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 Litigation 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.

The co-heads of the Regulatory Investigations Group are:

Margaret Chamberlain who is head of the Financial Services and Markets Department; and

Stephen Paget-Brown who is head of the Litigation Department.

FSA AND FCA ENFORCEMENT ACTION—THEMES AND TRENDS

1. Introduction

Plus ça change, plus c'est la même chose. Or, as The Who put it, "meet the new boss, same as the old boss". The enforcement actions we consider in this issue of the *Bulletin* cover both the final year of the FSA's existence and the first full year of FCA/PRA supervision. In many ways it has been "business as usual" for those subject to FCA enforcement with the new regulator clearly determined to pursue the "credible deterrence" strategy of its predecessor, although possibly with some subtle changes in focus. In addition, although individual facts may differ, there is a familiarity about the types of failings which seem to crop up time and again.

In contrast, at the time of writing there have been no published examples of enforcement actions from the PRA to illustrate its regulatory priorities or strategies. It seems likely that this will change in the near future, however, in light of an announcement in January 2014 that the PRA is undertaking an enforcement investigation into potential failings at the Co-operative Bank.

As before, the general level of fines continues to rise, with total FSA fines for 2012 exceeding £311 million and total FSA/FCA fines for 2013 hitting a record-breaking £474 million (although the substantial fines in relation to benchmark manipulation cases have undoubtedly swelled these figures). The largest fine levied to date was that imposed on UBS in December 2012 in connection with the LIBOR fixing scandal (£160 million, reduced from the original amount of £200 million due to early settlement).

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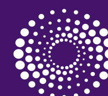

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Nonetheless, the FCA has demonstrated that it will also continue to target systems and controls failings, as evidenced by the £137.6 million fine paid by JP Morgan Chase in September 2013 for failing to monitor its "London Whale" trades adequately. Fines continue to rise and, in many ways, firms continue to make the same types of mistakes.

The FCA has started to focus on the compliance culture within firms, looking for an improvement in industry practices and standards of individual behaviour. Martin Wheatley, the FCA's chief executive, has spoken of the importance of "trust, confidence and integrity" with "firms themselves taking the lead in cultural change" (CFA European Investment Conference in November 2013). In keeping with this renewed focus on values and culture, the FCA has undertaken a range of actions against individuals for failure to act with appropriate fitness and propriety. Although many of these cases involved manifest dishonesty, the action against David Hobbs for lying to the FSA during the course of its investigation into alleged market abuse (the alleged abusive behaviour itself ultimately not being proved) provides a clear message about the consequences of attempting to deceive the regulator. The fact that the FCA continued to press the case for dishonesty all the way to the Court of Appeal, even though the substantive allegations of market abuse were dismissed by the Upper Tribunal, shows how far the FCA will go to pursue individuals that it considers are not fit and proper persons to continue to act in the financial markets.

More recently, there has also been renewed focus on the regulator's consumer protection objective, with action against firms who have failed to treat their customers fairly, including wholesale clients. State Street Bank Europe Limited and State Street Global Markets International Limited were subject to a joint penalty of £22.885 million in January 2014 for deliberately charging substantial undisclosed mark-ups worth approximately US$20 million on trades connected with transition management services. In many ways, for such an apparently clear cut example of overcharging against the interests of the client, it is surprising that the final penalty was not higher.

In February 2014, the FCA also fined Forex Capital Markets Limited and FXCM Securities Limited a combined penalty of £4 million (reduced by 20 per cent from £5 million for early settlement) for their failure to pass favourable price movements in foreign exchange rates on to their clients. In addition, the FCA criticised Forex for failing to notify the FCA that a separate company in its group had been investigated by the US authorities in 2010 for similar breaches and that a redress programme had been agreed with US customers.

These two cases illustrate that any suggestion that firms are failing to achieve fair outcomes for their clients, particularly where this involves an identifiable financial detriment, is likely to be severely punished.

Mis-selling, especially in connection with insurance products, is a continuing preoccupation for the regulator. Lloyds TSB and Bank of Scotland, Card Protection Plan Limited and Swinton Group Limited have each been subject to significant penalties in respect of the activities of their sales representatives. The FCA is also showing an increased interest in how firms' employee incentive plans can lead to increased risks in the behaviour of sales executives, which should prompt firms who remunerate staff using volume-based commission arrangements to review whether adequate safeguards are in place.

The FCA has also continued the FSA's thematic work in investigating the effectiveness of firms' anti-money laundering policies and procedures, with five banks being fined for related systems and controls failings in the last two years and an individual money laundering reporting officer also being found to be personally liable. The tone of the relevant final notices and the size of recent fines suggest that the FCA is becoming increasingly frustrated with continuing problems in this area.

As in previous years, there have been numerous examples of firms failing in their duties to ensure adequate protection for client money and assets, with BlackRock and Aberdeen Asset Managers both being fined for breaching the requirement to obtain acknowledgement of trust letters from banks with whom client money was deposited and SEI Investments being fined for breaching rules relating to reconciliation of client balances. The message on this theme remains consistent: firms should expect to be punished if there is any theoretical risk to client money caused by their failures, even if such risk is remote and never actually materialises.

In this issue, we consider a selection of the more notable FSA and FCA enforcement cases that were published between May 1, 2012 and March 1, 2014 in order to identify the key trends that have emerged and the lessons that should be learned by firms and individuals.

2. Market conduct

CRIMINAL ACTIONS

The FSA enjoyed considerable success in the latter half of 2012 and early 2013 in securing a number of high-profile convictions for insider dealing which resulted in significant custodial sentences. The FCA's first victory was scored nearly a year after legal cutover, in March 2014 with the conviction of Graeme Shelley (discussed below) (although that case arose out of Operation Tabernula, an investigation into suspected insider dealing rings commenced by the FSA back in March 2010). Nonetheless, a number of other individuals have been arrested on suspicion of insider dealing offences and a number of trials remain ongoing.

In May 2012, James and Miranda Sanders and James Swallow each pleaded guilty to multiple charges of insider dealing in contracts for differences ("CFDs"), between October 2006 and February 2008. Mrs Sanders's brother-in-law worked in a large US accountancy firm with access to information about proposed mergers and acquisitions which impacted the price of securities listed on the NYSE and NASDAQ exchanges. He and his wife (Mrs Sanders's sister) provided this information to the Sanders. Mr Sanders, who was a director of Blue Index Ltd, a specialist CFD broker, then placed trades in CFDs in order to benefit from those price movements and also disclosed that information to Mr Swallow, a co-director, who also used the information to deal in CFDs. They made combined personal profits of approximately £1.9 million and generated profits in excess of £10 million for their clients as a result of the trades. Mr Sanders was sentenced to four years' imprisonment and was disqualified from acting as a company director for five years, while Mrs Sanders and Mr Swallow were each sentenced to 10 months in custody. Mr and Mrs Sanders also had confiscation orders made against them requiring them to pay back almost £2 million.

In July 2012, six people were found guilty of disclosure of inside information and dealing while in possession of inside information in connection with spread bets placed between May 2006 and May 2008. The defendants had obtained confidential information relating to potential takeovers from Ersin Mustafa, a print room manager at JP Morgan Cazenove, and had then placed spread bets through a large range of accounts, resulting in a combined profit of over £730,000. Each was sentenced to imprisonment of between 18 months and three years and six months.

Richard Joseph was found guilty in March 2013 of six counts of conspiracy to deal as an insider in connection with very similar trading activities taking place between September 2007 and July 2008. Mr Joseph had also obtained confidential information relating to takeovers from Mr Mustafa and used this as the basis for spread bets, with a net profit of over £591,000. Mr Mustafa provided the information using pay-as-you-go mobile telephones and email "drop boxes" in an attempt to disguise its source and had been paid a significant sum of money (reportedly over £200,000) by Mr Joseph. Mr Joseph was subsequently sentenced to four years' imprisonment on each count, to run concurrently. Mr Mustafa appears to have fled to northern Cyprus.

In November 2012, Thomas Ammann pleaded guilty to two counts of insider dealing and two counts of encouraging insider dealing in connection with his role as an investment banker at Mizuho International Plc in 2008–2009. Mizuho had been advising Canon on its acquisition of a Dutch technology company, Océ, and Mr Ammann had received inside information in connection with the proposed transaction. He had subsequently disclosed that information to Jessica Mang and Christina Weckwerth, two individuals who were each involved in separate romantic relationships with Mr Ammann, and he had encouraged them to deal in Océ shares. Ms Weckwerth made a profit of €1 million and Ms Mang made a profit of £29,000. Both divided their profits equally with Mr Ammann. Mr Ammann was subsequently sentenced to two years and eight months' imprisonment, which would have been a sentence of four years, but for his early guilty plea. Ms Weckwerth and Ms Mang were, however, both acquitted of insider dealing charges.

In March 2013, Paul Milsom, a senior equities trader at Legal & General Investment Management, pleaded guilty and was sentenced to two years' imprisonment and made subject to an order confiscating £245,000 in illegitimate profits for his involvement in an insider dealing scheme. By virtue of his employment, Mr Milsom regularly came into possession of price-sensitive information concerning Legal & General's proposed trades, which were sufficiently large to create price movements in the securities which were the subject of the orders. Using unregistered pre-paid mobile phones, he would then leak this information to a broker at Novum Securities, Graeme Shelley, who would place "front running" orders in contracts for differences or spread bets in order to benefit from the subsequent change in price of the relevant underlying instruments. The profits from the trading, which the FSA alleged totalled over £400,000, were then divided between Mr Milsom and Mr Shelley in cash at face-to-face meetings. In March 2014, it was reported that Mr Shelley had received a two-year suspended sentence after pleading guilty to insider dealing charges in relation to the trades and had been subjected to a confiscation order of £588,000.

These cases serve as a reminder of the increasing tendency of courts to impose substantial custodial sentences for insider dealing, with the judge in Mr Joseph's case expressly referring to the need to use such penalties as a deterrent for others in the markets, given that the relevant behaviour may often be difficult to detect. They can also be seen as an indication of the regulator's willingness, in furtherance of achieving credible deterrence, to pursue often quite complex matters through the criminal courts and to seek custodial sentences, rather than using its powers under the civil market abuse regime.

CIVIL ACTIONS

The most significant civil market misconduct actions recently have occurred in connection with benchmark manipulation and have resulted in a number of very heavy fines for the firms involved. In June 2012, Barclays Bank Plc became the first financial institution to be fined in connection with misconduct in its LIBOR and EURIBOR submissions, resulting in a £59.5 million penalty, followed by UBS AG in December 2012, which was fined a record £160 million. The Royal Bank of Scotland Plc was also the subject of a final notice for manipulating its LIBOR submissions in February 2013 and was fined £87.5 million. The FSA found that while there was no specific conduct of business rule in the FSA Handbook or (at the time) in statute which prohibited benchmark manipulation, all three institutions had nonetheless breached its Principles for Businesses through their failure to uphold proper standards of market conduct and through the lack of effective management and control systems to prevent rate rigging. In addition, a senior manager at Barclays had raised concerns over a potential conflict of interest between the trading positions of the bank's derivatives traders and Barclays's role in making LIBOR submissions and had asked the compliance department to investigate. Compliance concluded that there was no risk that the LIBOR submitters were aware of the traders' positions and that information barriers were not necessary, even though there was the clear possibility of a conflict of interest. The compliance officers made no attempt to question the submitters or to discuss the issue further with senior management. Barclays was therefore also found to have failed to exercise due skill, care and diligence as a result of the compliance function's failure to follow up on the concerns raised.

The FCA continued the FSA's work in this area by fining ICAP Europe Ltd £14 million in September 2013 for its role in attempting to manipulate Japanese yen LIBOR submissions made by traders at UBS AG in order to generate additional profits for UBS. ICAP's brokers would provide deliberately distorted assessments of the correct level of Japanese yen LIBOR which became increasingly important during

the financial crisis where the paucity of interbank transactions meant that there was little concrete data on which to base rate submissions. In return for this assistance, UBS's traders provided benefits to the relevant ICAP brokers, including meals, commissions and on one occasion, a favourable rate on a transaction.

The FCA also fined Rabobank £105 million in October 2013 for attempted manipulation of Japanese yen, US dollar and sterling LIBOR rates, both through deliberate distortion of its own rate submissions and through collusion with other panel banks and interdealer brokers who influenced those banks. Rabobank's Audit Group had carried out an audit of the group in which the bank's LIBOR submitters were based and had noted in its working papers that one submitter had stated that submissions were based on suggestions from a trader. Nonetheless, the audit group failed to take any further action and did not escalate the issue to senior management. The FCA therefore found that in addition to failing to uphold proper standards of market conduct and failing to have effective systems and controls, Rabobank had also failed to exercise due care, skill and diligence when operating its business.

The benchmark manipulation cases are a reminder that the regulator is willing to take action on the basis of the Principles for Businesses alone where no other specific rule covers the relevant conduct. This accords with recent statements by the FCA that firms should focus on whether or not conduct is the "right thing to do", rather than whether it is something which is not technically prohibited. The cases are also a powerful reminder that there is no "safety in numbers" in matters of market conduct—merely because other individuals or institutions may be conducting themselves in a similar manner does not mean that the FCA will accept that the conduct is in accordance with proper standards in the market.

2.1 Jay Rutland (Final Notice: July 9, 2012)

2.1.1 Penalty

Mr Rutland was fined £30,000 and was prohibited from performing any function in relation to any regulated activity for engaging in market abuse and for failing to act with honesty and integrity, as required by Principle 1 in the FSA's Statements of Principle for Approved Persons ("APER"). The FSA indicated that it would have imposed a fine of £160,000, but for evidence that such a penalty would have caused Mr Rutland serious financial hardship.

2.1.2 Summary

Mr Rutland was a senior broker at Pacific Continental Securities (UK) Limited ("PCS") during the relevant period and was approved to carry out the then CF21 investment adviser controlled function. The principal business of PCS was the sale to the public of shares in AIM-listed companies with small market capitalisation and the provision of corporate finance services to AIM issuers. Mr Rutland was responsible for managing a team of junior brokers and ensuring that they met certain sales targets. While his basic salary at PCS was £18,000, the FSA found that he had earned almost £500,000 for the 2006–2007 tax year, primarily as a result of commissions on sales of shares that were concluded by him and his team.

In relation to the market abuse element of the misconduct, on March 27, 2007, Mr Rutland received via the PCS corporate finance department price-sensitive confidential information in relation to an AIM-listed company, Provexis Plc ("Provexis"), indicating that it would soon be entering into an agreement with Unilever to develop one of its products. Mr Rutland subsequently amended a sales script in respect of Provexis shares (which had previously been approved by PCS's compliance department) to remove certain risk warnings and to include references to a pending agreement with a major food manufacturer and a predicted resulting increase in Provexis's share price. He circulated this via email to his team of brokers with the words "Gentlemen, this script does not exist" and instructed his team to encourage as many customers as possible to buy Provexis stock.

PCS's compliance department subsequently reminded Mr Rutland and his team that they should not make any reference to Provexis's proposed agreement with Unilever as this could constitute insider dealing, but Mr Rutland failed to take any steps to amend the unapproved Provexis sales script. When the agreement with Unilever was announced to the market on March 30, 2007, Provexis's opening share price rose by 19.81 per cent compared with the previous day's closing price.

In relation to the allegation of market abuse, Mr Rutland argued, *inter alia*, that the information relating to Provexis in the amended sales script was already generally known in the market and therefore could not amount to inside information. He relied on the fact that Unilever was not specifically named as the counterparty in the sales script and the specific product to which the agreement related was not identified. Mr Rutland also argued that it was Provexis which had disclosed the inside information to his broker team at a presentation on March 28, 2007 and that the presentation should be categorised as amounting to information generally available to the market. He also denied being the author of all of the amended sales scripts.

The FSA found that by altering the scripts to remove required risk warnings in order to improve sales and by deliberately including inside information in the Provexis sales script, Mr Rutland had demonstrated a serious lack of honesty and integrity, in breach of Principle 1 in APER.

In addition, the FSA concluded that Mr Rutland had disclosed inside information in relation to Provexis otherwise than in the proper course of his employment, contrary to the market abuse provisions in Section 118(3) FSMA. He had also encouraged other members of his team to engage in behaviour which, if he had engaged in it himself, would have amounted to market abuse and therefore had breached Section 123(1)(b) FSMA. The information relating to Provexis in the amended sales script was precise because it identified circumstances which were expected to come into existence (i.e. a potentially lucrative commercial agreement) and it was sufficiently specific to allow conclusions to be drawn about the possible effect of those circumstances on Provexis's share price (i.e. that it would increase as a result). The information was not generally available when Mr Rutland circulated the revised sales script, which was prior to Provexis's presentation the following day. Even if that presentation had been the source of the inside information, the effect of that disclosure was only to make the attendees from PCS insiders in respect of that information; it did not make that information generally available to the market. Mr Rutland did not make the disclosure of the information to his staff subject to any confidentiality requirements and there was no legitimate justification for disseminating it. The use of the phrase "this script does not exist" was clear evidence that Mr Rutland understood that the information ought not to have been circulated.

2.1.3 Lessons to be learnt

- Information can be sufficiently precise to amount to inside information even if certain elements of the information lack specificity—for example, because the counterparty to a pending transaction is not identified or the precise subject matter of that transaction is not known.
- The fact that an issuer provides a presentation to brokers does not by itself mean that the contents of that presentation have necessarily become publicly available and therefore cannot amount to inside information. Although many issuers would be sufficiently knowledgeable to forewarn brokers that they will be receiving inside information and will need to keep that information confidential, brokers who have concerns about being "wall-crossed" should raise this with issuers in advance or may find themselves inadvertently becoming insiders.

2.2 Stefan Chaligné, Patrick Sejean and Cheickh Tidiane Diallo (Tribunal Decision: September 28, 2012; Final Notices: January 24, 2013)

2.2.1 Penalties

Mr Chaligné was fined €362,950, representing disgorgement of benefit, and an additional penalty of £900,000 and was prohibited from performing any function in relation to any regulated activity.

Mr Sejean was fined £650,000 (the FSA's original fine of £550,000 having been increased by the Upper Tribunal for being too lenient) and was prohibited from performing any function in relation to any regulated activity.

Mr Diallo was subject to a statement of censure and was prohibited from performing any function in relation to any regulated activity. The FSA indicated that it would have imposed a fine of £100,000, but for evidence that such a penalty would have caused Mr Diallo serious financial hardship.

2.2.2 Summary

Mr Chaligné was the founder of Iviron Fund ("Iviron"), a Cayman Islands investment fund in which he was also the largest shareholder with an overall beneficial stake of approximately 24 per cent. The remaining interests in Iviron were owned by various members of Mr Chaligné's family and a number of his close friends. In addition, he was also the founder and beneficial owner of all the shares in Cambos Investment Limited ("Cambos"), a company incorporated in the British Virgin Islands which acted as the investment manager of Iviron.

Mr Sejean was employed as a salesman and had been approved to perform the CF30 customer controlled function in the London office of Cantor Fitzgerald Europe ("CFE"), which provided execution-only brokerage services to Cambos. During the relevant period, Mr Chaligné was one of Mr Sejean's most significant clients.

Mr Diallo was described by the Upper Tribunal as an analyst and relatively inexperienced trader within CFE who, like Mr Sejean, had been approved to perform the CF30 customer function.

On December 28, 2007, Mr Chaligné telephoned Mr Sejean to instruct him to place certain trades on December 31, 2007, which coincided with Iviron's year end. The proposed trades included instruments issued by five different entities which were traded on exchanges in the EU constituting prescribed markets for the purposes of the UK market abuse regime. The abusive trades represented significant proportions of all the orders which were placed in respect of the relevant securities (others were traded on markets in Switzerland and North America); in all but two instances, the trades represented more than half of the average daily volume of trading in each security across the previous three months. Although all of the trading occurred in securities which formed part of Iviron's portfolio, a number of the trades appeared to have been entered into via a separate investment account which was maintained on behalf of Mr Chaligné and his family. The FSA found that Iviron's holdings increased in value by over €2.4 million as a result of the trades that took place on December 31, 2007, amounting to an increase of 2.88 per cent in the fund's net asset value.

A similar set of trades was entered into by Mr Sejean on Mr Chaligné's behalf on January 31, 2008, which the FSA alleged were designed to cause a further increase in Iviron's net asset value at month end. The FSA alleged that the motive behind the trades was to improve Iviron's investment performance and lead to increased management fees being payable to Cambos (and therefore indirectly to Mr Chaligné).

During the course of the FSA's investigation, Mr Sejean conceded that he understood that the proposed trades would be likely to constitute market abuse and that he took no steps to challenge Mr Chaligné or to revise his instructions. Mr Chaligné argued that he was not acting dishonestly in ordering the trades and that he was merely trying to support the prices of the relevant securities in a period of extended volatility following the onset of the financial crisis. The shares which had been purchased had been retained rather than being immediately resold in order to generate a rapid profit as a result of the increased price. As a result, he argued, Iviron and the private account had each assumed a real investment risk to the relevant securities.

The Upper Tribunal found that Mr Chaligné's purpose had not been to increase the management fees due to Cambos, but had instead been to support Iviron's net asset value in order to discourage investors from withdrawing their investment and to continue to foster the view that he was a competent investment manager. Nonetheless, it still considered that Mr Chaligné's behaviour was dishonest in the sense that he must have been aware that he was transgressing ordinary standards of behaviour when ordering the trades or he must otherwise have wilfully closed his eyes to that obvious conclusion. As the abusive behaviour had occurred at year end and again at month end, but not in the intervening period, the Upper Tribunal concluded that Mr Chaligné did not merely have the purpose of supporting the prices of Iviron's investments, as he claimed.

The Tribunal found that Mr Sejean's conduct was "as serious a case of market abuse of its kind as one might conceive", given that he had been involved in both the December 2007 and January 2008 trading and had by his own admission been aware that this constituted market abuse. In addition, Mr Sejean conceded that one of his main motivations in facilitating the trades was to increase his commission and to retain Mr Chaligné as a lucrative client.

Although the Tribunal was slightly more sympathetic to Mr Diallo, noting that he was fearful that refusing the trades might lead to his dismissal and that he was genuinely remorseful, it nonetheless concluded that as an intelligent man and an approved person he should have refused to engage in market abuse. It also noted that he had not made any attempt to object to Mr Sejean about his instructions, even in a limited manner.

2.2.3 Lessons to be learnt

- The Tribunal was highly critical of both Mr Sejean and Mr Diallo for failing to point out to Mr Chaligné that his proposed instructions would amount to market abuse. In its view, even though CFE was acting in an execution-only capacity, clients should be able to rely on investment firms refusing to accept instructions which are improper.
- The fact that Mr Chaligné may not have had the motive of increasing the level of fees payable to Cambos could not excuse his conduct where he knew that his actions were improper. The Tribunal drew a clear distinction between knowledge and motive for the purposes of the market abuse regime.
- The Tribunal considered the fact that Mr Sejean had enlisted the assistance of an inexperienced subordinate to undertake the abusive trading was a serious aggravating factor.
- The Tribunal confirmed that the purpose of a prohibition order is primarily to protect market participants and/or consumers and that, in the absence of entirely exceptional circumstances, deliberate conduct which amounts to market abuse must result in such an order, even if the underlying reasons for the conduct are not themselves dishonest. This further suggests that persons found to commit such deliberate market abuse are likely to be subject to a prohibition order even if they have not personally gained from their conduct. The case also confirms that it is not necessary for a person to be an approved person for the purposes of FSMA in order to be the subject of a prohibition order.
- The decision also indicates that the Tribunal will adjust penalties upwards where it considers that there is a compelling reason to do so. Although it was stated that this power must be used sparingly in order to avoid discouraging meritorious references, it is clear that the subjects of FCA or PRA enforcement action may need to consider this risk in deciding whether to refer a case to the Tribunal.

2.3 Michael Coscia (Final Notice: July 3, 2013)

2.3.1 Penalty

Mr Coscia was fined US$903,176 (approximately £598,000 under the exchange rate at the time) for engaging in market abuse. This reflected a 30 per cent discount for early settlement, without which the fine would have been US$1,155,076 (approximately £764,770). The fine included disgorgement of the financial benefit obtained by Mr Coscia as a result of the abusive trading, amounting to US$315,376.

2.3.2 Summary

Mr Coscia was an experienced trader based in the United States who traded oil futures on ICE Futures Europe through a direct market access provider. He placed trades using a bespoke high-frequency trading ("HFT") automated algorithmic system which he had designed and which was capable of placing a series of related orders within milliseconds of each other.

Mr Coscia's trading strategy involved placing a small "resting order" at the best available price on the exchange (i.e. either the best bid or the best offer price), followed by a series of much larger orders on the other side of the trading book (i.e. if the resting order was a buy order, the large orders would be sell orders in respect of the same future, and vice versa). The HFT programme would place these large orders within the space of approximately 300 milliseconds, after which the programme would automatically cancel them if they had not already been executed.

The FCA alleged that the large orders were designed to create an exaggerated impression of supply (if these were sell orders) or demand (if these were buy orders), moving the bid or offer price, as applicable, of the relevant future closer to that of the resting order. This meant that Mr Coscia was able to buy futures more cheaply or sell futures for a higher price than would otherwise have been available in the absence

of the large orders. In order to avoid Mr Coscia having to settle the large orders at what was in reality likely to be an unfavourable bid or offer price, as soon as any part of a large order was executed, the HFT programme would cancel all remaining large orders immediately. However, if the resting order was only partially executed, the HFT system would not intervene. The FCA found that the system had therefore been deliberately constructed to favour the execution of the resting order over the large orders.

Once the resting order had been executed, Mr Coscia would reverse the trade to close out the open position that had been established. The FCA found that as a result of the design of the HFT programme, only 0.1 per cent of the large orders were ever fully executed, compared with 44.5 per cent of the small resting orders. The effect of this was that the large orders could not be considered to represent genuine supply and demand in the market, but served to give a misleading impression of liquidity. This allowed Mr Coscia to generate a profit on trading at the expense of other ICE market participants.

Given the very fast operation of the HFT programme, the FCA concluded that the participants who were most likely to be adversely affected were those using HFT or automated trading techniques, rather than those inputting manual trades. The FCA identified one market participant who had withdrawn from ICE during the period directly as a result of Mr Coscia's trades on the exchange.

The FCA found that Mr Coscia had committed market abuse by effecting trading orders which gave, or were likely to give, a false or misleading impression as to the supply of, or demand for, oil futures traded on ICE. The transactions had not been effected for legitimate reasons or in accordance with generally accepted market practice.

The ICE also undertook a separate investigation and concluded that Mr Coscia's trading had breached the rules of the exchange prohibiting disorderly or aggressive bidding or offering.

2.3.3 Lessons to be learnt

- The case confirms the previous guidance in Market Watch No.33 (August 2009) that layering of trades is likely to amount to market abuse through misleading behaviour and/or distortion of apparent liquidity. The fact that the FSA had previously issued specific guidance on layering was an aggravating factor.
- The FCA appears increasingly confident about taking enforcement action in respect of HFT trading and other trading via automated systems, which are increasingly becoming an area of focus. The final notice refers to the FSA's previous enforcement action for layering against Canada Inc (formerly Swift Trade) which was upheld in a decision of the Upper Tribunal in January 2013 (and has recently been confirmed in a subsequent judgment of the Court of Appeal in December 2013—see below).
- The case also demonstrates that the FCA will continue to pursue overseas persons for market misconduct as part of its credible deterrence strategy.

2.4 7722656 Canada Inc (formerly Swift Trade Inc) (Court of Appeal Judgment: December 19, 2013; Final Notice: January 24, 2014)

2.4.1 Penalty

Following the rejection of its reference to the Upper Tribunal in January 2013 and its appeal to the Court of Appeal in December 2013, 7722656 Canada Inc ("Canada Inc") (formerly Swift Trade Inc) was fined £8 million for engaging in market abuse.

2.4.2 Summary

Canada Inc had been formed following the amalgamation of Swift Trade Inc ("Swift Trade") and another company, both of which were incorporated in Canada. As the successor company to Swift Trade, Canada Inc inherited all of Swift Trade's liabilities, including those relating to the period during which the market abuse was alleged to have taken place. Canada Inc was dissolved on December 13, 2010, six months before the FSA issued its decision notice on May 6, 2011.

The FSA found in its decision notice that traders had used Swift Trade's facilities to place "layering" orders for contracts for differences ("CFDs") in relation to shares which were listed on the London Stock

Exchange, thereby effecting transactions or orders to trade which gave, or were likely to give, a false or misleading impression as to the supply of, demand for or price of one or more qualifying investments. Swift Trade obtained access to the LSE through direct market access provided by Merrill Lynch and Penson Financial Services. Once traders had placed an order for CFDs, Merrill Lynch and Penson would automatically place hedging orders to buy or sell an amount of shares equivalent to those specified in the order without any human involvement by employees at either institution.

Canada Inc referred the FSA's decision notice to the Upper Tribunal on two grounds: first, that the company no longer existed as a legal entity when the FSA had issued its decision notice, and secondly that, as traders using Swift Trade had been effecting trades in contracts for differences, the relevant behaviour had not been in relation to "qualifying investments" for the purposes of market abuse legislation. The Upper Tribunal had rejected both arguments, finding that the traders were either Swift Trade employees or affiliated persons who had deliberately caused manipulative orders in the related quoted shares to be placed by exploiting Merrill Lynch's and Penson's automated systems. The Upper Tribunal also found, relying on expert evidence from a Canadian lawyer, that the effect of Canadian company legislation was that the dissolved company could still have a limited existence for the purposes of being made a defendant to certain legal actions and therefore could be the subject of the FSA's decision notice. Canada Inc appealed to the Court of Appeal on the basis that the Upper Tribunal had erred in finding: (a) that Swift Trade's behaviour related to qualifying investments; and (b) that Canada Inc continued to have a limited existence in May 2011.

The most important aspect of the Court of Appeal's judgment, on which all three appeal judges were agreed, concerns the issue of whether Swift Trade had effected orders to trade and whether its behaviour had taken place in relation to qualifying investments. It had been agreed that CFDs were not qualifying investments for the purposes of the UK market abuse regime, but the court found that Swift Trade had effected the transactions in the listed shares themselves by placing the CFD orders so as to trigger the automated hedging trades. The court endorsed the observation of the Upper Tribunal that the abusive behaviour did not need to be solely that of Swift Trade because the legislation clearly stated that the behaviour could be that of "two or more persons acting jointly or in concert". For these purposes, the court found that the term "jointly" merely required action to be taken by one person together with another and did not require that both parties perform the action with the same ultimate intention. Further, even if Swift Trade did not effect orders to trade in qualifying investments because those orders technically related to CFDs, its behaviour nonetheless clearly occurred "in relation to qualifying investments" for the purposes of the legislation because the CFDs were contracts triggering automatic hedging orders in those shares. The phrase "in relation to" was, the court said, intended to be deliberately wide in the context of the statute.

The court found that the Upper Tribunal had been entitled to rely on the expert evidence as supporting the view that the company existed in a limited manner at the relevant date, and that the Upper Tribunal's conclusions of fact could only be overturned if the conclusion had either been reached without any evidence or otherwise had been a conclusion which no reasonable tribunal could have reached. There were sufficient statements in the expert evidence to provide an evidential basis for the Upper Tribunal's findings.

2.4.3 Lessons to be learnt

- The case is important in confirming that persons may be taken to be acting jointly for the purposes of the market abuse regime even where they act with entirely different unconnected motives. As in the Swift Trade case, a person whose behaviour may not by itself constitute abusive behaviour may still commit market abuse where that behaviour can be linked to the actions of another person which, when taken together with the original behaviour, satisfy the necessary criteria. The difficulty for firms and their advisers may lie in determining the limits of this principle. The fact that Merrill Lynch and Penson's orders in the listed shares were triggered involuntarily through an automated system might have been conclusive in construing those acts as an indivisible part of joint behaviour with Swift Trade. However, it is questionable whether, for example, there would still have been "joint" behaviour if Merrill Lynch or Penson had needed to place the orders with some element of human input into the process, but where they were unaware of Swift Trade's abusive purposes.

- The decision is also a reminder that appeals against the decisions of the Upper Tribunal are only possible on questions of law, rather than questions of fact. In limited circumstances, a challenge to the Tribunal's findings of fact may amount to a question of law, but only where those findings are manifestly irrational or lack any obvious basis. Firms wishing to lodge a successful challenge to the Tribunal's findings of fact will therefore need to meet a very high evidential standard.
- The civil market abuse regime is complex, as there are a number of separate market abuse behaviours which, in order to constitute an offence, must occur in relation to particular specified categories of securities. The FSA/FCA had based its case on the manipulating transactions behaviour in s.118(5) FSMA, which the legislation requires must take place in relation to qualifying investments which are admitted to trading on a prescribed market (or in respect of which a request for admission to trading has been made). The CFDs in the case were not qualifying investments under FSMA and therefore it would appear *prima facie* (as argued by Swift Trade's counsel) that the trading could not be said to meet the statutory criteria for the offence. (This can be contrasted with the criminal insider dealing offence under the Criminal Justice Act 1993, where trading in CFDs which have the purpose of securing a profit or avoiding a loss by reference to fluctuations in the value of listed shares or debt securities is directly caught—see the Sanders/Swallow case above.)
- However, it is in this context that the court's comments on the phrase "in relation to" as used in s.118 FSMA with reference to qualifying investments are interesting, as their potential effect is to widen the ambit of the market abuse regime by applying a concept similar to that of "related investments" to all market abuse behaviours (which would tend to render the "related investments" concept otiose). The category of "related investments" is not relevant to the s.118(5) offence. It appears that this interpretation of the language used in the legislation may have resulted from the court's desire to prevent Swift Trade from escaping liability for what seemed like clearly egregious behaviour. However, as the Upper Tribunal had pointed out (and as the court noted in passing, but on which it refused to express a settled opinion), Swift Trade was likely to have been guilty of the separate market distortion offence under s.118(8) FSMA. That offence covers not only trading in qualifying investments, but also includes under s.118A FSMA trading in relation to investments whose subject matter is qualifying investments (such as CFDs in respect of which the underlying is listed shares). The decision may therefore reflect the fact that the FSA chose a less appropriate market abuse behaviour as the basis for its original decision notice (possibly in order to avoid having to prove that Swift Trade's behaviour would be considered by a regular market user to be below the standard reasonably expected of market participants, which is an integral element of the s.118(8) offence but which is not required under s.118(5)).
- While of concern, the significance of the court's interpretation of the phrase "in relation to" should not be overstated, since the particular reasoning may not be a necessary part of the judgment (given that the court had already found that joint behaviour had occurred in relation to the listed shares themselves) and may therefore amount to a non-binding *obiter* comment in future cases. In any event, because the hedging trades in the shares were automatically executed as a result of the trading in the CFDs, the reasoning may be confined to the particular facts of the case.

2.5 David Davis (Final Notice: July 5, 2012) and Vandana Parikh (Final Notice: August 6, 2013)

2.5.1 Penalty

Mr Davis was fined £70,258 (which included £3,442 representing disgorgement of financial benefit) and was prohibited from performing any function in relation to any regulated activity for failing to exercise due care, skill and diligence in managing the business of Paul E Schweder Miller & Co ("Schweder Miller"), a brokerage firm, when performing the compliance oversight (CF10) function, as required by Principle 6 of APER. The FSA considered that by his failure to challenge and make reasonable enquiries before authorising certain trading orders, Mr Davis had created a clear risk that market abuse may have occurred via orders placed through Schweder Miller.

Mrs Parikh was fined £45,673.50 for failing to exercise due care, skill and diligence when acting in her capacity as an approved person when performing the customer (CF30) controlled function at Schweder

Miller, as required by Principle 2 of APER. The FCA concluded that Mrs Parikh had failed to recognise the risk that her client, Rameshkumar Goenka, intended to commit market abuse.

Mr Goenka was the subject of a final notice on October 17, 2011, fining him over US$9.5 million for market manipulation contrary to s.118(5) FSMA.

2.5.2 Summary

Mrs Parikh, a broker at Schweder Miller for over 20 years, was approached in April 2010 by an investment adviser to Mr Goenka, a sophisticated, high net worth Indian investor based in Dubai. Mr Goenka's investment adviser asked Mrs Parikh for information about trading stocks in Reliance and Gazprom in the closing auction on the London Stock Exchange, which is used to determine closing prices for each traded security. The FSA found that the purpose of the proposed trades was to manipulate the closing price of the relevant stocks in order to secure gains or avoid losses on related structured products held by Mr Goenka.

Across a number of days in April 2010, Mrs Parikh discussed the mechanics of the closing auction with Mr Goenka and his adviser, including how to place trades in the auction in order to achieve a desired price level for Gazprom securities. On one occasion, she specifically asked Mr Goenka's adviser what Mr Goenka intended to do with Gazprom stock once it had been purchased in the closing auction and was told that it would be sold on the following day, as Mr Goenka was only interested in achieving a particular closing price for the securities on a certain date. Mrs Parikh did not identify any market abuse concerns resulting from this information, although the FCA found that she should have suspected that the proposed trading was abusive. Ultimately, the planned trading in Gazprom did not occur due to a market announcement which would have made Mr Goenka's proposed trades considerably more expensive.

However, in early October 2010, Mr Goenka's investment adviser again put Mr Goenka in contact with Mrs Parikh in order to arrange trading in Reliance stock in the LSE's closing auction. Mrs Parikh again discussed a desired price level with Mr Goenka and subsequently also with Mr Goenka's investment adviser, and was instructed that the Reliance stock price should be kept above a certain target level. She also informed Mr Davis, the compliance officer, several days before the date of the proposed trades that Mr Goenka would be placing a large order in the relevant stock.

Mr Goenka subsequently placed a number of orders in the closing auction for Reliance stock, the effect of which was to increase the closing price above a level which would otherwise have triggered a loss of over US$3 million on the relevant structured product. Mr Davis authorised the orders, having apparently discounted the possibility that the trades were connected with an underlying financial product. He did not contact Mr Goenka to make any additional enquiries, despite having been reminded by Mrs Parikh that Mr Goenka had previously sought to place large orders in respect of Gazprom stock in similar trading earlier in the year and that the proposed orders in the Reliance stock would amount to 280 per cent of the average daily volume of trading in those securities. The FSA concluded that detecting and preventing market abuse is a key element of the compliance officer function and that, through his inaction, Mr Davis had shown that he lacked competence and capability, thereby justifying a prohibition order against him. Mr Davis had benefited financially from the trading through his receipt of a share of the commission (worth over £3,000) in connection with the orders which he was subsequently required to disgorge.

2.5.3 Lessons to be learnt

- Firms and their employees are expected to remain vigilant in assessing the possibility that clients may be seeking to engage in abusive trading and should be prepared to seek additional information where circumstances can reasonably be considered to give rise to any such suspicions. Firms and approved persons who wilfully close their eyes to the possibility that clients are committing market abuse are therefore at risk of enforcement action.
- The FCA found that it was no defence for Mrs Parikh to argue that she had acted in accordance with the firm's internal compliance manual and had received the approval of Mr Davis in his capacity as Schweder Miller's compliance officer. Neither of those factors was taken as relieving her of her responsibility to consider whether Mr Goenka was deliberately seeking to manipulate closing prices in the auction and to make further enquiries to satisfy herself that this was not the case.

3. Financial crime systems and controls failings

Enforcement actions for failure to establish and implement effective anti-money laundering ("AML") policies and procedures have been a particular theme for many years and the last couple of years have been no exception.

While some of the key examples are analysed in more depth below, there were also a number of other instances of penalties being imposed within the relevant period. In July 2012, the FSA fined Turkish Bank (UK) Ltd £294,000 for failing to establish appropriate risk-sensitive procedures in connection with its relationships with correspondent banks. In particular, the bank had incorrectly classified certain jurisdictions as being low or medium risk despite warnings published by the Financial Action Task Force ("FATF") that the relevant countries did not impose AML regulatory requirements which were equivalent to those required by the UK. There had also been a failure to identify the beneficial ownership of the correspondent banks, meaning that Turkish Bank could not check the names of owners of those institutions against sanctions lists.

EFG Private Bank Ltd was fined £4.2 million in March 2013 for failure to maintain adequate information on its customer files which justified the risk categories applied to those customers, who were mostly high net worth individuals, many of whom came from jurisdictions identified as high risk for AML purposes. In one case, a customer file noted that allegations of corruption and money laundering had been made against an individual, but concluded that these were unsubstantiated without specifying how that conclusion was reached or including any evidence in support of it.

3.1 Habib Bank AG Zurich and Syed Hussain (Final Notices: May 4, 2012)

3.1.1 Penalty

The FSA fined Habib Bank AG Zurich ("Habib") £525,000 for failure to take reasonable care to establish and maintain AML systems and controls. The fine included a 30 per cent early settlement discount, without which it would have been £750,000.

The FSA also fined Mr Hussain, Habib's money laundering reporting officer ("MLRO"), £17,500 (originally £25,000 prior to the application of a 30 per cent early settlement discount) for breaching Principle 7 of APER through his failure to ensure that the business of the firm for which he was responsible complied with the relevant requirements and standards of the regulatory system.

3.1.2 Summary

The FSA found that between December 2007 and November 2010, Habib had maintained a flawed list of high-risk jurisdictions for AML purposes, in particular by excluding Pakistan and Kenya from the list of high-risk countries on the basis that it had a physical presence in those countries and therefore had specialist knowledge of those regions. Despite the fact that Habib based its list (aside from Pakistan and Kenya) on the Corruption Perception Index published by Transparency International, human error meant that several jurisdictions identified as high risk in that index were also accidentally omitted from the list of high-risk countries in Habib's AML policy, including Mauritania, Gabon and Tanzania.

The FSA also found that Habib failed to assess the "geographical" risks posed by the jurisdictions in which its corporate customers were operating, over and above those of the jurisdiction of incorporation and that it had failed to consider the greater risks posed by companies with significant beneficial owners in high-risk jurisdictions or whose representatives had not been physically present for identification purposes. In addition, Habib had failed to gather sufficient enhanced due diligence information for higher-risk customers or had not collected sufficient appropriate evidence for customer files to justify the conclusions drawn. For example, Habib had failed to ask certain customers for sufficient evidence of their source of the funds and, in one instance, had failed to investigate allegations that a particular account holder had previously been involved in corruption in Pakistan.

Habib was also criticised for its failure to carry out regular assessments of its AML policies and procedures and for providing inadequate training for staff members, even though the bank's MLRO had previously identified a number of AML failings in various branch audits. Insufficient records of customer accounts

had also been maintained, making it difficult for the FSA to assess whether Habib had been meeting its legal and regulatory obligations.

Mr Hussain was considered to be personally culpable due to his failure to take reasonable steps to correct the above deficiencies, even though the FSA acknowledged that his conduct was neither deliberate nor reckless.

3.1.3 Lessons to be learnt

- AML failings remain a key area of focus and firms should ensure that their AML policies are regularly assessed and updated, particularly if there is any indication that policies are not being properly understood or are incorrectly applied by employees.
- Firms should be careful to ensure that adequate records are kept documenting the application of their procedures in the context of each customer relationship and that sufficient evidence of checks is maintained on customer files. Firms must also be prepared to ask customers for additional information where answers to initial enquiries are incomplete, implausible or by their nature should give rise to additional concerns.
- Individual MLROs may be held personally liable if they fail to ensure that their firm's AML policies and procedures are adequate, regularly updated and correctly applied by other members of staff.

3.2 Guaranty Trust Bank (UK) Limited (Final Notice: August 8, 2013)

3.2.1 Penalty

Guaranty Trust Bank (UK) Limited ("GTB") was fined £525,000 for breach of Principle 3 of the Principles for Businesses through its failure to establish and maintain adequate AML systems and controls in respect of higher-risk customers. A 30 per cent settlement discount applied, without which the firm would have been subject to a fine of £750,000.

3.2.2 Summary

GTB is a wholly-owned subsidiary of a leading Nigerian financial institution providing banking services to customers in the UK and in several countries across West Africa. Between May 2008 and July 2010, approximately 70 per cent of GTB's 2,800 retail customers were classified as higher-risk relationships for AML purposes.

In the majority of the files reviewed by the FCA, GTB failed to maintain adequate evidence that it had carried out a proper assessment of the AML risks associated with its customers. While the FCA conceded that the customers had been correctly identified as high-risk individuals, the customer files failed to specify the specific risks relevant to each relationship and therefore the basis on which the bank had decided to accept those customers. In addition, the failure to include information on specific risks reduced the effectiveness of ongoing monitoring of the risks associated with doing business with each customer.

GTB also failed adequately to investigate or document the purpose of each business relationship with its customers and accepted customers' written answers in the account-opening documentation, even where this appeared to be contradicted by other available information. In a number of cases, the customer failed to give any answer to the question and did not appear to have been chased by GTB to provide the missing information, while in others information given was vague or implausible but was not investigated further. Documentary evidence verifying the customer's responses was frequently missing—for example, customers often stated the identity of their employer, but few customers provided pay slips or account statements to prove that the employment was the source of their funds and GTB did not request this evidence. In many cases, GTB's employees also failed to follow its AML procedures which implemented the MLRs, requiring sign-off from each of the firm's MLRO, managing director and executive director of operations before a politically exposed person could be accepted as a customer.

The FCA also found that GTB had failed to carry out adequate screening of potential customers in order to ensure that they were not listed as being subject to financial sanctions imposed by the UK, the EU or the United Nations. In particular, the results of the sanctions screening were not recorded on customer files unless there was a positive match and in a number of cases, screening was not carried out prior to

the accounts being opened. In some cases, more than two years elapsed after the account was opened before the screening was undertaken. Ongoing monitoring of customer accounts was also found to be insufficient, with a number of high-risk customer accounts not being reviewed for more than three years.

3.2.3 Lessons to be learnt

- This was the first enforcement action in respect of AML failings published by the FCA following legal cutover, but it is clear that the approach adopted is very similar to the reasoning used in the FSA-led AML enforcement cases listed above. In keeping with its new competition objective, the FCA also noted that firms that fail to meet the required AML standards also gain an unfair cost advantage over their competitors indicating the regulator's focus on how firms' behaviour may impact the market more generally.
- The FCA's criticism of GTB for failing to include the results of sanctions screening on customer files where there was no match seems somewhat harsh given that there was clear evidence that relevant information about positive matches was retained. It is unclear precisely what information the FCA considers should be filed if no match is found, especially given that this would appear to be of little use in ongoing risk monitoring of the relationship, but firms should nonetheless consider whether documentary evidence of such searches can be reproduced and retained in order to satisfy this requirement to "prove a negative".

3.3 Standard Bank Plc (Decision Notice: January 22, 2014)

3.3.1 Penalty

Standard Bank Plc ("Standard Bank") was fined £7,640,000 for failure to comply with the MLRs in connection with its commercial banking activities. The penalty was subject to a 30 per cent discount for early settlement, without which it would have been £10,914,900.

3.3.2 Summary

Standard Bank is the UK subsidiary of the largest banking group in South Africa and offers corporate and investment banking services to customers established in emerging markets. The FCA found that in the period between December 2007 and July 2011, Standard Bank had failed to take reasonable care to ensure that all aspects of its AML policies and procedures were applied appropriately and consistently to those of its corporate customers who were connected to politically exposed persons.

Standard Bank was criticised for giving insufficient guidance to its staff about the relevant risk factors that should be considered when categorising the money laundering risk associated with a customer relationship. Prior to April 2009, while the bank's policies identified particular jurisdictions as low, medium or high risk, there was little further guidance about other risk factors that should be considered when determining the risk rating. As a result, the FCA found that in a number of cases, a customer was assigned a risk rating solely on the basis of the jurisdiction in which the entity was incorporated, meaning that some higher-risk customers who were connected with politically exposed persons or who were involved in higher risk industries were incorrectly categorised as low or medium risk.

The FCA also concluded that the level of enhanced due diligence undertaken by Standard Bank in connection with its higher-risk customers was sometimes insufficient, with documentary evidence of beneficial ownership and the source of customers' wealth missing from the files that were reviewed. The bank was also criticised for its failure to meet the levels required by its own internal AML policies and procedures when carrying out enhanced due diligence in connection with customers who qualified for simplified due diligence under the MLRs, but in respect of whom higher-risk factors had also been identified. While Standard Bank had taken some steps which went beyond simplified due diligence in such cases, it had nonetheless failed to carry out sufficient additional due diligence to meet its own specified standards.

3.3.3 Lessons to be learnt

- The simplified due diligence regime in Regulation 13 of the MLRs provides that customer due diligence measures do not need to be applied to certain categories of customers (e.g. financial

institutions which are themselves subject to the Money Laundering Directive or companies with securities listed on a regulated market which are subject to specified disclosure obligations). However, the FCA emphasised in the Standard Bank case that this is subject to Regulation 14 which states that firms must apply enhanced due diligence measures and ongoing monitoring in any situation which by its nature can present a higher risk of money laundering or terrorist financing. As a result, firms will need to consider whether customers who may *prima facie* qualify for simplified due diligence nonetheless exhibit other higher-risk characteristics (e.g. due to a connection with a politically exposed person) which will require the firm to undertake additional customer due diligence measures both when the relationship is established and on an ongoing basis.

- The case acts as a reminder that firms must take care to ensure that internal AML policies and procedures are not only correctly drafted in accordance with applicable legal requirements, but—critically—are also being properly applied by employees in practice. Firms cannot use the defence that procedures which were not adequately followed may potentially have exceeded the standards required by law or regulations, as the FCA is nonetheless likely to treat this as evidence of a systems and control failing.
- In addition to the issues summarised above, Standard Bank was also criticised for systemic failings in not complying with its own policies and procedures regarding the periodic review of customer relationships as part of its ongoing monitoring obligations. This is a reminder to firms to ensure that the periodic review of business relationships is carried out in accordance with the frequency determined by their policies and procedures—a firm's AML obligations do not stop after completion of the initial client identification procedures.
- The FCA cited its previous enforcement action against other firms for AML failings as an aggravating factor when calculating the penalty to which Standard Bank was subject, even though the relevant final notices stemming from its 2011 thematic review had not been published during the period in which the conduct took place. This is a strong indication that the FCA will have very little sympathy in future for firms that repeat any of the AML failings identified in recent enforcement action and that penalties are likely to become ever higher in pursuit of the "credible deterrence" policy.
- The size of the Standard Bank penalty is significant, especially when compared with other fines for similar AML failings in the last two years. The majority of the fine (relating to Standard Bank's conduct in the period following March 6, 2010) was calculated on the basis of the new FCA penalty regime, which is considerably more punitive. The FCA's classification of the failings as "level 4" on the regime's five-level scale of seriousness (giving a starting figure of 15 per cent of relevant revenue at Step 2) is clear evidence that it intends to punish AML deficiencies severely, even if these are inadvertent.

4. Failure to provide adequate protection for client money

4.1 BlackRock Investment Management (UK) Limited (Final Notice: September 11, 2012)

4.1.1 Penalty

BlackRock Investment Management (UK) Limited ("BIM") was fined £9,533,100 for breaching Principle 3 and Principle 10 of the FSA's Principles for Businesses through its failure to arrange adequate protection for client money and its failure to organise its affairs responsibly and effectively with adequate risk management systems. BIM was also found to have breached specific requirements set out in the Client Assets Sourcebook ("CASS"). The penalty included a 30 per cent discount for early settlement, without which it would have been £13,618,800.

4.1.2 Summary

BIM's failings took place over the period between October 2006 and March 2010 and involved breaches of regulatory requirements resulting from BlackRock's acquisition of Merrill Lynch Investment Managers Limited (which was subsequently renamed BIM) in September 2006.

Prior to the acquisition, BIM had invested in money market deposits ("MMDs") on behalf of its clients which were made with banks included on a list of approved institutions maintained by BIM. BIM's policies and procedures required it to put in place trust letters with any third-party bank with whom MMDs had been made in order to ensure compliance with the CASS rules. In addition, each transaction had to be entered into the firm's recording system and only banks with whom trust letters had been concluded were allocated codes that could be entered into that system.

However, following the acquisition, BIM's oversight structure was changed so that it became possible for the firm's credit research team to add banks to the list of approved institutions without consulting the compliance department, whereas previously compliance approval had been required. Unaware of this change, the compliance department incorrectly assumed that since it was not receiving information about any amendments to the list, this meant that no new banks were being added. As a result, there was no compliance oversight requiring acknowledgment of trust letters to be put in place. At the same time, BIM's client portfolios were migrated to BlackRock's new transaction recording system, which no longer indicated whether trust letters were in place with the particular bank recorded as holding the MMDs.

BIM received a "Dear Compliance Officer" letter from the FSA in March 2009 highlighting the FSA's concerns that certain firms could be breaching CASS by failing to put in place trust letters with banks holding client money. BIM's compliance department carried out a preliminary review and determined that additional consideration of the classification of MMDs would be required. Eventually, the firm's trust letter arrangements were reviewed in January 2010 and members of compliance concluded that updates were necessary.

The FSA sent a further "Dear CEO" letter to firms in January 2010, again outlining concerns that deficiencies in client money protection remained across the industry. In particular, the letter outlined concerns that regulatory failings often occurred during periods involving acquisitions or restructurings and migration in relation to recording systems.

In February 2010, BIM identified that some trust letters had not been in place after October 2006 as required. The FSA was notified and its subsequent investigation revealed that four banks with whom BIM had deposited MMDs but had not put in place trust letters had not understood that the MMDs represented client money. As a result, there was a risk that, had BIM had become insolvent, those banks might have exercised a right of set-off against the relevant MMDs in respect of any amounts owed to them by BIM, meaning that clients may not have recovered the full amounts due to them or, at the very least, the return of client money may have been subject to undue delays. The FSA found that the average amount of client money without adequate protection during the relevant period was £1.36 billion.

4.1.3 Lessons to be learnt

- Firms should be especially vigilant during periods of change such as mergers or group reconstructions or where new IT or reporting systems are being introduced in order to ensure that regulatory requirements are not inadvertently breached. Firms are expected to plan in advance and to manage their strategic development in a manner which does not compromise their ongoing compliance with applicable rules.
- The situation in the present case could have been avoided, or at least could have been remedied much sooner, if there had been more effective communication between BIM's compliance department and the other areas of the business. The case therefore also acts as a clear reminder of the importance of joined-up thinking across firms and the dangers of a departmental "silo" approach.

4.2 Aberdeen Asset Managers Limited and Aberdeen Fund Management Limited (Final Notice: September 2, 2013)

4.2.1 Penalty

Aberdeen Asset Managers Limited and Aberdeen Fund Management Limited ("Aberdeen") were subject to a combined penalty of £7,192,500 (reduced by 30 per cent from £10,275,000 for early settlement) for beaching Principles 3 and 10 of the Principles for Businesses for failing to ensure that adequate risk management systems were in place and for failing to arrange adequate protection for client money and to comply with specific CASS rules.

4.2.2 Summary

The facts of the case are substantially similar to those of BlackRock Investment Management discussed above, in that between August 2008 and August 2011, Aberdeen failed to ensure that its placement of MMDs with third-party banks for its clients complied with the requirements in CASS by neglecting to obtain the correct trust letter acknowledgements from those institutions. This was the result of its failure to recognise that the MMDs were subject to the client money rules.

Aberdeen received the FSA's "Dear Compliance Officer" letter in March 2009 and was reminded of the requirement for trust letters in May 2009 during an FSA visit. Nonetheless, in January 2010, when Aberdeen received the FSA's "Dear CEO" letter, the firm responded to the FSA by confirming that it *was* in compliance with its obligations under CASS.

It was only in March 2011, when opening MMD accounts with a third-party bank that Aberdeen reconsidered the issue; this was because the third-party bank notified Aberdeen that it considered that the relevant deposits should be treated as client money. In light of this, Aberdeen's senior management discussed the matter between April and May 2011, but still considered that no trust letters were necessary. However, in July 2011 Aberdeen sought the FSA's view due to the firm's difference of opinion with the third-party bank. The FSA responded by informing Aberdeen that the MMDs were subject to the client money rules and that trust letters must be put in place as a matter of urgency.

The FSA/FCA concluded that the average daily amount of client monies at risk through the relevant period was £685,000,000.

4.2.3 Lessons to be learnt

- The FCA identified Aberdeen's failings as particularly serious given that it had received internal warnings about the need for trust letters from certain staff members who were formerly part of Credit Suisse and RBS and had also received two letters from the FSA emphasising the importance of ensuring compliance with the client money rules. In light of these public statements and the numerous enforcement cases on the issue (including the BIM and Aberdeen cases) the FCA is unlikely to have any tolerance for firms which make the same mistakes.
- No client money was ultimately identified as having been lost in either the BlackRock or Aberdeen cases and yet both firms received substantial fines. Firms are being heavily penalised for allowing client money to be subject to any risk of loss, even if that risk is remote and there is no evidence to suggest that the firm was actually at risk of financial failure during the relevant period.

4.3 SEI Investments (Europe) Limited (Final Notice: November 25, 2013)

4.3.1 Penalty

SEI Investments (Europe) Limited ("SEI") was fined £900,200 (reduced by 30 per cent from £1,286,000 for early settlement) for breaching Principle 10 of the Principles for Businesses due to its failure to ensure adequate protection for client money and for failing to comply with the CASS rules.

4.3.2 Summary

SEI provides asset management services to both professional and retail clients and also provides custody services to retail customers. Between November 2007 and October 2012, SEI failed to appreciate that its method of internal client money reconciliation was a non-standard method and therefore failed to provide a written confirmation from its auditors to the FSA that its systems and controls were adequate to enable it to use a method other than the standard one contained in the CASS rules. This resulted from the fact that SEI's professional advisers had themselves failed to identify that a non-standard reconciliation method was being used by the firm until April 2012, at which point SEI employed external consultants to provide the necessary confirmation.

In addition, during the relevant period, SEI recorded shortfalls and excesses in its client money records, but took no steps to make up any shortfall or deal with any excess as required under CASS. It also failed to notify the FSA that these shortfalls or excesses had not been dealt with by the end of the day on

which the relevant client money reconciliations had been run, and therefore that breaches of CASS had occurred. In certain cases, the required reconciliation was not run at all.

The relevant SEI employees who were responsible for oversight of client money were not properly trained on the application of the client money rules until April 2011. SEI's client money recording systems permitted manual adjustment by employees who had not received CASS training and on one occasion, a member of staff amended SEI's client money requirement from £14 million to £932,000 on the assumption that the former amount was unusually large and must therefore have been inaccurate.

As was the case in the BlackRock and Aberdeen cases, SEI received the FSA's "Dear Compliance Officer" letter in March 2009 and its "Dear CEO" letter in January 2010 and provided confirmation of its compliance with the CASS rules in response to the latter.

In November 2011, the FSA made a supervisory visit to SEI to investigate its CASS compliance and a report was issued in March 2012 identifying a number of failings, including that the firm's client money and asset returns ("CMAR") were incomplete and inaccurate and that its staff had insufficient understanding of the relevant client money rules. The FSA requested in June 2012 that SEI provide a skilled persons report on its CASS compliance which subsequently identified similar failures.

In its final notice, the FCA concluded that the average daily amount of client money at risk during the relevant period was approximately £84.3 million.

4.3.3 Lessons to be learnt

- The FCA noted that although SEI's professional advisers had themselves failed to identify that the firm was using a non-standard reconciliation method, primary responsibility for compliance with the applicable rules rests with the firm. Accordingly, a firm will not be able to hide behind inaccurate advice received from a third party in order to explain its failings (although this may be a relevant consideration when the FCA considers the seriousness of any particular breach and potential mitigating factors).
- The FCA again referred to the fact that the financial services industry had been alerted to a number of CASS compliance issues during the period in which SEI's failings occurred and cited this as an aggravating factor. Firms subject to future enforcement action for client money and client asset failings—particularly in respect of matters referred to in the various FSA and FCA public announcements and final notices—should expect to be penalised accordingly.

5. Failure to operate adequate governance, control or risk management systems

5.1 JP Morgan Chase Bank, NA (Final Notice: September 18, 2013)

5.1.1 Penalty

JP Morgan Chase Bank, NA ("JP Morgan") was fined £137,610,000 in September 2013 for breaching a number of the Principles for Businesses. These breaches occurred in connection with losses of US$6.2 billion incurred by the bank's synthetic credit portfolio ("SCP") as a result of trading in complex and high-risk credit default swap ("CDS") indices. These subsequently became known as the "London Whale" trades. The penalty was reduced by 30 per cent from the original amount of £196,586,000 as a result of early settlement.

5.1.2 Summary

The SCP had once been a highly profitable group within JP Morgan, but suffered significant losses in January 2012 following the unexpected bankruptcy of Eastman Kodak and deteriorating trading conditions throughout that month. SCP management proposed a solution to the senior management of the bank's chief investment office ("CIO") which involved buying additional positions against other defaults in the credit market which would be funded by selling credit default protection in respect of a particular investment grade CDS index. The resulting trades increased the SCP's notional exposure to the relevant index by approximately US$20 billion and exposed it to risks of incurring significant losses from small market movements.

In order to control the risk to which JP Morgan was exposed, the bank monitored its value-at-risk ("VaR") measure by setting limits at a firm-wide level and at the level of the CIO, which was responsible for the SCP. When the SCP's increasing numbers of trades caused breaches of the CIO's VaR limit in January 2012, that limit was consistently increased without any consideration of whether the upwards trend in VaR had wider risk implications.

During this period, JP Morgan had been working on a new, less conservative model for calculating VaR in relation to the SCP, which was introduced at the end of January 2012. This caused an immediate 40 per cent decrease in the CIO's reported VaR, but the VaR limit itself was not reduced at the same time, despite the fact that such reduction had originally been planned to reduce the bank's regulatory capital requirements. As a result, the SCP was able to take on additional risk by engaging in new trades, further increasing the size of the portfolio.

At the same time, the bank also used a comprehensive risk measure ("CRM") which was designed to estimate the possible losses on the SCP's trading portfolio over a period of one year in stressed market conditions. When this was calculated in mid-January 2012, the CRM was over US$3.15 billion, but by mid-February 2012, it stood at US$6.3 billion (which, in the event, turned out to be a more or less accurate prediction of the losses that were incurred). However, the CIO's risk management function initially rejected this measure as being based on a misunderstanding of the portfolio and seemed unwilling to consider whether the CRM had in fact correctly forecast a massive increase in risk in the SCP portfolio.

The SCP continued to incur significant trading losses throughout February and March 2012, with losses standing at over US$580 million by the end of the period, while the notional size of the SCP's portfolio stood at US$157 billion at the same date. As a result of press coverage, the group's trading position deteriorated further still.

During this period, the traders in the SCP adopted aggressive mark-to-market techniques in order to conceal their losses from the senior management of the CIO, using (as encouraged by SCP management) their own judgment to value their trading positions, rather than following guidance in US GAAP. Valuations used by the traders began to diverge significantly from the mid-market point in the bid/ask spread. The CIO's valuation control group failed to challenge these valuation estimates and was persuaded by the traders to alter its own independent valuations.

In March 2012, SCP management instructed the traders not to recognise any mark-to-market losses which could not be attributed to a specific market event, resulting in deliberate mis-marking of assets to conceal losses. By April 2012, the trading situation had become so desperate that the SCP's traders would set a desired overall profit and loss figure and "reverse-engineer" their valuations to achieve the desired result so as to report more favourable numbers to the bank's senior management. The FCA subsequently concluded that the valuation processes and risk limit monitoring in place within the bank were inadequate and ineffective.

At around the same time, JP Morgan's internal audit function began to investigate concerns that the SCP's valuations might be inaccurate. This investigation revealed that at the end of March 2012, the SCP's positions had been mis-valued by over US$300 million. Despite this, the bank's management filed a report of its first quarter net income with the US Securities and Exchange Commission on May 10, 2012, which assumed that the valuation of the SCP's positions had been made in accordance with US GAAP. As a result, JP Morgan was subsequently required to restate its earnings in July 2012 when senior management became aware of the true extent of the problem.

During a supervisory meeting with the FSA in March 2012, the bank's representatives did not inform the FSA of the very large notional exposure of the SCP and the mounting trading losses which were already massively exceeding estimates that had originally been provided to the regulator. In addition, the bank did not reveal that the SCP had breached its risk limits in January 2012 and that the subsequent reduction in the VaR measure was primarily due to the revised calculation methodology, rather than due to a reduction in trading positions.

During a subsequent discussion with the FCA in April 2012 which followed the publication of a *Wall Street Journal* article on the SCP's exposures, JP Morgan's representatives failed to inform the FCA that losses had continued to rise and instead confirmed that there had been no material changes in the SCP's

position. The FCA subsequently concluded that the bank's statements had been deliberately misleading and designed to provide false reassurance. Despite the FCA warning that it did not expect to receive any further surprises in connection with the SCP, the bank did not inform the regulator at two subsequent meetings in May or June 2012 of the fact that it had identified major flaws in the SCP's valuation of its positions. That information was only revealed in early July 2012, shortly before JP Morgan's earnings restatement. The FCA's investigation found that the bank had failed to be open and cooperative, as required by the FCA's rules and had created a risk which represented a potential threat to the UK financial system generally.

5.1.3 Lessons to be learnt

- While JP Morgan's failings were clearly egregious and the consequences enormous in terms of their financial implications, the case nonetheless contains some lessons for firms of all sizes.
- The failure of the CIO's valuation group adequately to challenge the estimates of the SCP's traders highlights the serious consequences that can result when individuals in oversight functions are insufficiently assertive or lack sufficient authority or experience to challenge other parts of the business.
- Similarly, the approval by the bank's senior management of its quarterly net income report in May 2012 appears to have resulted from the fact that key issues were not escalated to board level. This emphasises the importance of establishing and maintaining clear lines of communication within all firms to ensure that senior management understand key issues within the business.
- The FCA is prepared to impose fines which are beginning to rival those applied by US regulators where it considers that the firm's failings have been particularly serious or where the stability of the wider financial system has been put at risk. Firms should be left in no doubt that the general trend is for the FCA to push for significantly larger fines than have been levied in the past.
- In a deteriorating situation, it is likely to aggravate the FCA (and possibly the size of any future fine) to fail to report critical information of which the regulator would reasonably expect notice.

5.2 UBS AG (Final Notice: November 25, 2012)

5.2.1 Penalty

UBS AG ("UBS") was fined £29,700,000 for a breach of Principles 2 and 3 of the Principles for Businesses through its failure to conduct business from its London branch with due care, skill and diligence and failure to organise and control its business effectively with adequate risk management systems. The fine was reduced by 30 per cent from £42,400,000 for early settlement.

5.2.2 Summary

In September 2011, UBS became aware that one of the traders on its exchange-traded funds desk, Kweku Adoboli, had engaged in a large number of unauthorised trades which it subsequently had to close out with a resulting loss of US$2.3 billion. In order to conceal the trades from his managers, Mr Adoboli had input a number of fictitious trades into UBS's systems which gave the illusion that his trading positions were offset by other orders, when in reality those hedging trades had no external counterparties and therefore no economic effect. In addition, he had deliberately booked real external trades into the systems late in order to manipulate the reported profit and loss figures for the desk.

UBS conducted an internal investigation which concluded that the deception had been possible because there was insufficient supervision of activities in UBS's front office and insufficient coordination with the back office, which also did not understand many of the desk's trading activities. The desk's trading risk limits had been breached on a number of occasions, but no action had been taken by senior management and there had been no investigation into the causes of the breaches. While some anomalies in Mr Adoboli's booking of trades had been identified, he had not been sufficiently challenged by his manager in relation to the issue and his explanations were accepted at face value. In addition, the computer system designed to generate reports on the desk's activities also suffered from flaws; for instance, the report giving details of cancelled, amended or late trades was still being delivered to a former supervisor of the

desk, even though he no longer had any responsibility for its activities. Certain other reports were only sent to the desk's traders, rather than the desk's supervisory management team. This issue was identified by UBS's internal audit function during the relevant period, but as it was only graded as a "medium risk" issue, it was not escalated to UBS's board or audit committee for further consideration.

UBS's finance division had the task of validating the profit and loss reported by the desk by comparing this with its underlying trading positions. In appropriate circumstances, the division could suspend or adjust profit or loss calculations in order to reflect errors in booking trades or delays in pricing trading positions. In August 2011, Mr Adoboli was able to request profit and loss suspensions valued at approximately US$1.6 billion without these being challenged or escalated internally by the junior member of staff responsible.

The FCA concluded that generally there was a culture of back office staff attempting to facilitate trades and increase efficiency for front office traders within UBS, rather than a suitable compliance culture where traders' operations were appropriately supervised and their views and requests were adequately challenged.

Mr Adoboli was subsequently prosecuted for fraud by abuse of position and was found guilty in November 2012, receiving a seven-year custodial sentence. It was reported in July 2013 that his application for permission to appeal that sentence had been dismissed.

5.2.3 Lessons to be learnt

- The UBS case should be treated as a cautionary tale of the risks of compliance officers and supervisors within firms becoming too deal-focused, rather than seeking to challenge and verify assumptions and explanations put forward by other staff. While it is always easy to identify issues with the benefit of hindsight, the independent investigation in the case identified facts which ought to have raised concerns within the bank at the time, but which received insufficient attention due to a desire to continue supporting the activities of its traders.
- A failure to ensure that there is a culture of critical oversight and challenge can cost a firm dearly.

5.3 The Royal Bank of Scotland Plc and the Royal Bank of Scotland NV (Final Notice: July 16, 2013)

5.3.1 Penalty

The Royal Bank of Scotland Plc and the Royal Bank of Scotland NV (together, "RBS") were fined £5,620,300 (reduced by 30 per cent from the original amount of £8,029,100 for early settlement) for a breach of Principle 3 of the Principles for Businesses by failing to have adequate systems and controls for transaction reporting and for breaching specific reporting requirements in the FCA Supervision Manual ("SUP").

5.3.2 Summary

Between November 2007 and February 2013, RBS submitted inaccurate reports of approximately 44.8 million transactions to the FSA and failed to report approximately 804,000 additional transactions. The FCA's final notice concluded that the majority of these errors were the result of the use of an incorrect reference code used to identify the counterparties to each transaction, although certain reports exhibited other inaccuracies, including incorrect timestamps, incorrect prices, duplicate reporting or inaccurate identification of the relevant instruments being traded.

In addition, the FCA concluded that responsibility for transaction reporting was not clearly defined within RBS, with insufficient attention devoted to written reporting procedures and oversight of the reporting process. These problems were largely the result of the difficulty in integrating Royal Bank of Scotland Plc's systems with those of ABN Amro (which subsequently became Royal Bank of Scotland NV) following the takeover of the latter by the former.

Although the FCA noted that steps were taken to improve reporting systems from 2009 onwards, it nonetheless considered that RBS's failures were serious as transaction reports are an essential part of the regulator's attempts to monitor potential insider trading and market abuse in order to ensure market integrity.

5.3.3 Lessons to be learnt

- The FCA final notice is explicit in acknowledging that part of the reason for the penalty was to demonstrate to other firms the importance of ensuring that transaction reporting is accurate. Firms may wish to use the tool provided on the FCA website to sample their transaction reports and check their accuracy in order to ensure that they are not repeating errors made in the RBS case.
- The case is one in a long line of reporting failures published by the regulator. It illustrates that the FCA expects regulatory standards to be maintained at all times, including during periods involving major change such as mergers or corporate reconstructions. Firms will therefore need to engage in advance planning to ensure that suitable transitional systems are in place to ensure compliance with FCA rules during any such period.

6. Mis-selling and inappropriate sales incentives

6.1 Lloyds TSB Bank Plc and Bank of Scotland Plc (Final Notice: December 10, 2013)

6.1.1 Penalty

Lloyds TSB Bank Plc and Bank of Scotland Plc (together, "Lloyds") were subject to a combined £28,038,800 penalty for breach of Principle 3 of the Principles for Businesses in failing to have adequate systems to control the risks generated by their employee incentive structures. The fine was reduced by 20 per cent due to early settlement, without which it would have been £35,048,500.

6.1.2 Summary

Between January 2010 and March 2012, Lloyds was involved in the sale of insurance products, including both protection and investment policies, to customers through its bank branches. Lloyds's customer sales advisers were remunerated on the basis of incentive plans which involved the payment of variable base salaries and individual and team bonuses, as well as ad hoc payments and prizes, determined in accordance with sales targets. While the precise policies that had been adopted varied, their essential features were similar.

Basic salaries fell into one of multiple tiers: the difference between the lowest and higher tiers in certain cases could be worth over £50,000 per annum. Advisers who reached their individual sales targets across a number of consecutive periods could move up tiers and be paid a higher basic rate, while advisers who consistently failed to meet their targets could be demoted. The FCA concluded that this may have placed considerable pressure on sales advisers who were close to being demoted or promoted, which generated consequential increased risks of mis-selling to customers.

Advisers could also qualify for individual and team bonuses (representing up to 15 per cent of their basic monthly salary) if they achieved their sales targets over a three-month period, provided that they also satisfied a "risk gateway" requirement. An additional 20 per cent bonus would be payable if the relevant sales satisfied a particular product mix requirement. The FCA found that this structure created increased risks of mis-selling in relation to the marginal sales that would tip sales advisers over their individual target levels, because an adviser who only achieved 99 per cent of his target would usually receive no bonus at all. In addition, the product mix requirement and the use of increased sales points for certain product types created a strong risk of product bias, encouraging sales advisers to sell certain product types that might be less suitable for customers in order to maximise their own incentive payments.

Individual customer sales files were selected for manual checking by Lloyds's verification teams through the use of a "data mining" tool which identified certain product and customer characteristics. This tool allocated a risk rating to each customer file and selected files where a certain risk rating was exceeded. At the start of the relevant period covered in the enforcement action, there was no requirement that each sales adviser's files be subject to a minimum number of checks. As a result, certain advisers had none of their sales selected for scrutiny in some months. This was remedied in June 2011, after which all sales advisers had to have at least one file subjected to checks each month.

The FCA found that Lloyds did not structure these checks so as to focus on the higher-risk attributes of its sales incentivisation schemes—for example, by subjecting advisers close to the salary tier demotion or promotion thresholds to additional checks, or by checking files of those advisers who consistently hit their individual bonus targets.

The "risk gateway" score assigned to individual sales advisers by the verification team was designed to ensure that those advisers provided the correct information to customers and did not engage in mis-selling. The score was generated by allocating scores to 10 key performance indicators, which included inappropriate advice or incomplete or incorrect customer documentation identified through the analysis of customer files selected for review, as well as the number of complaints that had been upheld against the particular employee over a rolling period of several months. The higher the value allocated, the greater the risk posed by the adviser in that area. However, the model used meant that it was possible for sales advisers to achieve a pass mark on the risk gateway even if they achieved the maximum possible risk scores in relation to their customer sales advice. The FCA identified hundreds of examples of advisers receiving bonus payments while having given inappropriate sales advice during the relevant month, including one case where an employee had seven instances of inappropriate sales advice identified in the relevant month and still received a bonus payment.

6.1.3 Lessons to be learnt

- Firms using volume-based sales incentivisation plans should pay particular attention to this case, which demonstrates the potential mis-selling risks that can result where commission payments are not well structured and appropriately scrutinised. The increasing examples of enforcement action in this area demonstrate the FCA's growing intolerance for firms who are unable to ensure that customers are not exposed to unacceptable risks of mis-selling.
- Lloyds's failure involved two key aspects. First, the design of the remuneration system was defective through its creation of high-risk, all-or-nothing "pinch points" where advisers were close to achieving their targets or were facing the prospect of demotion. Secondly, the oversight system for sales advisers was itself flawed, being insufficiently focused on the major risks inherent in employees' activities and permitting advisers who repeatedly mis-sold products to continue to earn rewards. Firms need to identify the key areas of risk in their sales remuneration structures and either remove these by revising their policies or otherwise put in place compliance controls which will demonstrate to the FCA that those risks are effectively mitigated.

6.2 Card Protection Plan Limited (Final Notice: November 14, 2012)

6.2.1 Penalty

Card Protection Plan Limited ("CPP") was fined £10.5 million (reduced by 30 per cent from £15 million for early settlement) for breaching Principles 3, 6 and 7 of the Principles for Businesses through its failure to treat customers fairly and to communicate with those customers in a manner that was clear, fair and not misleading and through its failure to organise its compliance and governance controls effectively.

6.2.2 Summary

CPP was an insurance intermediary which sold credit card protection insurance and identity protection insurance during the relevant period, which covered January 2005 to March 2011. During this time, CPP sold over 4.4 million policies and received over £188 million in payments from customers, although part of that amount was subsequently paid to other entities by way of introduction fees.

Certain aspects of these policies purported to cover losses for which the policyholder would not in any event have been liable. For example, CPP's card protection policy claimed to protect customers from losses of between £50,000 and £100,000 (depending on the policy wording used over the period) for unauthorised transactions on their credit cards after the issuer had been notified that the card had been lost or stolen. Since customers are never liable for transactions made on a card after the issuer has been notified of such circumstances, they derived no benefit from this element of the product. CPP's sales representatives continued to market the product on this basis even after the FSA had notified the firm in 2008 following a supervisory visit that this practice was unacceptable.

CPP's salespersons used sales scripts which encouraged them to emphasise concerns about identity theft to customers and contained misleading facts and figures. The scripts also did not include sufficient information about what was included in and excluded from the cover offered. CPP purported to be selling its insurance products on a non-advised basis and therefore its sales representatives should have limited themselves to providing information about the relevant policies without making any recommendations. Nonetheless, in order to increase sales, CPP instructed its employees to question customer objections in a manner which went beyond merely providing facts about features of the products.

The FSA was also critical of CPP's policy renewal process, whereby customers whose policies were expiring would be sent documents indicating that the policy would be automatically renewed but which did not clearly state the steps that the customer needed to take in order to cancel the insurance. In some cases, customers never received the notification of renewal because CPP's customer address list was out of date, meaning that their policies were automatically renewed without their knowledge. Even where CPP became aware that certain customers might have moved property and therefore had not received notice of the renewal, it continued to effect renewals and to take payments from those individuals.

CPP's terms and conditions also contained a clause permitting CPP to take payment from a credit or debit card other than that originally used for payment. The FSA found that this term was likely to be unfair, because CPP received information about customers' other payment cards ostensibly to facilitate a feature of its card protection policies whereby a customer could make one telephone call to CPP to cancel all his relevant cards. CPP would also use that information to recover payment where a customer had deliberately cancelled a direct debit to CPP. The use of that information to recover money without the express consent of the customer had the clear potential to result in consumer detriment.

6.2.3 Lessons to be learnt

- Firms selling products on a non-advised basis must ensure that they do not inadvertently cross the line into providing advice or recommendations. While CPP's sales representatives did not consider that they were advising customers, their selling techniques (particularly when seeking to persuade customers who had initially refused to buy policies to do so) went beyond merely providing product information and therefore the FSA found that sales agents should have been complying with additional conduct of business rules applicable to advised sales.
- CPP's sales scripts and products literature contained a number of unsubstantiated facts and figures which the FSA found should not have been used to market its products, while certain other statements made by sales representatives were either false or misleading. Firms should ensure that the accuracy of any statements made during the sales process has been properly verified and is checked regularly.

6.3 Swinton Group Limited (Final Notice: July 16, 2013)

6.3.1 Penalty

Swinton Group Limited ("Swinton") was fined £7,380,400 (reduced by 30 per cent from £10,543,500 due to early settlement) for breaching Principles 3, 6 and 7 of the Principles for Businesses through its telephone sales of monthly insurance policies. Swinton also set aside £11 million to fund redress measures.

6.3.2 Summary

Swinton is a general insurance intermediary which is involved in the sale of insurance products including vehicle, home, travel and life insurance, to retail customers. Between April 2010 and April 2012, Swinton was engaged in the business of selling monthly add-on insurance policies to customers who had purchased core insurance policies from either Swinton or other brokers. These add-on products offered cover for adverse events such as accidental physical injury, vehicle breakdown or emergency home repairs and generated almost £93 million in income for Swinton during the relevant period.

Swinton sold the relevant products on a non-advised basis, both through its face-to-face high street branches and through telephone sales, with its sales representatives using pre-prepared sales scripts.

The FCA found that these scripts suffered from a number of defects, including that employees were not instructed to clarify that the monthly add-on policies were optional extras to the core products and could therefore be declined by customers. It was only after the optional policies had been sold that customers received information which stated that these were separate products.

In addition, while the sales scripts did instruct sales representatives briefly to describe the limitations and exclusions applicable to the relevant policy, they did not prompt employees to seek customer consent to proceed with the sale of the product on the basis of only that limited information. When the FCA reviewed Swinton's sales calls, it found that in the vast majority of cases sampled, the salesperson failed entirely to disclose information about applicable exclusions or limitations prior to sale of the policy.

The add-on products offered by Swinton involved different levels of cover, but the sales scripts did not instruct the sales representative to inform the customer of the available levels and their prices. Instead, it directed the salesperson to ask a set of questions which effectively directed the customer towards the highest (and most expensive) form of cover available. Customers were also offered initial three-month periods of free cover under the policies and were told that they could cancel the policy at any time during that period. However, the sales script did not instruct Swinton's employees to explain what would happen if the policy was not cancelled at the end of the three months or the steps that the customer would need to take in order to effect a cancellation within that period.

More generally, in its review of Swinton's telephone sales, the FCA found that in half of the sales sampled, the salesperson spoke too quickly, especially during the parts of the call where limitations, exclusions and cancellation rights were being discussed. Some of the information provided was entirely inaudible. In a number of cases, the salesperson also failed to correct customers when it became clear that the customer had misunderstood information that had been provided.

Swinton monitored sales calls during the relevant period, but primarily focused on the sales of core insurance products and did not focus on aspects such as whether exclusions and limitations had been properly explained, whether the sales representative had spoken clearly and at an appropriate speed or whether there had been any checks that the customer had understood the relevant information prior to the sale being concluded.

Swinton also deliberately re-designed the terms of its vehicle breakdown insurance in order to allow it to sell duplicate cover to customers by removing a "duplicate cover" clause. This was despite the fact that Swinton was aware that those customers would receive no additional benefit and would be paying for two similar policies.

During the relevant period, Swinton operated an employee sales incentive system involving the allocation of a certain percentage of income from a branch's sales target to be divided between the management and sales representatives within that branch. In addition, individual employees could receive incentive payments of up to 30 per cent of their monthly salary if they met their individual monthly sales targets. The incentives available for the add-on monthly policies were greater than those available for the core products, resulting in a strong product bias in some branches towards selling the optional products. Individual sales calls were monitored and bonuses could be reduced by 25 per cent for non-compliant sales. However, a bonus would still be available for a non-compliant sale, albeit at a reduced rate, and therefore this did not operate as an effective incentive against mis-selling.

6.3.3 Lessons to be learnt

- The case acts as another reminder of the need to ensure that customers are provided with all necessary information in a clear manner, even where products are being sold on a non-advised basis. Firms using pre-set scripts should ensure that these are subject to appropriate periodic review and that sales advisers are clearly directed to provide key information to customers at appropriate points.
- As with the Lloyds case, firms need to be mindful of the mis-selling risks created by inappropriately structured sales incentivisation policies and should assess whether risk mitigation steps are adequately designed and applied in order to address those risks.

7. Failure to disclose information of which the regulator would reasonably expect notice

7.1 The Prudential Assurance Company Limited, Prudential Plc and Cheick Tidjane Thiam (Final Notices: March 27, 2013)

7.1.1 Penalty

The Prudential Assurance Company Limited ("Prudential") was fined £16 million for a breach of Principle 11 of the Principles for Businesses by failing to disclose appropriately information of which the FSA would reasonably expect notice in connection with a proposed corporate acquisition.

Prudential Plc was also fined £14 million for breach of the Listing Principles through its failure to be open and cooperative with the FSA (acting as the UK Listing Authority) in accordance with its obligations as a company listed on the London Stock Exchange.

The FSA also published a statement of censure against Mr Thiam, Prudential's chief executive officer and chairman, for being knowingly concerned in Prudential's breach of Principle 11.

7.1.2 Summary

In December 2009, Prudential was approached by AIG in connection with a possible acquisition of AIG's subsidiary, AIA, which carried on the group's Asian operations. In January 2010, Prudential's board of directors was briefed on the potential transaction and determined that a key risk in relation to the proposed deal would be a premature leak to the market of Prudential's interest in AIA. The FSA was identified as one potential source of leaked information and the board determined that it would attempt to manage Prudential's obligations to the FSA in a manner which reduced the risk of any leak occurring.

On February 1, 2010, Credit Suisse, which was acting as one of Prudential's advisers in connection with the acquisition, informed Prudential that the FCA would need to be notified of the proposal. It was expected that Prudential would announce the transaction to the market on February 15, 2010 and Credit Suisse advised that disclosure of the details should be made to the FSA by February 3 at the latest. Despite this advice, Prudential considered that an approach to the FSA was not necessary at that time because of continuing uncertainty about whether the transaction would actually occur.

On February 5, 2010, Mr Thiam met with the CEO of AIG to provide details of an indicative proposal from Prudential's board which included a proposed price range for the purchase of AIA, financing proposals and the acquisition structure. By February 11, following further discussions with the US Treasury and AIG, Mr Thiam reported to the Prudential board that the prospects for the transaction had improved considerably. However, when Mr Thiam and another director of Prudential met with the FSA's supervisory team the following day, they did not disclose the proposed deal, notwithstanding that the FSA asked a number of questions about Prudential's intentions in the Asian market and its future financing plans.

By February 15, 2010, draft sale and purchase documents were being negotiated and Prudential's largest shareholder had been briefed on the transaction and had indicated its support, but still the FSA was not informed. A revised transaction timetable was drawn up on February 26 which proposed informing the FSA of the deal on March 1, 2010, the same day that the acquisition documentation was due to be signed. Prudential eventually approached the FSA in the afternoon of February 27, but only as a result of the publication of rumours about the transaction in the media that morning.

Although the purchase agreement was signed on March 1, 2010, it was conditional upon FSA approval. The FSA's supervisory team commenced an analysis of the effects of the transaction on Prudential's business and it was agreed that the prospectus for Prudential's proposed rights issue (which was necessary to fund part of the acquisition) would not be published until the FSA confirmed that it would not object to the deal. Due to the complexity of the proposals, the FSA had not completed its analysis by the original scheduled publication date for the prospectus on May 5, 2010 and publication was eventually delayed by two weeks until May 18.

In the event, the transaction did not proceed for commercial reasons.

7.1.3 Lessons to be learnt

- The case serves as a salutary reminder that the FCA may pursue action for a breach of Principle alone.
- The FSA's final notice is replete with statements emphasising that it expected Prudential to disclose information about the proposed deal "at the earliest opportunity". Early disclosure was all the more important given the enormous scale of the transaction, which was potentially worth over US$30 billion, and the length of time it would take to assess the regulatory impact. While Prudential had argued that the guidance in the FSA Handbook requiring disclosure "at the earliest opportunity" was vague and could not reasonably form the basis of enforcement action, the FSA rejected that contention. The requirement meant exactly what it said—i.e. once a firm became aware of information relating to its business of which the FSA would reasonably expect notice, appropriate disclosure was required at that point. The FSA concluded that it should have been objectively obvious to Prudential that early disclosure of the proposals was required in order to permit the FSA to exercise its supervisory functions properly, both because of the length of time that would be necessary to assess the plans and because the matter could have a potential impact on the stability of and confidence in the UK financial system generally.
- Mr Thiam argued that the statement of censure against him was unmerited and that he could only be personally liable if his conduct was "so obviously wrong ... that it was clearly outside the bounds of reasonableness". In addition, he contended that it was inconsistent with previous statements made by the FSA in its report in December 2011 on the failure of RBS which indicated that the FSA would only pursue individuals where it had strong evidence of their personal culpability. The FSA disagreed, concluding that the RBS report was not an FSA statement of policy and that its enforcement action was consistent with its policies as described in the Enforcement Guide and its Decision Procedure and Penalties Manual. Mr Thiam's formulation of the test to be applied was simply another way of stating that his conduct needed to be below the standards of what was reasonable in all the circumstances at the time. In the opinion of the FSA, Mr Thiam's individual behaviour had fallen below those standards.
- The FSA also rejected Mr Thiam's arguments that there were no grounds for finding him personally responsible, concluding that his own sensitivity regarding the possibility of a leak from the FSA was a significant cause of the failure to notify the FSA of the transaction at an early stage. It was not a defence to argue that other members of the Prudential board had been equally involved, as that did not make Mr Thiam any less responsible as an individual.
- The FSA was clear in its final notices against both Prudential and Mr Thiam that the enforcement action was motivated by a strong desire to achieve a deterrent effect against other firms and their senior management. Firms should expect that the FCA will adopt a similar approach in the future. In particular, directors and senior managers at firms should take note of the fact that collective decision making will not necessarily protect them from being personally liable if those decisions are found to be unreasonable in the circumstances—indeed, in appropriate cases, that may simply render all participants in the decision equally responsible.

8. Failure to meet required standards of fitness and propriety

8.1 David Hobbs (Court of Appeal Judgment: July 29, 2013; Second Upper Tribunal Decision: December 13, 2013; Final Notice: February 14, 2014)

8.1.1 Penalty

Mr Hobbs was prohibited from performing any function in relation to any regulated activity due to his failure to meet required standards of fitness and propriety after the Upper Tribunal concluded that he had lied to the FSA and to the Tribunal in connection with an action for alleged market abuse.

8.1.2 Summary

In July 2010, the FSA sent Mr Hobbs a decision notice which alleged that he had engaged in market abuse in 2007 while employed as a proprietary trader specialising in LIFFE-traded coffee futures and related derivatives at Mizuho International Plc. The substance of the allegations related to an order

placed by Mr Hobbs seconds before the market closed on August 15, 2007 which had the effect of increasing the price of certain coffee futures above a specified exercise price for put and call options. The FSA contended that the purpose of the order was to give a misleading impression to the market in order to manipulate prices for Mr Hobbs's own profit, although in the event no profit was actually made. In addition, the FSA's notice also found that Mr Hobbs had lied to the FSA during its investigation into his conduct and therefore did not meet the standards of fitness and propriety required to remain an FSA approved person.

Mr Hobbs referred that decision to the Upper Tribunal which concluded that Mr Hobbs's trades had been effected for legitimate reasons and conformed with accepted practices in the coffee futures market. However, the Tribunal also concluded that Mr Hobbs had given unsatisfactory evidence during its proceedings and had been untruthful when seeking to explain the reasons behind the relevant coffee trades. Nonetheless, since it had rejected the FSA's allegations of market abuse, the Tribunal directed that the FSA should take no action against Mr Hobbs.

The FSA referred the Tribunal's decision to the Court of Appeal, which found in July 2013 (by which time the FSA had become the FCA) that the Tribunal had erred in law in failing to consider whether, even if Mr Hobbs had not been guilty of market abuse, his conduct in lying to the FSA and subsequently to the Tribunal meant that he was no longer a fit and proper person. The Tribunal had incorrectly characterised the FSA's entire case as involving an allegation of dishonesty based solely on the alleged market abuse, whereas in reality that was only one of the grounds advanced. The FSA's decision notice had set out as a separate ground its allegation that Mr Hobbs was no longer a fit and proper person due to misleading explanations that he had provided to the FSA during the course of its investigation and it was incumbent on the Tribunal to consider that issue separately (particularly in light of its own findings of fact that Mr Hobbs had lied), even when it concluded that the market abuse allegations had not been proven. The matter was remitted to the Tribunal to consider the issue again.

In November 2013, the Upper Tribunal ruled that Mr Hobbs should be the subject of a prohibition order in light of its findings that he had lied to both the FSA and the original Tribunal in the case.

8.1.3 Lessons to be learnt

The case acts a reminder of the potentially serious consequences of attempting to mislead the FCA and should serve as a warning of the lengths to which the FCA will go to pursue individuals whom it considers are not fit and proper persons to act in the financial markets. It is not necessary that an individual's deception be linked to any other misconduct in order to justify enforcement action.

8.2 Michael Conway (Final Notice: December 16, 2013)

8.2.1 Penalty

Mr Conway was prohibited from performing any function in relation to any regulated activity due to his failure to meet required standards of fitness and propriety while acting as director of a corporate trustee of certain occupational pension schemes ("OPSs").

8.2.2 Summary

Mr Conway was the sole shareholder and director of CBW Pensions Forensics Ltd ("CBW"), which acted as a corporate trustee to six OPSs between June 2007 and July 2011. He was also a joint director of Staverton Wealth Management Limited ("Staverton") and held 40 per cent of the shares in that company.

CBW was not authorised by the FSA during the relevant period to conduct any regulated activities and therefore in February 2008, Mr Conway appointed a corporate independent financial adviser ("IFA") to arrange and manage the investments of the OPSs. The individual at the IFA who advised CBW in relation to the OPS investments, Mr Powell, had previously worked at Staverton several years before. The IFA was paid for its investment advice through an agreement with CPW that permitted it to retain commission paid by providers of the investment products in which the OPSs invested their assets. These commission payments were usually paid out of the OPSs' investments and therefore the schemes were effectively funding the remuneration received by the IFA.

In May 2007, Mr Conway had concluded an introducer agreement on his own behalf and that of Staverton with the IFA under which the IFA would pay each of them a specified percentage of the commission it received in respect of any business they introduced to the IFA. The effect of this arrangement was that Mr Conway, both directly and through his part ownership of Staverton, subsequently received a share of the commission paid by the OPSs to the IFA for the services it provided to the schemes. The FCA concluded that these payments amounted to over £2.1 million and that the relevant arrangements were never disclosed to the OPSs.

The FCA and the Pensions Regulator found that Mr Conway's status as a direct and indirect beneficiary of the commission arrangements represented a conflict of interest with his role as the director of the corporate trustee of the OPSs. Mr Conway was effectively incentivised to encourage the OPSs to churn investments because each time commission was paid by a new investment product provider this generated income for the IFA which was subsequently shared with Mr Conway and Staverton. The FCA's investigation also concluded that Mr Conway had created a sham introducer arrangement between the IFA and a third party in 2008 which was designed to conceal a payment of over £50,000 to him.

In order to discharge its obligations as a trustee under pensions legislation, CBW received reports prepared by the IFA which recommended investments for the OPSs. In March 2010, Mr Conway emailed Mr Powell and instructed him to advise the OPSs to disinvest £8 million of their assets in order to facilitate CBW re-investing that amount in a particular investment fund. Mr Conway threatened to appoint a new IFA if Mr Powell did not agree. Mr Powell advised that the proposed investment would create an over-concentration in a single high-risk and illiquid asset class, but ultimately prepared reports for the OPSs recommending investing in the relevant fund. The FCA concluded that this was an exercise of improper influence by Mr Conway over Mr Powell which breached the requirement for independent advice under the Pensions Act 1995.

8.2.3 Lessons to be learnt

- A prohibition order was made against Mr Conway notwithstanding that CBW was not carrying on any regulated activities and Mr Conway was not an approved person. The case illustrates that the FCA will seek to obtain pre-emptive bans against individuals who become implicated in any dishonesty or impropriety in order to prevent them from taking up future roles in the financial services industry.
- Recent cases suggest that individuals will not escape a prohibition order on the basis that they are willing to give an undertaking not to work in the financial services industry in the future. In such circumstances, the FCA will usually seek to impose a prohibition order (which will therefore remain on an individual's record), but may persuaded to vary the terms of that order at a future date if sufficient justification can be demonstrated by the relevant person.
- As part of its focus on increasing standards across the industry, the FCA has indicated a particular interest in looking at how firms and individuals manage conflicts of interest. Firms need to be able to demonstrate that they have identified and managed conflicts or have otherwise disclosed these to their clients where appropriate.

Issue 117—Payments and PSD2

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Coverage:

- Overview of current payments regulation in the UK - Payment Services Regulations, Bank Conduct of Business Sourcebook (BCOBs);
- Changes to payments regulation being proposed by the second Payment Services Directive;
- Introduction of the new Payment Systems Regulator following the Financial Services (Banking Reform) Act 2013;
- Regulation of the Single Euro Payments Area (SEPA);
- Proposed Payment Accounts Directive on comparability of fees, account switching and access to basic bank accounts;
- e-money regulation;
- Innovation in payments and mobile money.

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