath.

In the circumstances, the Tribunal concluded that there was no basis with which it could interfere with the FCA's decision to impose a prohibition order due to Mr Hussein's lack of integrity through failing to be open and honest with the FCA. It did, however, emphasise that it would be open to the FCA to revoke the prohibition order in the future, given that in the opinion of the Tribunal, Mr Hussein's behaviour was not such as to justify barring him from the financial services industry forever.

3.2.3.3 Comment

Despite Mr Hussein's failings, there is a palpable sense in the Tribunal's written decision that it had some reservations about the nature of the FCA's enforcement action. It expressed concerns that Mr Hussein was a relatively junior trader who had engaged in a limited number of offending conversations, whereas more senior individuals within UBS who appeared more culpable had not been subject to enforcement action. The Tribunal was also particularly withering about the observations of the FCA's counsel that one explanation for why senior managers at UBS had escaped enforcement was because "not everybody is in the jurisdiction and … the documentation that is referred to as fingering senior people is not extensive … the senior people somehow manage to keep their fingerprints off the relevant documents sometimes".

The difficulty of ensuring the accountability of senior individuals may be lessened under the new SMCR, given its focus on holding senior managers accountable for regulatory failures in the areas of regulated firms for which they are responsible, although there may still be an evidential difficulty in proving what it is reasonable for a manager to be expected to know or do in any given circumstance.

The Tribunal's decision also emphasises the importance of individuals providing consistent and honest information to regulators. While the Tribunal had some sympathy for Mr Hussein's argument that his statements at his initial FCA interview had to be viewed in the context of having limited time to prepare and recall events from years before, it is clear that once a person has had the opportunity to consider the facts in detail, the FCA and Tribunal will not accept excuses for inconsistent explanations. Providing false or misleading information is very likely to form a reasonable basis for the FCA or PRA to conclude that a person lacks integrity and, in turn, a finding of a lack of integrity will almost always justify a prohibition order against that individual.

Although in Mr Hussein's case the Tribunal concluded that he had not been reckless, this nonetheless serves as a useful reminder that individuals can still be found to lack integrity through recklessness, i.e. where an individual turns a "blind eye" to the possibility that (s)he is engaged in or is facilitating wrongdoing, this will not prevent the regulator from taking action against that person for a lack of integrity.

4. Senior management conduct

In recent years, the language of the FCA has shifted to a greater emphasis on concepts such as firms' "culture" and whether senior management are setting the right "tone from the top". In part, this may be a natural evolution of the increased focus on governance and individual accountability following the report of the Parliamentary Commission on Banking Standards which set out the conclusions of its investigation into the 2007/08 financial crisis and into financial scandals such as mis-selling and benchmark manipulation. In turn, that report led to the development of the SMCR, which is designed to reinforce the responsibility of all individuals involved in the provision of financial services within a firm and which, while currently applying primarily to UK banks, is expected to be extended to all FCA-authorised firms from late 2019.

One of the principal purposes of the SMCR is to resolve issues surrounding potentially blurred accountability so that it is easier for the FCA or PRA to identify specific senior individuals within regulated firms who should be held responsible for particular regulatory failures. However, the SMCR may also sit alongside a broader renewed regulatory focus on whether senior individuals' conduct is appropriate and whether it explicitly or implicitly communicates the correct messages to more junior staff about the importance of honesty, integrity and proper compliance with applicable laws and regulations.

During the period under review, there were three significant actions against senior individuals within firms who failed to uphold the governance and leadership standards expected by regulators: James ("Jes") Staley at Barclays Bank, Paul Flowers at the Co-operative Bank, and Charles Palmer at Standard Financial Group Ltd. Although the facts in each case were very different, they are united by a broader message from the regulators about the importance of senior individuals behaving with the highest standards of integrity, ensuring effective governance arrangements and not undermining the regulatory regime or wider confidence in the UK financial services industry.

4.1 Paul Flowers: March 2018

4.1.1 Facts

Mr Flowers was made subject to a prohibition order preventing him from performing any function in a regulated firm on the grounds that he was not a fit and proper person due to inappropriate behaviour while acting as the chair of Co-operative Bank Plc and his subsequent behaviour thereafter.

Between April 2010 and June 2013, Mr Flowers acted as chair of the bank, eventually resigning as a result of substantial operating losses incurred by the business in early 2013 amid the continuing aftermath of a poorly executed merger with the Britannia Building Society. During his time as chair, Mr Flowers used a mobile phone provided by the bank to make personal calls to a premium rate chat line, in breach of the applicable expenses policy. He received a formal warning from the bank about this behaviour in July 2011 and repaid the relevant costs.

Over a number of months in 2012 and 2013, Mr Flowers also used his work email account to send and receive inappropriate messages, some of which contained sexually explicit content. A number of other messages discussed the unlawful purchase, offering and consumption of cocaine, GHB, and ketamine. When interviewed by the FCA, Mr Flowers accepted that the relevant messages breached the bank's computer use policy and, in relation to the sexually explicit messages, that these also breached requirements in the bank's Code of Conduct for Directors to uphold the bank's values and not to bring it into disrepute. However, he denied that the messages relating to the purchase, supply and use of unlawful drugs breached that code, although the FCA concluded that such messages clearly brought the bank into disrepute and therefore were incompatible with the code's requirements.

Mr Flowers was convicted before a magistrates' court in May 2014 of the unlawful possession of cocaine, methamphetamine, and ketamine, following his arrest in November 2013. This was after he had left his position as chair at the Co-operative Bank and after he had ceased to be an approved person. However, the FCA found that his failure to comply with the standards of behaviour required under the criminal law was further evidence that he lacked the willingness to comply with other required standards of behaviour, including those applicable under FCA regulation if he were to work in financial services in the future.

Taken together, Mr Flowers's conduct evidenced a serious lack of integrity and a disregard for applicable standards expected of an approved person. Furthermore, due to the adverse publicity surrounding his actions, he no longer had the required reputation to permit him to carry on regulated functions in the financial services industry and to allow him to do so would risk undermining consumer and market confidence. Mr Flowers sought unsuccessfully to justify his actions by reference to difficult personal circumstances during the relevant period.

4.1.2 Comment

On its face, the Flowers case is not particularly controversial. There are few commentators or industry participants who would argue that a conviction for a serious criminal offence cannot be relied upon by the FCA as evidence of a lack of integrity or that Mr Flowers's conduct on his business computer and telephone was acceptable behaviour. However, the FCA's general approach to the case and some of the commentary in the final notice merit further reflection.

The first interesting aspect is the FCA's observation (reinforced by opinions obtained from other board members during interviews with the regulator) that it is one of the functions of the chair to set the "tone from the top" and to establish clear expectations about the bank's culture. As noted above, this is an increasing area of focus for the FCA, which takes the view that personal misconduct by a senior executive, even if it does not relate directly to the firm's provision of financial services, may nonetheless create a harmful effect throughout the firm by encouraging a disregard for proper standards. Senior individuals should therefore reflect very carefully upon their broader behaviour to ensure that the FCA does not have grounds to allege that this is indirectly encouraging a negative or inappropriate wider business culture.

The FCA's final notice refers in several places to the fact that Mr Flowers had agreed to uphold high standards in his capacity as a Methodist minister. It is not immediately clear why this should be relevant. It is true that the FCA's guidance in its Fit and Proper Test for Approved Persons ("FIT") states that it will consider whether a person demonstrates a willingness to comply with other legal, regulatory and professional requirements and standards other than those under the financial regulatory system. However, this has often been understood to refer to standards which might also be relevant to a person's role (for example, standards applied by the Solicitors Regulation Authority or Bar Council for a qualified lawyer, or standards applied by the Financial Reporting Council for accountants, auditors and actuaries). The FCA may have been attempting to argue that failure to adhere to the standards expected of a religious figure was further evidence of Mr Flowers's personal predilection to ignore various different codes of behaviour to which he was subject, such that it was pertinent to the question of whether he could be trusted to comply with regulatory requirements in the future. However, this point is not explained expressly in the final notice. This raises questions about whether individuals who otherwise perform very similar roles in a regulated firm should be judged by different standards because of their other roles or appointments outside of the financial services industry.

The FCA does not appear to have approached the case specifically on the basis that the inappropriate *content* of Mr Flowers's emails was in itself indicative of a lack of integrity. Instead, the final notice focuses more widely on the *misuse* of the email account constituting a breach of the bank's internal policies and the fact that the chair of the bank should be expected to comply with the standards set for the relevant business. This suggests that where senior individuals breach internal policies, this may in itself be evidence of a lack of integrity by virtue of failure to adhere to applicable rules, even though the conduct giving rise to the breach may not necessarily breach specific regulatory requirements or amount to criminal behaviour.

4.2 James ("Jes") Staley: May 2018

4.2.1 Facts

Mr Staley, chief executive of Barclays, was fined a combined total of £642,430 by the FCA and PRA in May 2018 as a result of attempting to identify the sender of a potential anonymous whistleblowing letter that was received by another member of Barclays's board in June 2016.

The letter purported to be from a shareholder of the Barclays Group and raised a number of personal allegations in relation to behaviour by a senior employee within the bank at that employee's previous employer, as well as allegations relating to Mr Staley's role in hiring the relevant employee. The letter was forwarded by the recipient to Barclays's Compliance department, where it was analysed by the Investigations & Whistleblowing ("I&W") team. Given the nature of the allegations raised, the I&W team decided to treat the letter as potentially falling within Barclays's whistleblowing policy, which was designed to protect any employee of the Barclays Group from detriment where that employee reported "inappropriate conduct". Inappropriate conduct was considered to be any behaviour or practice that ran counter to Barclays's values, or any wrongdoing or unethical behaviour.

The letter subsequently came to the attention of Mr Staley, who concluded that it did not fall within the scope of the bank's whistleblowing policy because the policy (at that time) only covered Barclays's employees and the letter purported to come from a group shareholder. In addition, he considered that the allegations related to behaviour which had not taken place at Barclays and that they were false and malicious and therefore would not benefit from whistleblowing protection in any case. Mr Staley forwarded a copy of the letter to a former colleague and discussed the contents of the letter with another former colleague, both of whom were not Barclays employees. His intention was to form a "support network" for the employee who was the subject of the allegations in case they became public knowledge.

Shortly afterwards, another anonymous letter making similar allegations about the same employee was received at Barclays's New York office. That letter raised substantially similar allegations to the first letter, but purported to come from a group of employees within the bank, although it did not name specific individuals. When it was brought to Mr Staley's attention, he recognised that it could be subject to the whistleblowing policy as it claimed to come from employees, but also concluded that it was likely that both letters were in fact sent by the same person. He failed to consider the possibility that if both letters were sent by the same person, they could *both* have been sent by somebody who was an employee and who would therefore be protected under the whistleblowing policy.

Mr Staley subsequently asked security staff to obtain the first letter and to try to identify its author, although the letter was never actually provided to the security team. The following day, Mr Staley was informed in a meeting that included Barclays's general counsel and group HR director that it was generally inadvisable to try to identify the author of an anonymous letter and that it was possible that the first letter should be treated as a whistleblow.

A little over a week later, Mr Staley was informed by telephone by the Compliance department that the investigation into the letters had not yet been concluded, but that the allegations contained in them appeared to be unsubstantiated. Nonetheless, Compliance also cautioned that in the circumstances, they did not consider that this was a case where the bank should take any further steps to try to identify the author. Mr Staley mistakenly understood this to mean that the first letter was no longer being treated as subject to whistleblowing protection and therefore that as CEO, he now had authority to deal with the matter as he saw fit. Without checking with Compliance, the I&W team or Barclays's board, Mr Staley informed the security team that they were authorised to resume attempts to identify the author of the first letter. Although the security team subsequently undertook an investigation, they were unable to discover the author's identity and several weeks later, informed Mr Staley that it was not possible to do so.

In early 2017, Barclays's board discovered Mr Staley's attempt to identify who had written the first letter and reported this to the FCA and PRA. The FCA concluded that Mr Staley's conduct had breached the requirement in the SMCR Code of Conduct ("COCON") to act with due care, skill and diligence, as well as specific whistleblowing provisions in the Senior Management, Systems and Controls sourcebook ("SYSC"). The PRA found that Mr Staley had breached Individual Conduct Rule 2 in the PRA Conduct Rules on the basis that he had not acted with due care, skill and diligence.

Both the FCA and PRA noted that Mr Staley had a conflict of interest in relation to the first letter, given that it made allegations about his own role in the hiring of the impugned senior executive. He therefore should have maintained an appropriate distance from the ongoing investigation and avoided taking any action which could be seen as interfering in the process or amounting to pressure on the author to withdraw the complaint. Mr Staley's behaviour indicated that he had allowed his objectivity to be overridden by his own interest in the matter and his instructions to the security team to identify the author of the first letter had risked compromising the independence of the investigation by Barclays's Compliance department. He should have recognised the need to take expert advice from the Compliance and I&W teams within Barclays before taking any action. As such, he had failed to uphold appropriate standards of governance, which was a crucial element of the role of the CEO of a bank, and had fallen short of the required standards of due skill, care and diligence.

4.2.2 Comment

In some ways, Mr Staley might be considered fortunate to have been subject only to a finding that he had failed to act with due care and skill. The final notices show that the regulators considered that he was negligent in seeking to identify the author of the first letter, rather than reckless or deliberate in his breach of the applicable standards. This is important because the FCA's guidance in SYSC indicates that it will treat any evidence that a person has acted to the deliberate detriment of a whistleblower extremely seriously and that might well justify a finding that the relevant person lacked integrity, which typically would point more strongly in favour of the use of a prohibition order. The FCA also emphasised that it considers that whistleblowing is a very valuable source of information for regulators and that Mr Staley's actions risked compromising that resource by suggesting that individuals might not be protected if they spoke out anonymously about alleged poor behaviour. It is therefore advisable for firms and individuals to proceed extremely cautiously in relation to whistleblowing scenarios; in all cases, the firm should adhere strictly to the procedures that are in place and should avoid the impression that any potentially interested parties could be interfering with the investigation or outcome of any complaint.

Mr Staley's case again indicates the focus of both the FCA and the PRA on the responsibility of senior individuals, such as chairs and CEOs, to ensure high standards of governance within a firm and not to act in a way which may undermine such standards or may be seen to encourage others within a firm to do so. Both regulators emphasised that the requirement to act with due skill, care and diligence is more exacting in the case of a CEO than for other, more junior employees and that when a CEO is faced with circumstances that could undermine the impartiality of his/her judgement, (s)he must take steps to maintain appropriate independence of decision-making. It is therefore extremely important for senior individuals to be able to recognise when their independence could be considered to be compromised and therefore when they should distance themselves from procedures or decisions in order to avoid the impression of a potential conflict of interest. This is not always an easy judgement to make and will vary depending on the circumstances; in the whistleblowing context, in particular, it is important not only that an independent and fair investigation is in fact carried out, but also that it is *seen* to be independent and fair so as to maintain the confidence of employees and regulators.

It is notable that, in a similar way to in the Paul Flowers case above, the FCA and PRA also referred to the high public profile of Mr Staley and Barclays within the financial services industry as exacerbating the risk of undermining confidence in whistleblowing regimes. This links to the FCA's increasing focus on how the culture of a firm may be influenced by how others perceive those at the top of the hierarchy. It also implies that individuals and firms that attract more publicity (whether for positive or negative reasons) may eventually be judged by a subtly different standard because the regulators are aware that the relevant situation may have a more significant impact on public confidence.

4.3 Charles Palmer: September 2017

4.3.1 Facts

Mr Palmer was fined £86,691 by the FCA and made subject to a prohibition order preventing him from performing any significant influence function in a regulated firm on the grounds that he had failed to act with due care, skill and diligence, in breach of Statement of Principle 6 of the FCA's Statements of Principle for Approved Persons. He had referred his case to the Upper Tribunal for a rehearing; the Tribunal essentially agreed with the FCA's reasoning and found against him in August 2017.

Mr Palmer was the majority shareholder and chief executive of a group of firms comprising Standard Financial Group Ltd, which operated an adviser network of appointed representatives ("ARs"). This meant that members of the network did not need to obtain authorisation from the FCA to provide their advisory services, but instead could rely on the authorisation of one of the principal firms forming part of the group, subject to those principal firms remaining responsible for the activities of the ARs from a regulatory perspective. Although Mr Palmer acted as the *de facto* chief executive of the firms, during the relevant period from February 2010 to December 2012, he was never approved by the then-FSA to perform that function.

When the network was at its largest in March 2011, it had almost 400 ARs and over 500 registered individual advisers. The group's business model involved it offering a "lighter touch" service as principal to the ARs, effectively advertising itself as exercising less control over the way the ARs operated their business than would be typical with a normal principal firm. This meant that unlike a traditional adviser network, the group would not limit the ARs to advising on specific products on approved lists or require them to use standardised documentation. The ARs paid a fixed monthly fee to the group to belong to the network, rather than paying a percentage-based commission on their advisory income, which was the typical model in the wider market. As a result, the group was commercially more attractive to the ARs than many competitor networks because it was cheaper and more flexible.

However, as the Tribunal noted, there were increased regulatory risks inherent in this model. The group's less prescriptive approach to the ARs meant that it exercised less control over their activities and therefore would have needed to undertake much greater monitoring to ensure that they complied with the applicable regulatory requirements. This led to a fundamental conflict between regulatory and commercial imperatives, since membership of the network was advertised as involving "light touch" oversight and therefore more intrusive monitoring would have been contrary to the commercial expectations of the ARs.

It is clear from the facts of the case that Mr Palmer was a dominant personality on the group's board and saw the group as his own personal business, although he denied to the FCA that this was the case. The Tribunal found that other members of the board, including the chairman, presented insufficient challenge to Mr Palmer and did not ask sufficient questions. As a result, it also concluded that he was responsible for setting the tone and culture of the firm, even though the board was collectively responsible for approving the group's strategy and business plan.

The FCA's argument (which was ultimately accepted by the Tribunal) was that Mr Palmer had failed to exercise due skill, care and diligence when managing the potential risks to underlying customers of the ARs that arose as a result of the group's business model. In 2010, he had been fined £49,000 after an earlier enforcement action by the FSA, which concluded that he had breached his responsibilities by failing to ensure a proper reporting structure within the group and failing to exercise adequate control over the advisory network. This followed on from concerns that had been expressed by the FSA in 2008 after a supervisory visit which criticised the group's systems and controls and recommended the formation of a risk committee. However, until October 2012, risk issues were in practice addressed by meetings of the group's executive management team, rather than a separate dedicated committee. Mr Palmer had also emphasised to the group's compliance officer that the compliance officer worked "for the IFAs [i.e. the financial advisers within the AR network], not the FSA" and that he should "get behind them". In addition, the Tribunal found that Mr Palmer had formed the view that an internal audit function within the group was unnecessary and therefore that although one existed on paper, it did not actually operate in practice to verify the group's compliance with regulatory requirements.

In 2012, the FSA undertook a supervisory visit to the group and identified a significant number of governance failures. In particular, it noted that there was a weak control environment and that the group took insufficient steps to ensure that ARs joining the network operated proper standards and were likely to deliver good customer outcomes. The FSA also noted that the group's approach was essentially to serve the ARs, rather than to focus on the services provided to the underlying customers receiving the advice. In turn, this had led to concerns about the quality of the advice provided by the ARs to customers in connection with complex transactions, such as pensions switching arrangements, or higher risk investments, such as unregulated investment funds.

The Tribunal concluded that Mr Palmer had failed to act with due skill, care and diligence by failing to understand the risks involved in the group's operating model and by only being reactive to problems that occurred. He was complacent as regards significant mis-selling risks in relation to the complex products upon which ARs were advising and had failed to ensure that the group itself operated a proper internal risk function and had clearly delineated compliance responsibilities. However, the Tribunal also found that there was nothing inherently wrong in treating the ARs as the group's customers; that merely reflected the legal and commercial status of the relevant arrangements. The problem was failing to recognise that the group *also* owed responsibilities to the underlying customers of the ARs and failing to implement a governance structure to oversee the proper discharge of those responsibilities.

As regards the imposition of a prohibition order, the Tribunal started from the position that in cases of a lack of competence, it would generally be inappropriate to impose a prohibition order unless the lack of competence was such that Mr Palmer was likely to represent a risk to the public in the future. However, in the present case, he had shown a lack of competence over an extended period, including following feedback from the FSA on the group's failings and after previous disciplinary action against him personally. He had therefore failed to learn sufficient lessons from his past mistakes and even before the Tribunal itself, he had been unable to recognise the seriousness of his misconduct. As a result, the Tribunal considered that a prohibition order was fully justified.

4.3.2 Comment

Interestingly, the Tribunal stated that it placed "little weight on the issue of culture" in relation to its decision and that it was "reluctant to say that matters of tone and culture in themselves can amount to demonstrating a lack of due skill, care and diligence", which is somewhat at odds with the FCA's increasing focus on culture as a key factor in enforcement actions. The Tribunal's logic was that while the culture of a firm clearly can influence the way in which individuals within the organisation behave, it was more important to focus on the outcome of an individual's behaviour rather than factors that may have influenced why that behaviour occurred. It may be that this approach is specific to the issue of a lack of competence and would not, for example, be the Tribunal's approach in relation to questions about integrity, which may have a more direct nexus with the firm's culture and values. Nonetheless, it raises an interesting question about the extent to which the regulators' focus on firms' cultures should be relevant to enforcement in certain cases.

Mr Palmer's case also provides an illustration of the risks of firms losing sight of their regulatory responsibilities while pursuing their broader commercial objectives. Fundamentally, he viewed Standard Financial Group's relationships with its ARs as the key priority, given that those relationships generated the group's revenue, but failed to appreciate that the group still had a regulatory responsibility in relation to the advice provided to underlying clients. By conceptualising the relationship as one designed to facilitate the easiest possible outcome for the ARs, Mr Palmer essentially endorsed a model which encouraged reduced levels of supervision in a context where regulatory rules call for enhanced levels of oversight.

The case also illustrates the risks of individuals becoming dominant on the board or other governing body of a regulated firm, such that there is a lack of proper challenge from other individuals. Not only does this increase the risk of the firm having a dysfunctional governance structure, but it also leads to the possibility that the dominant individual may well be considered to have assumed personal responsibility for the relevant aspects of the firm's operation. This issue was compounded in Mr Palmer's case by his failure to obtain FSA approval to hold the position of chief executive, even though he was in substance performing that role. Individuals should therefore be careful that their roles do not expand to include activities which would require them to be approved to carry out another controlled function (or senior management function, as the case may be) where they have not obtained the necessary prior approval.

5. Lack of integrity

For as long as the financial services industry has been in existence, there have been individuals within it who have behaved unscrupulously and, somewhat depressingly, there remains no shortage of recent examples.

Apart from the market misconduct cases discussed above, the remaining examples of cases involving a lack of fitness and propriety during the period under review demonstrate a fairly flagrant disregard for ordinary standards of honesty and integrity. To a large extent, these cases are unsurprising and reinforce the self-evident conclusion that engaging in dishonest and/or unlawful activities will almost inevitably lead to the individuals concerned being banned from the financial services industry and, where appropriate, being subjected to significant penalties.

In January 2018, Alex Hope was subjected to a prohibition order, following his conviction in April 2014 of one count of unlawfully operating a collective investment scheme (or purporting to do so) and a further conviction in January 2015 of one count of dishonestly making a false representation for his own gain, for which he was sentenced to a total of seven years' imprisonment. These offences arose out of Mr Hope's operation of a "Ponzi scheme" type arrangement whereby he promised investors huge returns in connection with foreign exchange trading. In fact, Mr Hope used investors' money to finance a lavish personal lifestyle and to the limited extent that he did enter into trades, they were loss-making. To conceal the truth, he produced two sets of false accounts for investors and when the FCA began an investigation, he attempted to persuade investors not to cooperate with the regulator. In September 2016, Mr Hope was sentenced to a further 603 days in prison following his failure to comply with a confiscation order for approximately £166,000 made under the Proceeds of Crime Act. The long custodial sentence imposed, the FCA's continued attempt to recover investor funds and Mr Hope's lifelong ban from the financial services industry should serve as a strong illustration that defrauding investors will be severely punished.

During the review period, there were also two cases of individuals fabricating investment adviser qualifications with the intention of misleading accredited bodies or the FCA into believing that they were qualified to provide retail advice. Alexander Stuart was fined £34,000 and made subject to a prohibition order in March 2018 following his dismissal from St James's Place Wealth Management Plc, while Darren Cummings was fined £29,300 and made subject to a prohibition order in June 2018 after knowingly providing falsified statements of qualifications to the FCA as part of an application to obtain retail investment advice permissions for DCC Financial Ltd, a firm at which he was a director. In both cases, the FCA concluded that the conduct was deliberate, dishonest and had the potential to cause serious harm to customers. As a result, both men were found to have committed a Level 5 breach on the FCA's five level scale of misconduct (i.e. the most serious type of breach) and were considered to pose a risk to consumers and to the integrity of the wider financial system, such that they should banned from the financial services industry. While it should go without saying that deliberately falsifying documents will always constitute compelling evidence of a lack of integrity (as well as potentially amounting to a criminal offence in certain situations), clearly there will always be some individuals who cannot resist the temptation to deceive the regulator. In such circumstances, they should expect the maximum possible punishment and an abrupt end to their careers in financial services.

An arguably even more cynical attempt to mislead the FCA and consumers was undertaken by John and Colette Chiesa, former owners of a financial advisory firm, who were subject to enforcement action in October 2017.

5.1 John and Colette Chiesa: October 2017

5.1.1 Facts

John and Colette Chiesa were both made subject to prohibition orders and withdrawal of approval for their performance of FCA controlled functions, following the deliberate concealment of their assets from a trustee in sequestration (the Scottish equivalent of a trustee in bankruptcy/insolvency). In addition, Mrs Chiesa was fined £50,000.

Mr and Mrs Chiesa were founding partners in a firm, Westwood Independent Financial Planners, which provided personal investment advice. In October 2011, after the firm's failure to pay commission due to an affiliated financial adviser, Westwood became insolvent and was placed into sequestration. Since the firm was structured as an unlimited liability partnership under Scottish law, Mr and Mrs Chiesa were personally liable for all of its debts and were placed into sequestration at the same time.

Westwood had previously provided investment advice to a number of clients in relation to geared traded endowment policies ("GTEPs"), which were risky investments, the performance of which depended in part upon the longevity of the original policyholder. These GTEP sales resulted in a significant number of claims against Westwood, the liability for which was ultimately a personal liability of the Chiesas. As a result, from 2008 onwards, once the prevailing regulatory environment made it clear to them that they could be personally liable for the firm's mis-selling of GTEPs, Mr and Mrs Chiesa began to implement arrangements to protect their money and assets from creditors through the use of offshore trusts, loans that were never intended to be repaid and reorganisation of their finances so that an offshore company paid many of their expenses.

When the trustee in sequestration met with the Chiesas in December 2011, he explained to them that they were under a legal duty to provide a full disclosure of their financial circumstances. However, they provided misleading information about their financial position which was inconsistent with information they had provided to a bank only months before, and subsequently signed written statements to that effect. As a result, they maintained that they could afford to pay only £200 per month each to their creditors. Between 2011 and 2014, Mr and Mrs Chiesa nonetheless received over £1.39 million through their offshore arrangements, including significant expense payments in relation to clothes, jewellery, cosmetic dentistry, luxury car payments, travel and foreign currency, catering and party hosting services, and helicopter lessons. In addition, the Chiesas had failed to disclose to the trustee that they had other significant assets, including a number of life assurance policies with an estimated surrender value of over £270,000 and jewellery worth over £100,000.

By September 2016, the Financial Services Compensation Scheme, which had inherited all the claims filed against Westwood when it entered sequestration, had paid out over £3.85 million in compensation to affected customers (although the FCA concluded that customers would have been entitled to over £5 million if they had not been subject to the £50,000 compensation limit because they were claiming directly from Westwood or the Chiesas, rather than the scheme).

Mrs Chiesa was subsequently interviewed by the FCA in February 2015 and made a number of misleading statements about her personal assets and about her knowledge and understanding of the relevant business and financial arrangements, including the offshore structures.

In October 2016, after having received decision notices from the FCA, the Chiesas referred the notices to the Tribunal. In March 2017, they applied to the Tribunal for disclosure of the internal decision-making processes of the FCA's Enforcement division, alleging that the FCA had brought the enforcement actions in bad faith. The Tribunal concluded that the Chiesas had offered no credible evidence that the FCA had acted with an improper motive and that a mere allegation of bad faith alone would not justify ordering disclosure, following which Mr and Mrs Chiesa withdrew their original substantive Tribunal references.

5.1.2 Comment

Clearly, the behaviour of Mr and Mrs Chiesa was dishonest and represented a deliberate and highly sophisticated attempt to circumvent the application of insolvency law for their own personal gain. In such circumstances, the imposition of prohibition orders was surely inevitable.

Potentially of more interest is the interim application made by the Chiesas to the Tribunal to seek specific disclosure of the FCA's internal decision-making processes. It is clear from its published decision that the Tribunal considered the application to be manifestly ill-founded. It noted that the subject matter of the main Tribunal reference was the alleged misconduct of Mr and Mrs Chiesa and that any allegations of potential misconduct by the FCA in its decision making were not relevant to the central question of whether the Chiesas lacked integrity. Even if the allegations made against the FCA were correct, they would not affect the separate issue of Mr and Mrs Chiesa's conduct which would still need to be analysed, albeit that they might be grounds for a complaint to the Complaints Commissioner.

Although the Chiesas maintained the Tribunal had a broad duty to investigate any alleged abuse of process by the FCA if this passed a certain evidential threshold, the Tribunal concluded that the evidence before it did not in any case cross that threshold (which it considered to be the balance of probabilities) or provide any grounds for inferring bad faith on the part of the FCA. Nor was it correct to assert that the case could only be dealt with fairly and justly by the Tribunal if it investigated the allegations of bad faith, since that would be equivalent to saying that a mere allegation of bad faith would require the FCA to disclose its decision-making processes, which could not be correct. In the circumstances, the Chiesas had failed to prove on the balance of probabilities that there was any bad faith and so disclosure would not be ordered.

6. Failure to exercise due skill, care and diligence

With the expansion of the SMCR to all FCA firms in December 2019 and the resulting increased focus on accountability of senior individuals, the issue of whether senior managers have exercised due skill, care and diligence in the performance of their functions may gain renewed prominence. Clearly, however, the relevant steps that an individual can reasonably be expected to take in order to satisfy that standard will depend upon the particular factual context in each case.

A fairly egregious example of failure by a compliance officer to satisfy the relevant standards of competence is illustrated by the case of David Watters, whose involvement in designing and monitoring policies and procedures for advising on pension transfers fell far below the level of skill, care and diligence expected by the FCA.

6.1 David Watters: July 2017

6.1.1 Facts

Mr Watters was fined £75,000 by the FCA in July 2017 for breaching Statement of Principle 6 of the FCA's Statements of Principle for Approved Persons by failing to act with due skill, care and diligence in connection with certain pension transfers effected by an advisory firm, Lanyon Astor Buller Ltd ("LAB").

Mr Watters acted as LAB's compliance officer when, between February 2006 and April 2009, the firm provided advice to over 700 members of defined benefit pension schemes about transferring out of those schemes into defined contribution schemes as part of an "enhanced transfer value" ("ETV") exercise. This involved the sponsoring employer of the pension scheme offering the relevant scheme members a cash payment in order to agree to the transfer. LAB was paid an engagement fee by the relevant employer for providing advice to the scheme members, as well as an initial and ongoing annual commission from the pension provider to which members were transferred.

The FCA subsequently conducted a review of a sample of customer files relating to ETV advice provided by LAB. It found that in each of the files that it had reviewed, LAB had failed to record key factual information that was relevant to the customer's circumstances and had failed to provide suitable advice because it had not shown a good justification for recommending that they undertake the transfer, even though they would lose certain benefits or guarantees. In many cases, LAB had also sent customers a letter asking them to sign and return legally binding documentation to facilitate the pension transfer before the customer had been given any advice or analysis or had received a suitability report. The advice letters that were provided to customers did not contain clear recommendations, but merely listed options or relevant considerations and were insufficiently tailored to each customer's individual circumstances. LAB also failed to disclose before customers made a transfer application the full level of charges associated with the new pension product that was recommended or the commission that LAB would receive in connection with the transfer. None of the files contained any evidence that LAB had considered any other potential pension providers or an explanation as to why no other pension products had been analysed.

As LAB's compliance officer, Mr Watters had personal responsibility for ensuring that the firm operated an ETV advice process that complied with all relevant rules. He permitted the two pension advisers employed by LAB to design the advice process themselves without any independent oversight from a person who had suitable qualifications. While Mr Watters reviewed the finalised process, he did not have sufficient expertise in pension transfers to ascertain whether the process was in fact compliant with the then-FSA's rules. In fact, the remuneration arrangements of one of LAB's pension advisers were such that the relevant individual had a direct financial interest in advising scheme members to transfer, but Mr Watters failed to identify that this created a serious conflict of interest. He claimed to have undertaken limited biannual reviews of customer files, but the FCA was unable to find any record of this during its investigation. Although Mr Watters did hire external consultants in 2006 and 2007 to obtain advice on the ETV process, he was unable to evidence the instructions given to the relevant consultants or that they had the appropriate expertise to be conducting a review.

As a result of Mr Watter's failure to exercise proper oversight over the ETV process and failure to ensure that he was adequately informed about the risks of advising on pension transfers, he had failed to exercise the level of due skill, care and diligence required of a compliance officer. The FCA noted that it was inappropriate for him to have left the design of the ETV process to the pension advisers who would be giving the relevant advice, especially given that one of them had an obvious conflict of interest. The process itself suffered from many obvious flaws which breached applicable regulatory requirements and which would have easily been discovered if Mr Watters had carried out a proper review of customer files during the relevant period.

6.1.2 Comment

Many of the failings involved in the ETV process and the subsequent advice issued by LAB to its customers would have been manifestly obvious if Mr Watters had turned his mind to those issues. For example, when questioned by the FCA, he conceded that if a customer had signed a transfer form prior to receiving an advice letter, that would obviously show that the advice process was not being applied correctly. Since the customer files evidenced that that was precisely what had happened in a significant number of cases, a basic review of a sample of customer files would have revealed the problem. Firms should not underestimate the importance of quality assurance reviews when they are providing services to external clients in order to allow any regulatory failings to be identified and addressed in a timely manner. It is particularly important that firms themselves identify rule breaches and then take immediate steps to rectify them; the FCA generally takes a dim view of firms that require the FCA to identify their own failings.

Similarly, it should have been obvious to Mr Watters that allowing a financial adviser to design the ETV process when that adviser had a pecuniary interest in advising customers to transfer their pensions to a new provider involved a significant conflict of interest and was inappropriate. Firms need to ensure that compliance oversight structures have the necessary degree of independence and that where conflicts of interest may arise, additional safeguards are put in place to ensure that the risk of harm to customers is minimised.

Finally, it is clear that the compliance function must have the necessary expertise to be able to understand the business that it is overseeing and the regulatory rules that apply in relation to that business. Where necessary, this may involve taking external advice or engaging consultants, but a lack of necessary expertise will not be a defence and where this leads to regulatory failures, it may act as evidence of a person's failure to exercise the required level of skill and diligence.

7. Communications with customers

The FCA has long been concerned with the clarity of firms' communications with customers and the importance of ensuring that any information provided is fair, clear and not misleading. The Vanquis Bank case in February 2018 illustrates how expensive mistakes in this area can be, with the FCA requiring the bank to operate a restitutionary scheme to compensate customers who were inadvertently misled by the bank's sales staff. The failure of those sales staff to explain the full cost of a payment protection product led to customers incurring additional costs and, in some cases, had a serious effect on customers' ability to repay their credit balances over time. Firms would be well advised to review sales communications on a regular basis and to consider whether they may inadvertently have omitted relevant information which the customer requires to make an informed choice.

The enforcement action against Bluefin Insurance Services Ltd highlights the potential issues that may arise where firms hold themselves out as offering independent services, but are affiliated with other product providers. The case also demonstrates the need for firms to implement concrete and practical policies and procedures to address conflicts of interest, particularly when these may be inherent in the firm's business model.

More generally, firms should note that inaccurate client communications may not only cause regulatory issues, but could in some circumstances lead to claims under the general law (e.g. in misrepresentation), either concurrently with, or instead of, claims for a breach of applicable regulatory rules. As such, ensuring that customers are provided with all necessary information in an accurate manner should be a key priority.

7.1 Vanquis Bank Ltd: February 2018

7.1.1 Facts

Vanquis Bank Ltd was subject to a £1,976,000 penalty in February 2018, as well as a mandatory requirement to refund customers an estimated £11,876,000 under an FCA-imposed restitutionary scheme, due to its failure to treat customers fairly and failure to communicate with them in a way that was fair, clear and not misleading. In addition, Vanquis voluntarily agreed to pay a further estimated amount of £156,905,000 by extending the restitutionary scheme to other customers who may have been affected before Vanquis became subject to FCA regulation. All in all, it will therefore have cost the firm approximately £170 million.

Vanquis was a specialist credit card lender that serviced 1.7 million customers, ranging from prime to sub-prime borrowers. In most cases, customers chose a Vanquis credit card because they had found it difficult to obtain credit from other providers and Vanquis's products allowed customers to access credit and build up their credit ratings. Vanquis's credit card business became subject to FCA regulation on 1 April 2014 when responsibility for consumer credit was transferred to the FCA; before that date, it was regulated by the Office of Fair Trading.

Vanquis's customers were required to activate their credit cards by telephone. During that telephone call, they would be offered the opportunity to "opt in" to a Repayment Option Plan ("ROP"), which was a product that was designed to assist customers in managing their use of credit. Broadly, the ROP provided customers with a number of benefits, such as:

- the ability to "freeze" their account for up to two years (so that they did not pay any interest on the relevant amount outstanding) where certain events occurred, e.g. unemployment, long-term illness, maternity or paternity leave, etc.;
- "payment holidays" where the customer could choose not to make a monthly payment that would otherwise be due for a month of their choice every 12 months;
- a "lifeline" which would apply automatically if the customer missed a payment for any reason which meant that the customer would not be charged a fee for the late payment; and
- SMS reminders when payments were becoming due and when the customer was near to their credit limit or had exceeded the limit.

In each case, these benefits were subject to a number of detailed conditions, but reliance on any of the benefits would not result in adverse entries on the customer's credit file.

The ROP had a monthly cost of 1.29% of the customer's outstanding credit balance for the full plan (which was offered to those who were in employment), or 1.19% for the standard plan (which was offered to those such as retired individuals, students or the unemployed). As a result, the cost of the ROP varied depending on the size of the customer's credit card balance; where the customer had repaid the balance in full, there was no charge for the ROP. A high proportion of Vanquis's customers purchased the ROP, for example, in March 2014, over 49% of customers had purchased the product.

During the sales call for the ROP, the sales adviser relied on a script. Part of that script required the sales person to inform the customer that "the plan costs just £1.29 [or £1.19, as applicable] for every £100 of your outstanding balance each month". However, this statement did not fully explain that the cost of the ROP was added to the credit balance for the customer's credit card each month and in all of the recordings of sales calls subsequently sampled by the FCA, this was not made clear. The FCA concluded that this was misleading because while the principal cost of the ROP was 1.29% (or 1.19%, where applicable) of the outstanding balance, there was an additional cost due to the interest charged on that principal cost. This varied between 19.9% and 79.9%, depending on the interest rate of the credit card that had been issued. In practice, this meant that the true cost to the customer was higher and in some cases, customers making the minimum payment on their credit card found that this was not in fact reducing their outstanding balance as a result.

When Vanquis became FCA-authorised for its consumer credit activities in 2014 (following the closure of the Office of Fair Trading), the FCA expressed concerns about whether customers understood the full cost and benefits of the ROP. In April 2016, following further engagement with the FCA, Vanquis agreed to the voluntary imposition of a requirement that it should immediately cease offering the ROP to all customers who had not already purchased it.

The FCA concluded that Vanquis had breached Principle 6 of the FCA's Principles for Businesses by failing to treat customers fairly due to the deficiencies in the sales calls discussing the ROP which meant that customers were not informed that interest would be charged on the ROP cost. In addition, the FCA found that Vanquis had also breached Principle 7 by failing to communicate with customers in a fair, clear and not misleading manner due to the lack of clear information on the interest charges. Although the FCA only had jurisdiction to require Vanquis to pay restitution to affected customers from 1 April 2014, Vanquis voluntarily agreed to apply the restitutionary scheme to sales of the ROP that had occurred since June 2003.

7.1.2 Comment

The Vanquis case is a good illustration of how easy it is for customer communications to become misleading if critical information is omitted. In their desire to provide simple and comprehensible information to clients, firms must ensure that they do not fail to disclose important information that the client would require in order to make an informed choice about the product being offered or service being provided. In the present case, although the information omitted may seem relatively minor, it had a significant effect for certain clients, including those who were failing to pay off their credit card balances because the minimum payment each month was insufficient to cover the additional cost of the ROP.

7.2 Bluefin Insurance Services Ltd: December 2017

7.2.1 Facts

Bluefin Insurance Services Ltd was fined £4,023,800 in December 2017 for breaching Principle 7 of the FCA's Principles for Businesses by failing to communicate in a clear, fair and not misleading way with customers when it held itself out as being a "truly independent" insurance broker. In addition, Bluefin was found to have breached Principle 3 by failing to operate adequate systems and controls to ensure that brokers made recommendations on the basis of customers' needs, rather than to achieve Bluefin's business strategies.

During the relevant period spanning March 2011 to December 2014, Bluefin operated over 40 offices across the UK and was a wholly-owned subsidiary of the insurance company AXA (although it has subsequently been sold and is no longer owned by an insurer). Bluefin marketed itself to its clients as being a "truly independent" insurance broker which would conduct a search of the market to find the best insurance policy to meet the client's needs. However, because Bluefin was owned by AXA, which itself offered insurance products in the market, the firm's business model suffered from an inherent conflict of interest which needed to be carefully managed, i.e. the risk that brokers would feel compelled to recommend AXA products to customers, even though a policy from a different insurer might have better suited the customer's needs. This was exacerbated by Bluefin setting an annual target for the amount of policy cover that it aimed to have underwritten by AXA each year, effectively incentivising brokers to recommend AXA products in order to ensure that the relevant business targets were met.

In particular, Bluefin had arranged a "preferred facility" with AXA in relation to certain combined cover for small and medium-sized enterprises ("SMEs"). Brokers were informed that they should recommend this preferred facility to SME customers wherever possible and that compliance with that requirement would be closely monitored. While there was also another preferred facility which was not provided by AXA, in practice, brokers generally identified AXA as the target insurer wherever possible.

Although Bluefin had a conflicts of interest policy which acknowledged the resulting conflicts, the policy did not provide sufficient practical advice to brokers on how they should manage that conflict on a day-to-day basis and the records that they would need to maintain to evidence compliance with the relevant requirements. Brokers were also provided with conflicts training, but this was general in nature and involved an e-learning exercise, rather than providing specific guidance on the steps that brokers should be taking to minimise the risks arising from the inherent conflict from Bluefin's connection to AXA.

The customer files and transaction documentation maintained by brokers did not contain any analysis of conflicts issues in relation to each transaction and frequently did not include a clear commercial justification for the broker's recommendation. Branch managers were supposed to be proactive in monitoring sales and ensuring that these met the necessary requirements, but used insufficiently targeted checks. Bluefin's Compliance department conducted a review of customer files during the relevant period and expressed a number of concerns. In particular, it noted examples of brokers who appeared to feel under pressure to recommend products carrying higher commissions from insurers or otherwise meeting Bluefin's business objectives. Despite these risks having been identified, senior management failed to act on them.

More broadly, the FCA also referred again to the issue of the culture within Bluefin and the fact that its internal communications frequently had the effect of dissuading brokers from taking the steps necessary to provide independent advice. This was because those communications actively discouraged brokers from performing a review of the whole market and instead encouraged them to use the preferred facilities Bluefin had in place. In addition, brokers were also discouraged from using the quotes available from the preferred facility insurers as leverage to obtain better quotes for third party insurers, even though this would have resulted in Bluefin's customers obtaining a better price for the relevant coverage. Bluefin offices that placed significant volumes of business with AXA were also actively praised, encouraging other brokers to work towards that goal.

7.2.2 Comment

It is clear that Bluefin's ownership by AXA represented an inherent conflict of interest given that there would always be a strong commercial incentive for Bluefin's brokers to favour AXA's insurance quotes. This was exacerbated by the use of formal targets to encourage placing business with AXA, as well as the broader culture of praising brokers who did so. Bluefin should have identified that its affiliation with AXA required more robust systems and controls to ensure that brokers were always acting in the best interests of the customer, rather than prioritising the group's commercial objectives. In practice, it is clear that the controls that were used did not provide practical guidance to brokers and were in any case undermined by the business targets promoted by Bluefin. Firms need to ensure that conflicts guidance and training gives clear, practical and relevant examples of when conflicts are likely to arise within the business and the specific steps that staff should take to address those conflicts.

It is clear that the FCA is increasingly looking at the culture and "atmosphere" that is encouraged by senior management within firms. Firms must ensure that even if they have robust policies and procedures that address all relevant regulatory requirements, the messages conveyed by senior management do not encourage potential non-compliance or otherwise undermine the purpose of those policies and procedures. In the Bluefin case, the firm's compliance department had in fact correctly identified that many brokers were indicating that they felt under pressure to recommend AXA policies even though there may have been other alternatives that were more suitable for the customer. However, senior management failed to appreciate the significance of that information and did not recognise that this meant that the limited conflicts of interest safeguards that were in place were not having the desired effect. Once senior executives came into possession of information that indicated that brokers were prioritising commercial objectives over customers' best interests, they should have taken steps to reiterate the importance of compliance with regulatory requirements and the need to put the customer first.

As in other cases, a more thorough review of samples of customer files would also have revealed that certain brokers might not have been prioritising the needs of their customers. The absence of clear justifications on the customer files for recommending a particular policy to customers might have been evidence that the relevant broker did not have a strong justification for recommending the AXA policy; in any case, the absence of any clear analysis of conflicts issues was at least potential evidence that conflicts of interest were not at the forefront of brokers' minds when they were providing the relevant advice. If branch managers had carried out more robust sampling, they would have been able to intervene more directly and at an earlier stage. In turn, early intervention by the firm itself is crucial to demonstrating to the FCA that the business has adequate systems and controls to identify and remedy failures.

8. Systems and controls failures

Firms' failure to operate adequate systems and controls to ensure compliance with their regulatory obligations is a perennial feature of FCA enforcement. In part, this is due to the very wide ambit of the FCA's systems and controls principle (Principle 3 of its Principles for Businesses) which makes it a natural and relatively dependable basis upon which to found enforcement proceedings. In many cases, it is also true that regulatory breaches can be traced back to improperly designed policies or systems or the inconsistent or incorrect application of formal procedures within a firm. The converse is also true; that is, firms that have carefully designed policies and procedures with adequate oversight, regular compliance testing and appropriately calibrated management information are less likely to commit serious regulatory infractions and more likely to be able to reassure the FCA that any failures that do occur are unfortunate isolated occurrences.

The key cases during the period under review evidence some very familiar failings. Merrill Lynch International became the latest large financial institution to be punished for regulatory reporting failures, this time in connection with reporting certain elements of transactions in exchange-traded derivatives under EMIR. In the same way as fines for transaction reporting failures in previous years, the case illustrates the perils of rushed implementation and inadequate quality assurance in connection with automated reporting systems or other significant IT projects. It also demonstrates how seemingly minor technical issues can cause reporting errors to proliferate rapidly within organisations which undertake a high volume of transactional activity, leading to significant penalties.

It seems that no enforcement round-up would be complete without an example of a firm being fined for AML systems and controls failings. This year, that role fell to the UK branches of Canara Bank, a state-owned bank based in India, whose UK senior management and front office staff evidenced a serious lack of understanding about how to apply customer due diligence requirements. In light of the constant regulatory focus on these issues, all firms that are subject to AML requirements would be well advised to read the final notice in detail and consider whether they might have any similar deficiencies within their own organisations.

Finally, the FCA imposed a penalty on Interactive Brokers (UK) Ltd in connection with its delegation of market abuse monitoring requirements to its US affiliate, which resulted in the operation of a global automated system that was inadequate to satisfy UK regulatory standards. The case is a useful example of the potential pitfalls in trying to operate a global set of rules across an international business, as well as being a timely reminder of the standard expected by the FCA in this area, given the regulator's recent focus on the implementation of the EU Market Abuse Regulation.

8.1 Merrill Lynch International: October 2017

8.1.1 Facts

In October 2017, Merrill Lynch International ("MLI") became the first firm to be fined by the FCA for transaction reporting failures under the European Market Infrastructure Regulation ("EMIR") after it was fined £34,524,000 for failing to report 68.5 million exchange-traded derivatives ("ETD") transactions between February 2014 and February 2016. The FCA found that in addition to breaching the specific requirements under EMIR, MLI had also failed to comply with Principle 3 due to its operation of inadequate systems and controls throughout the relevant period.

Due to uncertainty about when regulators would implement the EMIR reporting requirement, MLI delayed fully resourcing its reporting implementation project until November 2013, when it was confirmed that the reporting obligation would apply from 12 February 2014. An internal request for additional resources was made in January 2014, but was not approved by MLI until March 2014, with the result that when the reporting obligation began to apply, the ETD reporting team had less than 50% of the original projected resource. Once reporting began, MLI did not operate any independent testing of the automated system that it had implemented; the only individuals who tested the system were those who were responsible for its day-to-day operation, a fact of which MLI was aware.

MLI's automated reporting system contained an error which meant that certain transactions in exchange-traded derivatives that were undertaken through external non-EU brokers did not result in the generation of the necessary report for the market side leg of the trade. It was only in October 2015 that MLI began carrying out manual tests on the reporting system. In November 2015, the FCA asked MLI about certain reports that it had been submitting to its EMIR trade repository, which subsequently prompted MLI to carry out further investigations. These additional tests identified that there was an error within the system, prompting MLI to disclose its reporting failures to the FCA in February 2016.

8.1.2 Comment

The MLI case is a cautionary tale about the need for firms to ensure that there has been adequate planning of business critical projects prior to their implementation and that adequate resources have been allocated to all relevant projects. Clearly, this can become difficult where there is extended uncertainty about the application date of certain regulatory rules or the nature of the final substantive regulatory requirements. However, individuals who are responsible for the relevant business area need to ensure that expectations in relation to the necessary level of resources and the lead time required for implementation are clearly communicated to the firm's senior management. Where application dates for new requirements are uncertain, for example, where legislation is still being negotiated but could enter into force relatively quickly after it is eventually agreed, firms will need to carry out a cost-benefit analysis of beginning their implementation projects quickly, rather than waiting for further legal certainty. In so doing, they should take into account a range of factors, including any relevant regulatory guidance, the feasibility of the firm accelerating its implementation processes if the legislative timetable accelerates and the risks involved with waiting for additional clarity. Generally speaking, where implementation may involve designing and constructing complex systems with a long lead time (e.g. automated reporting systems), it is more likely that the firm will need to begin its preparations much earlier, particularly if it is possible to use an approach that allows for further customisation at a later date once the final requirements are settled (which will not always be the case).

MLI only discovered the error in its reporting systems as a result of questions from the FCA about its reports. Generally speaking, the FCA will judge a firm more harshly when it is the regulator, rather than the firm itself, that has had to identify that the firm has breached regulatory requirements, particularly where the breach has occurred over an extended period. If MLI had operated some form of independent testing of its ETD reporting system, it would have increased the chances of the bank being able to identify the relevant failings at a much earlier stage, thereby reducing the extent of the erroneous reporting and the resulting regulatory penalty. Firms should not underestimate the value of quality assurance by a separate internal function (e.g. internal audit or compliance teams), particularly in relation to projects which may have significant regulatory consequences if they are implemented incorrectly.

8.2 Canara Bank: June 2018

8.2.1 Facts

Canara Bank was fined £869,100 and made subject to a 147-day restriction on opening deposit accounts for new customers following its failure to operate adequate anti-money laundering ("AML") systems and controls between November 2012 and January 2016.

Canara was part of a state-owned bank based in India and operated two branches in the UK in London and in Leicester. In April 2013, following two previous visits to the bank, the FCA expressed concern about Canara's processes for assessing and documenting AML and sanctions risks in connection with its trade finance business. The regulator asked the bank to undertake a remediation exercise in relation to the affected clients so as to ensure that there were proper risk assessments on all client files and that robust sanctions screening was carried out. In addition, the FCA asked Canara to clarify which individual members of staff were approving the relevant transactions. A month later, the bank responded to the FCA confirming that it had taken all necessary action to remedy the deficiencies.

Two years later, the FCA returned to Canara for a follow-up visit and noted that the bank continued to have serious weaknesses in its AML systems and controls. In particular:

- there was no evidence that AML risks were being properly managed at any level within the organisation;
- senior management were unable to explain applicable AML requirements;
- the bank placed undue reliance on an external auditor to identify any issues on a monthly basis, when that auditor used a checklist that did not specifically address AML issues;
- AML procedures in relation to higher-risk customers were inadequate, with a failure to apply enhanced due diligence or to use enhanced ongoing monitoring for the relevant relationships;
- the general approach to customer files was inadequate, with a lack of documented customer risk assessments, inconsistent and inadequate screening and ongoing monitoring, and inadequate assessment of whether customers' activities were unusual in the context of the expected business relationship;
- even where the bank's staff identified potential adverse media coverage or other risks that suggested that customers might present a higher degree of AML risk, these did not appear to be considered during the customer on-boarding process or thereafter;
- Canara's staff had not received any AML training since 2012 (i.e. three years previously); and
- while the bank had confirmed to the FCA that the necessary remediation exercise requested by the FCA in 2013 had been completed, in reality it was clear that this was not the case.

Given the continued failings, the FCA required Canara to appoint a skilled person to carry out an internal review. The resulting report concluded that the bank's internal three lines of defence structure was ineffective, its AML manual was deficient in relation to the monitoring of ongoing customer relationships and there was a widespread lack of understanding of the applicable AML rules. Amongst other specific failings, the skilled person found that:

- "walk-in" customers who used Canara's money remittance services were not monitored from an AML perspective, meaning that the bank was unable to identify repeat or linked transactions by the same individuals which could have amounted to an ongoing business relationship for the purposes of the AML rules;
- the bank had an inconsistent approach to dealing with potential politically exposed persons ("PEPs") and where a PEP was identified, the customer files did not contain sufficient information about the bank's conclusion as to the associated level of risk; and
- there was inconsistent recording of key details about customers, including a lack of information about the intended nature of the customer relationship, the identification of beneficial owners, evidence of the customer's source of wealth and/or the rationale for the use of opaque ownership structures.

The FCA later concluded that, due to the structure of Canara's systems, remittance transactions through the London branch were recorded separately from remittance transactions undertaken through the Leicester branch, with no ability to identify potentially linked transactions. There was some evidence of ongoing reviews of customer files, but this focused on the credit risk posed by individual customers and there was no evidence that the reviewers were assessing whether there had been any change in circumstances for AML purposes.

As a result of these failings, the FCA found that Canara had failed to take appropriate remedial action following the FSA's original visit in 2012 and operated a culture where AML was not seen as a priority. There was insufficient managerial oversight, inadequate staff training and a failure to operate proper systems and controls to take adequate steps to prevent money laundering.

8.2.2 Comment

AML failings are certainly not a novel occurrence; at least one firm has been subject to enforcement action for breach of applicable AML requirements in each year since the FCA was established in 2013.

The persistence of AML-related enforcement actions is testament to two factors: first, it is clear that AML rules, sanctions compliance and the issue of financial crime more broadly are a key regulatory priority for the FCA, such that it is willing to devote considerable amounts of supervisory resources to detecting and pursuing breaches in this area. Indeed, the constant stream of penalties being imposed may in part be a deliberate strategy to keep firms focused on this important issue. Secondly, it is also clear that many firms struggle with AML compliance, often because their staff do not have sufficient understanding of the applicable requirements or because they have not translated the regulatory rules into sufficiently clear and practical procedures within the organisation. In certain cases, some firms have inappropriately prioritised commercial considerations over AML compliance. The rules in this area continue to evolve, with the Fourth Money Laundering Directive having entered into force in June 2017 and the Fifth Money Laundering Directive now scheduled to take effect from 10 January 2020. In most cases, these new rules are evolutionary rather than revolutionary, such that firms which have implemented a solid foundation of appropriate, risk-based checks and controls and robust senior management oversight are likely to be well-placed to ensure future compliance.

Many of Canara's failings are very similar to those of firms which have previously been subject to enforcement action. It has long been a criticism by the regulator that firms fail to ensure that customer files record all of the relevant evidence and analysis required to perform a proper risk assessment of each customer; the FCA's general approach is to treat the absence of such documentary evidence as indicating that the firm did not in fact gather the relevant evidence or do the necessary risk checks. Firms should therefore ensure that they have a proper process for recording the full extent of the analysis performed and that appropriate records of any checks (e.g. sanctions screening, database searches, press searches, etc.) are retained. In many cases, it will be appropriate to use standardised checklists and accompanying guidance to give practical directions to staff, but firms should also ensure that the use of standardised documentation does not become a mere "tick-box" exercise which undermines the use of sensible judgement in each case.

The Canara case is also a good illustration of the importance of operating systems that are sufficiently integrated to allow information held in different silos to be compared or aggregated for the purposes of AML assessments. The separate information held by the London and Leicester branches could have fundamentally changed the analysis of certain customer relationships if the bank had had the ability to combine the relevant data and consider the resulting implications in the round. When performing AML assessments, firms should ensure that the appropriate individuals (whether they are in the first line business unit, or in compliance or another oversight function) have access to all of the relevant information sources required to form a holistic view on the level of risk posed by the customer relationship.

8.3 Interactive Brokers (UK) Ltd: January 2018

8.3.1 Facts

Interactive Brokers (UK) Ltd ("IBUK") was fined £1,049,412 in January 2018 for breaching Principle 3 of the FCA's Principles for Businesses by failing to operate adequate market abuse detection systems between February 2014 and February 2015.

IBUK was an online broker which offered arranging and execution services to clients in relation to various derivatives, including contracts for difference ("CFDs"), index futures and index options. IBUK formed part of a larger group which included its US affiliate, Interactive Brokers LLC ("IBLLC"). During the relevant period, IBUK delegated post-trade surveillance of its clients' transactions to IBLLC, which operated a global automated surveillance system covering the entire group. The system produced a number of reports that were designed to flag potentially suspicious transactions and IBUK also delegated the investigation of any positive "hits" on those reports to IBLLC's compliance team. The automated surveillance systems used by the group generated over 50 different reports. However, IBLLC had designed and calibrated the systems without adequate input from IBUK to ensure that monitoring would comply with UK regulatory requirements.

Staff within IBLLC had access to IBUK's market abuse policies and procedures through the group intranet, but IBUK had not actively drawn this to the attention of the IBLLC compliance team. Instead, staff within IBUK used ad hoc emails and undocumented telephone conversations to discuss aspects of the policy and its implementation with their US counterparts. IBUK never offered any formal training to IBLLC compliance staff or checked that they had understood the content of the policy and how it related to their market surveillance responsibilities. The policy itself merely restated the relevant UK market abuse law as it stood at that time, without explaining how this was relevant to the particular market abuse risks inherent in IBUK's business. In addition, it did not contain any practical guidance about what sorts of client transactions might be suspicious or when a reviewer should be considered to have formed a reasonable suspicion that market abuse might have occurred so as to trigger an obligation to make a report to the FCA. Earlier versions of the policy noted that it was IBLLC's compliance team who were responsible for reviewing the post-trade surveillance reports generated by the group's automated monitoring systems, but did not give any guidance on how those reports should be reviewed.

Where IBLLC identified potentially suspicious transactions undertaken by IBUK's clients, it was supposed to escalate the transaction to IBUK for further consideration. However, the policy did not describe the circumstances in which escalation was required and the reviewers within IBLLC were not required to consult with IBUK or to document their analysis. There was also no provision for IBUK to perform periodic assessments of the quality of IBLLC's reviews in order to ensure that suspicious transactions were being escalated appropriately. During the relevant period, staff within IBLLC only escalated one case of suspected insider dealing and six cases of suspected market manipulation to IBUK for further consideration. The FCA noted that following its review of IBUK's market abuse controls, the number of escalated instances of suspected insider dealing significantly increased and that there was a corresponding increase in the subsequent submission of suspicious transaction reports to the FCA.

During the relevant period, the FCA identified three transactions which should have given rise to a reasonable suspicion of insider dealing, but which did not result in IBUK submitting any reports to the FCA. In each case, the relevant clients purchased large numbers of CFDs over shares shortly before positive market announcements led to significant increases in the share price of the relevant issuers. The exposures incurred by each of the clients to the relevant shares were significantly larger than the typical exposures they would assume when trading, which should have led IBLLC to conclude that they were unusual in the context of the clients' trading profiles. In two of the cases, the client had never traded in the relevant shares in the preceding year, except for the suspicious transaction. Only one of these transactions was flagged by the automated surveillance system operated by IBLLC, and that transaction was never escalated to IBUK because the relevant reviewer concluded that the unusual profitability was due to the increase in the issuer's share price. The reviewer failed to consider the timing of the trade and its close proximity to the price increase or the fact that the price increase resulted from the disclosure of favourable information by the issuer to the market which could previously have been leaked to the client.

8.3.2 Comment

Market abuse remains another key FCA regulatory priority. It is therefore important that firms which are subject to obligations under the market abuse regime have implemented robust systems and procedures in this area. Given the increase in information available to the FCA as a result of the significant expansion of transaction reporting following the implementation of MiFID II, the regulator may be in a better position to identify suspicious transactions that should have been flagged by firms' internal systems.

Many international financial services organisations will seek to operate global systems in order to reduce operational complexity within the business. In many cases, this will require the relevant firm to assess the rules to which it is subject in each jurisdiction and to apply the highest relevant standards in relation to each separate issue. The IBUK case is an example of the risks inherent in such an approach; namely, that the firm may ultimately implement systems and controls which are insufficiently targeted to meet the relevant regulatory requirements of a particular jurisdiction (in this case, the UK). Firms should therefore give careful consideration to the design of any set of global standards to ensure that the resulting procedures do not become too general to satisfy the firm's obligations in one or more relevant jurisdictions.

The case also illustrates the risks involved in outsourcing market abuse monitoring (or indeed other potential forms of regulatory compliance activities) to a third party, even if that third party is a member of the same group. Although staff in the US were tasked with carrying out the first level of monitoring, this delegation did not remove IBUK's responsibility for the performance of that function. As a result, individuals with the necessary expertise within IBUK should have exercised much closer oversight over the monitoring staff within IBLLC to ensure that those staff were applying appropriately rigorous standards and understood the relevant UK rules. IBUK failed to investigate whether the very low level of transactions being escalated by IBLLC was due to inappropriate automated surveillance being applied and/or a lack of understanding amongst IBLLC's reviewers as to the circumstances in which a trade should have been flagged. Generally speaking, where a firm is identifying unusually low levels of suspicious transactions, senior management should undertake periodic reviews to satisfy themselves that the relevant systems and procedures remain appropriate and are being applied properly. Automated surveillance systems are often necessary where the firm undertakes a substantial number of transactions, but they should not be used as a substitute for human judgement and must be appropriately calibrated according to the most significant market abuse risks that result from the firm's business model.

Market abuse training for staff is also a key component of a firm's market abuse procedures. Firms must ensure that staff understand the most relevant market abuse risks in the context of the firm's particular activities, rather than by reference to abstract concepts. It is also important for firms to be clear about when staff should escalate their suspicions and the procedures for doing so. Policies and other materials provided to staff should give clear, practical instructions for the most common types of situations and explain whom individuals may contact if they have any questions or concerns.

Issue 160

Solvency II Update

Authors: Geoffrey Maddock and Alison Matthews, Herbert Smith Freehills

The third anniversary of the implementation of the Solvency II regime for UK and other EEA (re) insurers approaches on 1 January 2019 and the UK Government and regulators are preparing for the implementation of the regime into UK domestic law when the UK leaves the EU. After a reminder of the background and legislative structure of the regime, this Bulletin will review both the possible areas for change which might be expected at an EU level in forthcoming years and the areas which have been suggested for change in the UK, once the UK is free to make changes after it has left the EU. It will also explain the UK Government's and regulators' anticipated approach to bringing the regime into UK domestic law.

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The regulatory environment in which financial institutions operate has been one of constant change and evolution in recent years, not only as a result of the UK regulators' own initiatives, but also as a direct consequence of the need to implement European directives within the UK, and domestic and international responses to the credit crisis.

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