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, enforcement action and disciplinary proceedings. The Group has extensive experience in advising individuals and companies in relation to both internal and external investigations and enforcement proceedings by the FSA, the Serious Fraud Office, the London Stock Exchange, HMRC and non-UK regulators (including the SEC). The Group has advised in respect of a wide range of alleged misdemeanours, including manipulation of trading records, client money failings, mismarking, market abuse, systems and controls failings, loss of customer details, mis-selling, money laundering failings, breaches of the requirements regarding the marketing of unregulated collective investment schemes and others. It has also challenged FSA "minded to refuse" notices in connection with approved persons applications.

The co-heads of the Regulatory Investigations Group are:

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

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Stephen Paget-Brown who is a senior partner in the Litigation Department.

FSA ENFORCEMENT ACTION—THEMES AND TRENDS

1. Introduction

It is likely that by this time next year, subject to any delays in the parliamentary process, the FSA will have ceased to exist and the government's so-called "twin peaks" model of regulation will be established with two frontline regulators in place, the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA"). The PRA will be responsible for the prudential supervision of banks, building societies, insurers, friendly societies, credit unions, Lloyd's of London and certain significant investment firms. The FCA will be responsible for the prudential supervision of all other firms and for conduct of business regulation of all firms (including those prudentially supervised by the PRA). So how much change is this likely to involve as regards regulatory enforcement?

The FCA will take over the FSA's current enforcement responsibilities, including those in relation to prosecution of criminal and civil market abuse cases, and will do so with even more enhanced statutory powers than those the FSA has enjoyed until now. Although there is much that is still unclear as to how the two regulators will work together in practice as regards the day-to-day supervision of dual-regulated firms, in terms of enforcement action, at least, we can probably expect a significant degree of

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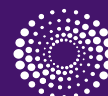

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continuity as the baton passes from the FSA to the FCA. In other words, many of the FSA's existing enforcement priorities and preoccupations are likely to become those of the FCA in seeking to discharge its functions in accordance with its statutory objectives.

For instance, it is clear that the FCA intends to pursue the policy of credible deterrence as vigorously as (if not more so than) the FSA has done. This will mean even higher penalties against high-profile targets, both firms and individuals. There has been a continuing trend of imposing significant, exemplary sanctions against senior individuals in the market, particularly in the context of market conduct cases. It should be noted that this does not just involve the imposition of heavy fines: the FSA has shown that it will use its powers to ban people from the industry in certain circumstances and will seek custodial sentences as regards criminal insider dealing prosecutions. So, the loss of one's livelihood—even liberty—will continue to be at stake. As the FSA said in its final Business Plan (2012/13) published in March 2012:

> "As part of our credible deterrence strategy, we believe that actions against individuals are more likely to lead to a change in behaviour and increase standards of conduct in the industry, so we will continue to focus our efforts in this area in 2012/13."

While some of these cases against individuals so far have related to what, on the facts, appear to be patently culpable behaviour (e.g. Rameshkumar Goenka was fined over US$9.5 million for a clear case of deliberate market manipulation), others (such as the fines against Andrew Osborne, Alexander Ten-Holter and Caspar Agnew for their involvement in the Punch Taverns/Greenlight cases) are likely to send shivers down the spine of any senior person working in the highly pressurised financial services industry. The message from the FSA is clear: the highest standards are expected of those within the regulated sector. Errors of judgment made in the heat of the moment may fall to be punished, even where there is nothing particularly deliberate or reckless about the conduct, and even if no personal benefit is gained. These may all be factors that may be taken into account by the regulator in mitigating the ultimate penalty, but they should not be misconstrued as defences. A slip in a single telephone call or e-mail could result in serious repercussions.

As in previous years, the FSA has shown that it is prepared to impose heavy fines on firms which have failed to implement adequate systems and controls in countering the risks of financial crime. In July 2011, Willis Limited was fined nearly £7 million for its systems and controls failings as regards payments to overseas third parties. The large fine (the highest so far for failing to maintain financial crime systems and controls) reflects the size and importance of Willis and therefore the fact that it should be setting the standard for the industry. Willis was also criticised for the fact that it had failed to improve its controls adequately, despite public warnings (by way of a thematic review and the action taken against Aon Limited for similar failings in 2009). There is no doubt that this is a "hot topic" for the FSA. In March 2012, it published a report setting out how and to what extent investment banks are establishing effective anti-bribery and corruption ("ABC") controls. Generally speaking, the FSA considers that most firms have more work to do in this area and most have not properly taken account of the rules covering bribery and corruption, either before the Bribery Act 2010 or after. None

of the firms that the FSA had visited in preparation for the report had taken action or considered taking action in response to the thematic review of commercial insurance brokers' ABC controls or the related enforcement actions against Aon and Willis. There is therefore an unequivocal warning that the FSA—and from next year the FCA—will continue to focus on ABC issues. Firms should therefore take note of the Aon and Willis cases, and the FSA's ABC report.

In March 2012, the FSA fined Coutts & Company £8.75 million for failures in its anti-money laundering systems and controls (the highest to date for such failings), again targeting a big, household name in order to send a warning to the industry as a whole not to become complacent with the day-to-day processes and procedures by which AML is carried out in relation to clients. The effectiveness of these processes and procedures "on the ground" and in practice should be reviewed regularly—left unchecked, failings can become embedded or hidden within those processes and therefore can be repeated persistently over periods of time. Checklists and templates should be used with caution and relevant personnel should be properly trained to use them.

Failure to comply with the client money and client assets rules remains a top enforcement priority for the FSA (and will be so for the FCA). The cases against Towry Investment Management Limited in September 2011 and against Integrated Financial Arrangements Plc in December 2011 highlight how apparently simple failures (failing to perform reconciliations, not doing client money calculations, failing to obtain adequate acknowledgement of trust letters etc) can expose clients to the risk that they might lose their money (or at least face difficulties in recovering it) in the event that the firm were to go insolvent—and are part of a larger initiative to improve standards in this area. In the FSA Business Plan 2012/13 the FSA noted that "its supervisory work shows that many firms have inadequate records, ineffective segregation of client assets and a low level of awareness of requirements in this area". The FSA has signalled the fact that it will be strengthening its intensive regulatory and supervisory approach in relation to client money and client assets; this will mean more visits, thematic projects and desk-based reviews. Later this year (October 1, 2012) the CASS Resolution Pack rules will come into force for in-scope firms. The FSA is also considering its response in relation to the recent judgment in the Lehman Brothers International (Europe) Supreme Court client money appeal and will also be reviewing the client assets regime generally in the light of the collapse of MF Global. In short, all in-scope firms should expect much more attention from the FSA and the FCA in this area and should be pro-active in ensuring that they comply with the specific rule requirements—including keeping records and carrying out daily client money calculations. In other words, they should not wait for the FSA or FCA to point out any such failings to them.

Failings in the way firms deal with retail clients have also hit the headlines and have resulted in some very large sanctions. The Bank of Scotland was fined £3.5 million in May 2011 for its failings in handling retail client complaints properly and fairly: significantly, the FSA also announced that it expected that the bank would pay a total of £17 million compensation to customers. A number of mis-selling cases rehearse familiar themes: unsuitable advice to retail customers in relation to the selling of structured capital at risk products ("SCARPS") (Credit Suisse (UK) Limited was fined £5.95 million October 2011 and will pay redress to customers who have suffered loss); unsuitable advice to customers in failing to calibrate their appetite for risk with the inherent risks associated with fund investment (Coutts & Company was fined £6.3 million in November 2011 and will pay redress to customers who have suffered loss); and the mis-selling of unsuitable investment products to elderly customers (HSBC Bank Plc was fined £10.5 million (the largest fine to date against a firm for retail failings) and will pay redress expected to reach £29.3 million). As can be seen, the overall cost to firms which are found to mis-sell products to retail customers can be spectacularly large.

The FSA has expressed its increasing frustration with the fact that firms are making the same mistakes time after time. As Tracey McDermott, the acting director of the Enforcement and Financial Crime Division, said in a speech at the City and Financial Conference in February 2012:

> "Everyone—inside and outside the industry wants [trust and confidence in the financial services industry to be rebuilt]—so why doesn't it happen? The past few years have seen ever-increasing penalties for retail failings. Redress to customers from enforcement cases in 2011 alone exceeded £200 m .... Yet, despite this, we continue to see failings which indicate that the industry is not learning the lessons. It is not properly fulfilling its mandate of giving good advice to those who need it, ensuring that markets are fair and that, where risks are being taken, they are understood."

Under the new regime, the FCA will have an enhanced consumer protection remit and we can expect increased and earlier intervention both from a supervisory and enforcement perspective as it seeks to establish that retail customers are fairly treated and to address the frustration outlined above. It has been made clear that early intervention will not only be limited to the controversial statutory power to ban products. As Tracey McDermott said in the same speech:

> "... it may also include a willingness to take action—supervisory or enforcement—earlier in the cycle. So you might expect to see the FCA taking action, including Enforcement action, where our judgment is that a particular aspect of the firm's business model—its product selection, its remuneration practices, its training or recruitment, for instance—is likely to give rise to poor consumer outcomes. We won't wait to see if those outcomes occur."

So, while in many ways enforcement by the FCA is likely to feel like "business as usual", at least in terms of the key priorities for the immediate future, there will be changes by way of earlier intervention and potentially larger punitive and exemplary penalties. In addition, the FCA will have the power to publish warning notices, enabling publication of the "prosecution case" before the firm has had a chance properly to challenge it.

The Upper Tribunal has shown that it is prepared, in certain select cases, to challenge the FSA's decisions quite robustly, as evidenced by the decisions in favour of Jason Geddis (see below) and John Pottage (the former chief executive of UBS's UK wealth management business). The latter decision, published after the scope of our annual review, should be required reading for persons holding significant influence functions and compliance officers alike: despite the fact that the Tribunal cleared Mr Pottage of misconduct and found that he had not failed to take reasonable steps to ensure that the business of his firm complied with the relevant requirements and standards of the regulatory system, it did agree with the FSA that there were a number of "serious flaws" in the business, such as the lack of relevant management information available to senior management and shortcomings in the firm's compliance monitoring. Although the decision may have temporarily dented the FSA's credible deterrence strategy, and may provide some comfort that there are some real checks and balances to potentially misguided enforcement action, many of the factual findings will resonate and provide clues as to how one might mitigate the risk of receiving a Decision Notice in the first place.

In this issue, we review a number of the more important FSA enforcement cases that were published between May 1, 2011 and April 5, 2012, in order to highlight the important themes and trends which they reveal and which may have a bearing on the future direction of FCA enforcement action, and the practical lessons which firms and their compliance officers should take away from them.

2. Market conduct

As in previous years, the FSA's fight against market misconduct in its various guises remains one of its top priorities. The FSA continues to use a mixture of criminal and civil enforcement measures.

CRIMINAL ACTION

In some ways, in comparison to previous years, it seems to have been a "quieter" few months as regards published criminal market conduct cases. However, according to the FSA there are 20 individuals currently facing trial (16 for insider dealing and four for misleading the market). These will apparently be among the largest and most complex cases that the FSA has brought and include the regulator's priority areas of organised insider dealers and market professionals.

In December 2011, Rupinder Sidhu, a management consultant, was convicted of 22 counts of insider dealing and sentenced to two years' imprisonment. He had been involved with an ex-hedge fund trader and risk manager, Anjam Ahmad, in dealing in listed shares based on inside information obtained by Ahmad in his role as a trader at AKO Capital LLP. Unlike Mr Sidhu, Mr Ahmad had pleaded guilty and was convicted in June 2010 (as we reported in Issue 87 of the *Compliance Officer Bulletin*—June 2011). He received a suspended sentence of 10 months.

CIVIL ACTIONS

There have been (as there probably always will be) examples of what on the facts appear to be unarguable, flagrant market abuse. For example, Rameshkumar Goenka (Final Notice: October 17, 2011),

an Indian businessman living in Dubai, was fined a total of US$9,621,240 (£6,108,707) in October 2011 for intentionally submitting orders in Reliance GDRs in the dying seconds of the LSE closing auction. His intention was to drive up the theoretical price of Reliance shares, thereby avoiding what would have otherwise been a substantial loss for him on a structured product he held which was referenced to the Reliance share price. This is the highest fine the FSA has imposed on an individual to date.

In some ways, the case against Messrs Visser and Fagbalu involved a similar degree of apparent culpability, although the complicity of the compliance officer against the backdrop of a collapsing fund is, at least, a salutary tale (see below).

By contrast, there have been a number of market abuse cases where the culpability of the individuals involved has been much less obvious and deliberate, and where the full force of the regime and its potential impact on senior professionals can be seen. Andrew Osborne was fined £350,000 for disclosing inside information during a single 45-minute phone call, even though the FSA accepted that his behaviour was neither deliberate nor reckless and did not even demonstrate a lack of care—and he did not stand to make any personal benefit. See below for the summary of his case, and of the cases against the other persons involved the call and its aftermath (the Punch/Greenlight cases).

Finally, in the case of Jason Geddis (Final Notice: September 20, 2011; Upper Tribunal decision: August 26, 2011), there is a good example of the Upper Tribunal stepping in to disagree with the FSA's analysis and the application of what might be described as a more "humane" approach to what was an undeniable case of market abuse.

Mr Geddis was employed by Dresdner Kleinwort Benson as a trader with responsibility for trading on the London Metal Exchange ("LME").The FSA issued a Decision Notice against Mr Geddis in June 2010 in which it concluded that Mr Geddis had deliberately conducted market abuse during a single morning's trading by means of an abusive squeeze (by building up a dominant position) with the intention of making a profit for his employer and had not complied with the LME's Lending Guidance (which broadly requires members holding a dominant position to lend to the market at specified price levels when the market is in backwardation). The FSA proposed the imposition of a fine of £25,000 (reduced from £100,000 due to financial hardship) and prohibited him from performing any function in relation to any regulated activity. The Upper Tribunal conclusively rejected the FSA's analysis, fundamentally disagreeing with the regulator's interpretation of the factual events. It found that:

- the events of the day in question were inconsistent with a premeditated strategy of making profits through an abusive squeeze;
- Mr Geddis' initial trading was made in pursuance of a legitimate trading strategy and that from a certain point onwards he lost sight of that strategy and "got caught up in the excitement of trading"; and
- as soon as he realised his serious mistake he did the right thing which was to alert his superior.

The Tribunal found that the FSA had "misjudged the facts of the case and misjudged Mr Geddis" and that his behaviour (although undeniably market abuse) was committed through a lack of care in an exceptional situation and not through a deliberate abusive trading strategy. The Tribunal determined that the FSA should impose a public censure on Mr Geddis, rather than imposing a fine. It is clear that—while one should not draw too much comfort from the case—the Upper Tribunal is still prepared, in appropriate cases, to challenge the regulator.

There are a number of market misconduct cases which are subject to review by the Upper Tribunal. Perhaps the most notable of these (or at least the one that has recently caused the most publicity in the press) is the case against Ian Hannam (Decision Notice: February 27, 2012), a senior banker at JP Morgan and the so-called "king of mining". The FSA has decided to impose a £450,000 penalty against him for two cases of market abuse (improper disclosure) for disclosing inside information to third parties by e-mail. On the face of the factual chronology as set out in the Decision Notice, at least, the technical argument as regards the improper disclosure of inside information looks relatively clear, but Mr Hannam has publicly declared that he believes that the FSA's conclusions are wrong and that he will challenge them in the Upper Tribunal: it remains to be seen as to what extent, if at all, his challenge will be

successful. As a senior and well-respected figure in the City, Mr Hannam is (or would be) a big "scalp" for the FSA and the case against him forms part of a clear credible deterrence policy against senior industry participants *pour encourager les autres*.

2.1 The Punch Taverns/Greenlight cases:

Greenlight Capital Inc ("Greenlight") (Final Notice: February 15, 2012); David Einhorn (Final Notice: February 15, 2012); Andrew Osborne (Final Notice: February 15, 2012); Alexander Ten-Holter (Final Notice: January 26, 2012); Caspar Agnew (Final Notice: October 3, 2011)

2.1.1 Penalties

The FSA imposed a number of penalties and sanctions against the parties for engaging in market abuse in June 2009 as follows:

- £3,650,795 against Greenlight;
- £3,638,000 against David Einhorn (the owner of Greenlight) personally;
- £350,000 against Andrew Osborne (who had at the time led the corporate broking team at Merrill Lynch International ("MLI") acting for Punch Taverns Plc ("Punch") as joint book runner and co-sponsor on a new issue of shares);
- £130,000 against Alexander Ten-Holter, trader and former compliance officer at Greenlight (he was also prohibited from performing the compliance and money laundering reporting officer roles in future on the ground that he was not a fit and proper person to perform those functions); and
- £65,000 against Caspar Agnew, a trading desk director at JP Morgan Cazenove, for his role in executing the relevant trades but not reporting them as suspicious.

2.1.2 Summary

All of the above-mentioned cases resulted from the same set of facts and circumstances surrounding a single telephone conversation and its immediate aftermath. The telephone conversation took place between Einhorn (and a Greenlight analyst), representatives of Punch (including their CEO) and Andrew Osborne on June 9, 2009.

Greenlight is a US hedge fund investment management firm and David Einhorn its sole portfolio manager. The Greenlight funds held a number of shares in Punch (together with equity contracts for differences referenced to shares in Punch). On June 8, 2009, MLI raised with Greenlight the possibility of a new equity issue by Punch and invited Greenlight to be "wall-crossed". Once a third party agrees to be "wall-crossed" a company may impart inside information to him legitimately but the latter is restricted from trading. Mr Einhorn had refused this request and asked for the call to proceed on a "non wall-crossed" basis; the call proceeded on this basis on June 9, 2009.

During the course of the call, inside information—to the effect that Punch was at an advanced stage in the process towards issuing a significant amount of new shares, probably within the following week—was disclosed by Mr Osborne to Mr Einhorn. Following the call, and on Mr Einhorn's instructions, Greenlight sold 11.65 million shares in Punch, dramatically reducing the overall holding within the various funds. Following the announcement of the new equity issue on June 15, 2009, the Punch share price dropped by 29.9 per cent and as a result of the trading the Greenlight funds had avoided a loss of approximately £5.8 million.

Annexed to the Final Notices is a transcript of the relevant telephone conversation on June 9, 2009 which makes interesting reading, particularly since, at first blush, the fact that inside information was disclosed may not be immediately obvious.

The FSA considered the various breaches to be particularly serious because:

- Mr Einhorn was an experienced trade and portfolio manager—his position meant that:
  - he should be held to the highest standards of conduct and accountability; and

- it should have been apparent to him that the information he received on the call was confidential and price sensitive.

- Mr Osborne was an experienced corporate broker and had significant wall-crossing experience. He knew and understood market abuse laws and MLI's internal policies regarding wall-crossings and, specifically, what information could constitute inside information. The fact that he knew that Greenlight had refused to be wall-crossed meant that he should have taken great care not to disclose inside information—he did not do so.
- After the call, Mr Osborne was put on notice that Greenlight was selling its shares in Punch, but he failed to escalate the issue with MLI's senior management or legal or compliance personnel.
- Mr Ten-Holter, as the person approved to perform the compliance oversight function at Greenlight Capital (UK) LLP, had a key role in detecting and preventing market abuse but failed to take any action despite knowing of the suspicious circumstances surrounding Greenlight's sale of Punch shares.

2.1.3 Lessons to be learnt

A number of important points emerge from the various cases:

- For the recipient of information, it is not sufficient, having indicated a desire not to be provided with inside information (i.e. refusing to be "wall-crossed") to assume that no such information has been provided.
- Therefore, simply stating that one does not wish to receive inside information does not provide complete protection from potential market abuse action. It remains the responsibility of every person who receives information in whatever form to assess at the end of the conversation—or series of conversations—whether inside information has been imparted to him.
- The FSA noted that none of the pieces of information which Mr Osborne disclosed during the call would, in the context of that call, amount to inside information *in isolation*. However, the FSA's view was that *taken together* those pieces of information *did* in aggregate amount to inside information, because they disclosed to Mr Einhorn the purpose and anticipated size and timing of the impending issue. Therefore, one should not assume that there necessarily has to be a one-off, explicit disclosure of information in order to be caught; instead, an insider may disclose a number of apparently innocuous and disparate bits of information during a call (or several calls) which when pieced together amount to inside information.
- It follows from the above that, if a person is in possession of inside information but agrees to engage in a non wall-crossed conversation, he should be very careful about what information he volunteers or how he answers questions put to him. A series of seemingly innocuous questions may prompt the giving of seemingly innocuous answers which, when pieced together, amount to a disclosure of inside information.
- Reliance cannot be placed on the fact that a dialogue has been expressed in conceptual or hypothetical terms if, as a matter of fact, through the use of such terms inside information has been imparted.
- Although Mr Osborne had participated in a call with Punch and its legal advisers before the call with Greenlight (during which the advice was that the call could proceed on a non wall-crossed basis within certain constraints), the FSA's view was that those constraints were not followed—however, that Mr Osborne was also criticised for not having consulted MLI's own internal legal or compliance personnel before proceeding. Therefore, where advice is taken from an issuer's advisers in such situations, a firm should be careful to ensure that their own legal or compliance teams are alerted in advance and have confirmed that they are comfortable with any advice that might have been given by the issuer's advisers.
- Mr Osborne was fined despite the fact that the FSA acknowledged that his behaviour was neither deliberate nor reckless and did not even demonstrate a lack of care—he also did not stand to make any personal benefit. At worst, his behaviour was described as an "error of judgment—an honest mistake made under pressure in the course of a difficult telephone call at a tough time in the market, and which no one else noticed either, as no single comment constituted inside information". However,

despite all these potentially mitigating factors, the FSA concluded that it was appropriate to impose a large penalty of £350,000 on Mr Osborne to send a message of deterrence to other individuals of equivalent seniority. So, even honest and understandable errors of judgment, made under pressure, can result in draconian sanctions. All senior personnel should take note.

- The transcript of the call illustrates how difficult it is to control the direction of a "live" conversation, since discussions are by their very nature unpredictable and do not necessarily follow a defined structure. Even with the benefit of legal advice (and years of experience), it is possible for a participant inadvertently to go further than intended (or, indeed, than he realises at the time).
- Mr Einhorn and Greenlight were in the United States—these cases (and the separate market manipulation case against Mr Goenke in October 2011) serve as a reminder of the extra-territorial reach of the market abuse regime and the fact that the FSA will not shy away from pursuing people who are overseas but who breach the market abuse regime.
- A number of the FSA's findings were consistent with previous cases and/or guidance in relation to the meaning of "inside information" and serve as useful reminders, including that:
  - it was not necessary for it to be certain that the equity issue would in fact occur in order for the information imparted to be inside information: a reasonable expectation was sufficient;
  - one test of inside information is that the information is specific enough to enable a conclusion to be drawn as to its possible effect on price—in this context, a conclusion about the likely *direction* of movement is sufficient (and it is not necessary to be able to determine the likely *quantum* of movement). The FSA rejected Mr Osborne's assertion that his disclosures were not sufficiently specific: it stated that "the information disclosed, which included the anticipated size, purpose and timing of an equity issuance, contained sufficient detail" and therefore was specific enough.
- As regards the action against Mr Ten-Holter, responsible for performing the compliance oversight function at Greenlight UK, he was found to have placed over-reliance on his view of Greenlight Capital Inc's high standards of compliance in making any assessment of risk. It is important that compliance by FSA-regulated firms is considered on an *independent* basis and in the context of the specific UK requirements; caution should be exercised to avoid placing too much reliance on global group procedures or protocols in other jurisdictions which may not meet the UK requirements.

2.2 Nicholas Kyprios (Final Notice: March 13, 2012)

2.2.1 Penalties

Nicholas Kyprios was fined £210,000 for disclosure to an investor of confidential information in breach of Principles 2 and 3 of the Statement of Principles for Approved Persons. The fine included a discount of 30 per cent for early settlement, without which it would have been £300,000.

2.2.2 Summary

The case serves as an interesting footnote on the disclosure of information on a non-wall crossed basis, following as it did closely on the heels of the Greenlight cases (see above). Mr Kyprios was the Head Credit Sales at Credit Suisse Securities (Europe) Limited ("Credit Suisse"). Liberty, a US telecommunications company, appointed Credit Suisse as lead book runner for a potential bond issue the proceeds of which were likely to be used in part to finance Liberty's acquisition of a German cable television company, Unitymedia GmbH ("Unitymedia").

Mr Kyprios had been "wall-crossed" in relation to the Unitymedia bond issue in accordance with Credit Suisse's internal policies: amongst other things, under such policies employees were required to protect client information on telephone calls, especially on the trading floor. Credit Suisse's information barrier policy defined confidential information as "non public information" and stated that such information should be used only for the purposes for which it is provided. There were also procedures for the wall crossing of third parties.

Before the public announcement of Liberty's takeover of Unitymedia, Mr Kyprios spoke by telephone to two fund managers. Neither manager had agreed to be wall-crossed (the only non-wall crossed parties

he spoke to about the road shows prior to the announcement). Despite the fact that the managers were not wall-crossed, Mr Kyprios used guessing games with both managers to impart certain key information about the proposed bond issue, including the identity of the issuer, the potential rating of the issue, the fact that Unitymedia would redeem outstanding bonds and that the issue was M&A related. The potential investors invited to the London road show had only been told in advance about a potential deal that was expected to result in a debt offering denominated in Euro or US dollars.

The information which Mr Kyprios disclosed was not technically inside information for the purposes of the market abuse regime under FSMA. The majority of Unitymedia's outstanding bonds were not qualifying investments for the purposes of that regime and neither were Unitymedia-related CDSs. In respect of the remaining Unitymedia bonds that were qualifying investments they were, on the date of the announcement of the bond issue, all trading at or close to their call levels and therefore the announcement did not and could not impact upon their price. The FSA therefore did not pursue a case of market abuse against Mr Kyprios.

2.2.3 Lessons to be learnt

- Market misconduct does not start and end with the market abuse regime. As an approved person, Mr Kyprios breached two of the high-level principles to which he was bound—to act with due skill, care and diligence and to observe proper market conduct.
- While the information Mr Kyprios had was not technically inside information for the purposes of the market abuse regime, it was nevertheless *treated as such* by Credit Suisse's internal policies and procedures. Mr Kyprios therefore breached Principle 3 by disclosing such information, without authority from the client and in breach of the firm's wall-crossing procedures.
- The FSA made the point that Mr Kyprios's misconduct occurred on an open trading floor in possible earshot of traders who were responsible for trading the Unitymedia bonds and CDSs. This had the dual effect of increasing the number of people to whom Mr Kyprios might have disclosed the confidential information and of setting a bad example to junior employees.
- Mr Kyprios knew what he was doing was wrong. He prefaced one call by saying that he had been wall-crossed and so he wanted to be "careful to a certain extent". He also tried to argue that his guessing game was merely "banter" (an argument that is unlikely ever to go down well with the FSA) and that he did not intend to disclose "actionable" information. It is important that approved persons clearly understand their responsibilities, not only in relation to the market abuse regime, but also as regards the treatment of confidential client information and compliance with internal policies and procedures.

2.3 Michiel Visser and Oluwole Fagbalu (Tribunal Decision August 9, 2011; Final Notices: September 20, 2011)

2.3.1 Penalties

Mr Visser was fined £2,000,000, had his approved person's status withdrawn and was prohibited from performing any regulated activity for market manipulation, entering into fictitious transactions, issuing misleading investor communications and persistently ignoring a fund's investment restrictions.

Mr Fagbalu was eventually fined £100,000 for his complicity in Mr Visser's misconduct (the FSA's original fine of £500,000 having been reduced by the Upper Tribunal). He also had his approved person's status withdrawn and was also prohibited from performing any regulated activity.

2.3.2 Summary

In 2003, Mr Visser had established a hedge fund incorporated in the Cayman Islands called Mercurius International Fund. The hedge fund's investors (of which there were approximately 20) were primarily comprised of fund of hedge fund companies and other sophisticated investors. The hedge fund's UK-based investment manager was FSA-authorised Mercurius Capital Management Limited ("Mercurius"). Mr Visser was a director of the hedge fund and the sole director and CEO of Mercurius. Mr Fagbalu was employed as the chief financial officer and compliance officer at Mercurius.

The hedge fund was subject to an investment restriction (as set out in its prospectus) that it would not invest more than 30 per cent of its gross assets in the securities of any single issuer. One of the hedge fund's investors had secured an additional restriction by way of a side letter to the effect that the fund would not invest more than 30 per cent of its value in companies that had not been admitted on a recognised market or exchange.

During 2007 Mr Visser, with Mr Fagbalu's assistance, entered into a number of transactions as outlined below:

- Two financing transactions whereby the fund's holding in a company were sold to a counterparty and then repurchased from the counterparty a few weeks later at a higher price.
- On three separate dates, a series of transactions to buy small quantities of a company's shares (in which the fund already had a large holding) from a market maker at significant premiums to the opening price on those days, followed by a separate instruction to a broker to purchase further shares in the same company from the same market maker, which shares were later sold onwards by the broker to the fund. The intention of this activity in relation to what were broadly illiquid shares was to create the impression that there were two different buyers of the relevant company's shares and as a result the relevant company's shares rose in value, increasing the value of the hedge fund's holding in those shares and therefore bolstering the performance of the fund for that month.
- Two fictitious transactions towards the end of October 2007 whereby the fund purportedly purchased a large number of shares in a company at a heavy discount to the *market price*. These two transactions were included within the October NAV for the fund at the market price rather than the heavily discounted off-market purchase price offered. In reality the hedge fund had no money to effect the transactions and both were subsequently reversed.

During the same period, Mr Visser was instrumental in sending communications to the fund's investors which included several examples of successful trading which did not reflect the fund's actual trading performance. None of these communications disclosed the fact that the fund had become heavily invested in two large blocks of illiquid shares, both of which breached the 30 per cent concentration restriction in the prospectus.

The hedge fund collapsed in January 2008.

The FSA issued decision notices against both Mr Visser and Mr Fagbalu on March 15, 2010. Both referred the matter to the Upper Tribunal (although in the event Mr Visser did not attend the hearings).

In broad terms, the Upper Tribunal upheld the FSA's findings and concluded that:

- Mr Visser had not denied that he had committed market manipulation and in any event the evidence that he had was overwhelming.
- Both men embarked on a deliberate and calculated course of concealing facts from investors and misleading them. The Upper Tribunal reached what it described as "an inescapable conclusion that the breaches of the two investment restrictions were neither technical nor insignificant, but deliberate, persistent and foolhardy" and that they contributed in large measure to the collapse of the fund.

The Upper Tribunal confirmed the £2,000,000 penalty against Mr Visser. It gave short shrift to the latter's submission that the penalty was greater than any other penalty so far imposed upon an individual (ignoring elements of a penalty attributable to disgorgement): it was not surprised at the FSA's fine, because Mr Visser's conduct was worse than any other it had seen.

Perhaps somewhat surprisingly the Upper Tribunal ordered a large reduction in Mr Fagbalu's penalty to £100,000 because of his personal circumstances, having expressed a view that the RDC's recommended figure of £500,000 (as it appeared in the Decision Notice) "was entirely appropriate, if not lenient".

2.3.3 Lessons to be learnt

- There is no doubt from the facts that Mr Visser was the driving force behind the various acts of misconduct. However, Mr Fagbalu was punished for his complicity. As the Upper Tribunal noted, he was quite clearly a willing and active participant in the systematic concealment of the fund's true

position over many months. It was not sufficient for him to argue that he was simply acting on Mr Visser's instructions.

- As regards the market manipulation, Mr Fagbalu could not use his lack of dealing experience as an excuse—as "an obviously intelligent man" he could not possibly have thought that the best way for a purchaser to make a bargain is to offer more than the seller is willing to accept. There was no evidence that Mr Fagbalu protested or sought to report the market manipulation.
- The various cases of misconduct occurred against what clearly was a downward spiral in the fund's fortunes. As the Upper Tribunal noted, Mr Fagbalu's misconduct escalated as time passed and (while one would not expect most compliance officers to end up in Mr Fagbalu's position), there is perhaps a reminder to all that a deteriorating position in a firm's or fund's position must not be allowed to lead to any compromise in compliance obligations.
- While there is no discussion of the respective personalities of Mr Visser and Mr Fagbalu, the case against the latter should serve as a reminder that the compliance officer is expected to perform an independent and robust role—and not succumb to the force of personality that a senior person may have (Mr Visser was the sole director of Mercurius and its CEO).
- The fact that the Upper Tribunal settled on a reduced penalty against Mr Fagbalu should not be cause for comfort—this was only due to the extenuating circumstances of his personal circumstances. While he might have been the "less culpable" of the two, the FSA argued that his actions should be regarded as particularly egregious because of his responsibility for compliance oversight and for ensuring that his firm remained compliant with the FSA's rules.

2.4 Cattles and Welcome cases:
Cattles Ltd ("Cattles"); Welcome Financial Services Limited ("Welcome"); James Corr; Peter Miller (all Final Notices: March 28, 2012)
John Blake (Decision Notice: January 18, 2012—referred to the Upper Tribunal)

2.4.1 Penalties

Cattles and Welcome were both publicly censured for publishing information giving or likely to give a false or misleading impression in breach of s.118(7) of FSMA. Cattles was also found to be in breach of Listing Rules 1.3.3R (misleading information not to be published), Listing Principle 3 (integrity) and Listing Principle 4 (creation of a false market). Welcome was also found to have breached Principle 3 (management and control) of the FSA's Principles for Businesses. Had either company still been a going concern with significant surplus assets, the FSA would have imposed a substantial financial penalty.

James Corr, the former finance director of Cattles was fined £400,000 (reduced from £750,000 due to financial hardship) for engaging in market abuse (s.118(7) FSMA) and for being "knowingly concerned" in the breaches of the Listing Rules and Listing Principles by Cattles. He was also issued with a prohibition order prohibiting him from performing any function in relation to any regulated activity.

Peter Miller, the former finance director of Welcome was fined £200,000 (reduced from £400,000 due to financial hardship) for engaging in market abuse (s.118(7) of FSMA) and for being "knowingly concerned" in the breach of Principle 3 of the FSA's Principles for Businesses by Welcome.

John Blake, the managing director of Welcome has referred the FSA's Decision Notice of January 18, 2012 (in which the FSA decided to impose a financial penalty of £100,000) to the Upper Tribunal.

2.4.2 Summary

Cattles was an LSE-listed financial services company. Its wholly-owned subsidiary, Welcome (authorised and regulated by the FSA) conducted most of its business and engaged in sub-prime lending (i.e. retail consumer lending, providing low-value secured, unsecured and hire purchase loans to subprime borrowers at high levels of interest). This business represented nearly 90 per cent of Cattles' revenue.

Cattles' 2007 annual report contained misleading information in relation to the effect that deferments of missed contractual loan payments were having on the value of the loan book (broadly speaking, Welcome

had applied deferment to overdue loans without having made contact with the defaulting party and had not shown them as being in arrears whereas, in accordance with International Financial Reporting Standards ("IFRS") it should have shown such loans as being "past due but not impaired"). The annual report stated that only £0.9 billion of Welcome's £3 billion loan book was in arrears when, if IFRS had been applied correctly, the true figure would have been around £1.5 billion. Cattles had also announced a pre-tax profit of £165.2 million for 2007, but if IFRS had been applied correctly, Cattles would have suffered a pre-tax loss of £96.5 million.

To make matters worse, the misleading figures from the 2007 annual report were replicated in a rights issue prospectus that Cattles released in April 2008, giving a misleading impression as to the firm's financial wellbeing. The FSA found that it was likely that investors would have regarded this as highly material when subscribing under the rights issue. The rights issue was subsequently fully subscribed. When the sorry state of Cattles' loan book was finally revealed in 2009, trading in shares was suspended. In March 2011 Cattles announced a scheme of arrangement under which shareholders would receive only 1p for each share (compared to the rights issue price which had been £1.28).

2.4.3 Lessons to be learnt

Both Cattles and Welcome tried to argue in their legal submissions that Mr Corr had acted in breach of his duties to Cattles, and that the case against Cattles was therefore "purely parasitic" based solely on the attribution to the company of the actions and state of mind of Mr Corr. They cited case law to the effect that if a company director acts in breach of duty, the director's conduct and knowledge should not generally be attributed to the company (although they accepted that the case for attribution may be different depending upon the purpose for which attribution is sought).

As regards market abuse, they argued that a company should only be liable for market abuse where it is "complicit and culpability is properly made out or its internal governance and systems are found wanting in so material a way as to permit the abuse to occur". Not surprisingly, the FSA gave short shrift to these lines of argument. The regulator stated that:

> "It is central to the purpose of financial services regulation that a firm is accountable for the activities carried on in its name. This is particularly so in cases of market abuse which may have an adverse effect on market confidence. The market abuse provisions are designed with this in mind. They are effects based and do not depend on knowledge. It is the effect of market abuse which can be so damaging."

While the companies had tried to argue that the state of mind of an individual should not be attributed to the body corporate, Mr Corr and Mr Miller tried to argue that they were not "knowingly concerned" in the breaches of their respective companies. The precise meaning of this phrase in the context of financial services legislation is not entirely clear, but the FSA places reliance on a case to the effect that a party can be knowingly concerned if he does not know as a matter of law that a breach had occurred, as long as he knows of the facts which give rise to the breach (*SIB v Skandex Capital Management A/S and Another* [1998] 1 WLR 712). No dishonesty is required. In the case in the Final Notice against Mr Corr, the FSA held that all the facts were known to him and that he had a high responsibility to discharge, or to assist in the discharge of, the very duties imposed by the rules. As regards Mr Miller, the FSA made the point that he was, given his responsibility as a director, *concerned* with the obligation of the firm to take reasonable care to organise its affairs responsibly and effectively and noted that:

> "There is very little evidence of challenge on your part to the way in which Welcome's affairs were organised and controlled despite your responsibility for the accuracy of the figures generated by the activities of the firm. You were prepared to accept what you were told on trust. This was an approach you *knowingly adopted*." (Emphasis added.)

Both men were experienced and held a senior position at their respective firms. The fines against both of them (although reduced due to financial hardship) are punitive and exemplary and reflect the degree of complicity which the FSA felt they both had in the publication of highly misleading information. There is no doubt that the FSA is pursuing senior personnel within financial services firms with renewed vigour; such personnel must be aware of the high level of regulatory responsibility that will be attributed to them if things go wrong.

3. Financial crime—systems and controls failings

3.1 Willis Limited (Final Notice: July 21, 2011)

3.1.1 Penalties

The FSA fined Willis Limited ("Willis") £6,895,000 for failing to counter the risks of bribery and corruption associated with making payments to non-FSA authorised overseas third parties, who assisted Willis in winning business from overseas clients, particularly in high-risk jurisdictions. This fine included a 30 per cent discount for early settlement, without which it would have been £9.85 million.

This is the highest penalty that the FSA has awarded for failures to maintain financial crime systems and controls to date.

3.1.2 Summary

The FSA found that, between January 2005 and December 2009, Willis did not take reasonable care to establish and maintain effective systems and controls for countering the risks of bribery and corruption. This was associated with making payments to overseas third parties who helped Willis win and retain business from overseas clients, particularly in high-risk jurisdictions.

The FSA found that Willis had breached Principle 3 (management and control) and the SYSC Rules. Specifically, the FSA found that Willis had failed to:

- establish and appropriately record an adequate commercial rationale for the overseas third parties payments (indeed, the FSA noted that 90 per cent of introductions occurring between January 2005 and August 2008 did not have an adequate reason recorded for sharing commission payments);
- ensure adequate due diligence on these parties to evaluate risk of doing business with them;
- review its relationships with those parties regularly to confirm if the relationships should be continued; and
- adequately monitor staff to ensure the recording of an appropriate commercial rationale and that sufficient due diligence had occurred.

These failings all contributed to a weak control environment, and therefore an unacceptable risk that payments could be used for corrupt purposes.

Although Willis introduced improved policies and guidance in August 2008 designed to mitigate the risks of bribery and corruption , the FSA found that these were not adequately implemented by staff; nor were failures by staff to adhere to them identified soon enough. The board was involved, but was not provided with sufficient management information regarding these new policies to assess if risks were being appropriately and effectively mitigated.

The FSA considered these failings to be particularly serious for the following reasons:

- Willis is one of the largest insurance/reinsurance brokerage and risk-management firms in the United Kingdom, and its position in the market sets an example in respect of its practices;
- the failings had occurred for a significant period of time;
- the revenue earned by Willis relating to the breaches was significant, with the gross commission from business introduced by the overseas third parties amounting to approximately £59.7 million;
- during the relevant period, the FSA had undertaken a thematic review of this area, had communicated with the industry and taken enforcement action for similar failings (including the high-profile action against Aon Limited in 2009 for similar bribery and corruption failings which incurred a fine of £5.2 million); and
- Willis focused on the procedural requirements on payment issues, rather than the substantive issues of whether there was an adequate commercial reason for it.

3.1.3 Lessons to be learnt

- Firms must not only establish appropriate anti-bribery and corruption systems and controls, but must also ensure that they are adequately *implemented* and *monitored* in practice. In this regard:
  - It is important that relevant staff members are given adequate training on what information they should be obtaining from overseas third parties and the rationale for obtaining that information. In the case of Willis, staff only recorded very brief and inadequate information; this in turn resulted in an inadequate due diligence process.
  - The focus of Willis' policy manual appeared to be to raise awareness of bribery and corruption issues, but not to give guidance to staff on how to address these issues in practice as and when they arose.
  - Without adequate documentation and due diligence, Willis was unable to monitor the effectiveness of its procedures. This meant that, although the board became involved from 2007, there was insufficient information available to it (even after the policies were improved in 2008) for it to be able to assess effective risk mitigation. It is important that firms ensure that their systems and controls are sufficient to enable senior management to identify areas of policy that require clarification and improvement, and groups of staff that need specific training.
- When reviewing systems and controls, firms should ensure that they focus on *substantive* issues in order to ensure that remedial measures are put in place and not simply (as Willis did) to look at *procedural* issues (such as whether the correct authorisation had been obtained). Even after the new guidance in 2008, Willis continued in its failings.
- Although the FSA did not find that Willis' conduct was deliberate or reckless, the failings created an unacceptable risk that payments to overseas third parties could potentially be used for corrupt purposes (regardless of whether any of the business was in fact corrupt).
- As has been seen before, the FSA will be hard on firms that do not appear to have learnt the lessons from recent thematic reviews and/or high-profile enforcement actions. The Willis case—and the publication of the FSA's paper on *Anti-bribery and corruption systems and controls in investment banks* (March 2012)—should be required reading for all firms in the investment banking sector; but other firms would also do well to take note.

3.2 Coutts & Company (Final Notice: March 23, 2012)

3.2.1 Penalties

The FSA fined Coutts & Company ("Coutts") £8.75 million for failing to take reasonable care to establish and maintain effective anti-money laundering systems and controls in breach of Principle 3 of the FSA's Principles for Businesses. The fine included a 30 per cent discount for early settlement without which it would have been £12.5 million.

3.2.2 Summary

For a three-year period from December 2007, Coutts sought to expand its international customer base by taking on new customers. A number of the customers were classified as high risk (because of the assessed riskiness of their country of origin) and some of those were also classified as "politically exposed persons" ("PEPs"). In 2010, as part of its thematic review into how banks manage the risks arising from PEPs and other high-risk customers, the FSA visited Coutts to assess its AML systems and controls. In the light of concerns raised by this visit, the FSA reviewed a sample of Coutts' files relating to PEPs and other high-risk customers and found a number of failings, including:

- A failure, across a number of different private banking teams, and during every year of the relevant period, to assess adequately the level of money laundering risk posed by prospective and existing high-risk customers—in particular, Coutts had failed to identify a number of PEPs.
- A failure at the establishment of a new business relationship to gather an appropriate level of due diligence information about a large number of prospective high-risk customers—in particular, there

had been failure to question whether there was a legitimate rationale for a complex ownership or control structure used by particular clients. Where enhanced due diligence ("EDD") was called for, the gathering of this was also inadequate. Private bankers were required to fill in a checklist designed by the AML team but were inadequately trained in how to complete it and there was no guidance as to how one should establish a customer's source of wealth.

- A failure on the part of the Coutts AML team to apply sufficiently robust controls when new relationships were established with high-risk customers—the client "take on" process was led by the relevant private banker (whose performance appraisal and bonus award would in part be determined by whether he had met his targets for new customers). The AML team, in approving a particular customer, failed to provide an appropriate level of challenge and scrutiny in the process, relying inappropriately on the reputation and experience of the relevant private banker. In addition, there were no other "checks and balances", since AML approval had become the final hurdle (previously, a final "sign off" by a senior manager with Risk had been required before a customer was finally approved).
- A failure to apply appropriate monitoring to existing high-risk customers (to ensure that changes in circumstances and risk profiles were managed appropriately and that unusual transactions would be identified). In certain cases, the FSA found that individuals had been customers of Coutts for years without any changes to their personal circumstances having been noted. In other cases, Coutts had failed to pick up on adverse intelligence in the public domain relating to specific customers. Coutts also had inadequate systems for the storage of customer information: it was in fact held on disparate systems, making it difficult for the relevant banker to obtain a full picture of the customer and the business relationship.
- Failure to carry out adequate reviews of its AML systems and controls for high-risk customers. Coutts' annual review process was inadequate: for instance, the annual review template did not prompt the relevant private banker to update any information or due diligence and did not contain any guidance as to what information ought to be gathered and/or recorded. Bi-annual senior management review meetings were also inadequate, with discussions relating largely to administrative matters rather than considering the nature of the due diligence material held or whether any adverse intelligence had been gathered about a particular customer.

3.2.3 Lessons to be learnt

Coutts was evidently a high-profile target for the FSA and the case against the firm sends a deterrent warning specifically to the private banking market, but also to any firm which deals with higher-risk customers. As before with AML enforcement cases, the issue for the FSA is the failure in the relevant systems and controls, therefore heightening the *risk* that a firm will be used for criminal purposes, rather than any finding that any money laundering has in fact taken place. The following lessons can be drawn from this case:

- Inappropriate levels of due diligence at the customer "take on" stage will mean that a firm will not necessarily be able to analyse and deal with risks appropriately. Coutts adopted a definition of "PEP" that actually went wider than the technical definition in the Money Laundering Regulations 2007 (by including individuals who held public office in the United Kingdom), but such a conservative and prudent approach is not much help if there is a failure in practice to identify a PEP at the outset. The failure to identify PEPs meant that EDD procedures (which include the statutory requirement for senior management approval) were not followed.
- The MLRO/AML team should not place undue reliance upon the seniority, reputation and/or expertise of the person responsible for introducing a new customer. The MLRO/AML team is not there to "rubber stamp" potential customers following a mechanistic, template-based customer take-on process and the say-so of the customer-facing employee: instead, it should operate independently and robustly and challenge the process (and the relevant individual) where necessary.
- To the extent that customer-facing employees are necessarily involved in the process of taking on new clients, firms should ensure that they are adequately trained in order to understand the significance of what needs to be asked for and their role in that process. For instance, if a firm needs to establish a

customer's source of wealth, the relevant customer should understand when this requirement arises and what needs to be done in order to evidence the requirement.

- Templates and checklists are a useful tool as part of the wider AML systems and controls, but the case highlights the fact that any shortcomings or deficiencies in such templates or checklists, if not identified and rectified, will mean that failings will continue. For instance, in the Coutts case, the private bankers were not given guidance or training on how to complete the PEP annual review template and were not prompted by that template to update any information or due diligence. This raised the risk that potentially significant changes in a customer's profile would fail to be considered by the AML team.
- Coutts was criticised for not picking up adverse information about certain customers from publicly available sources. The importance of ongoing monitoring must not be underestimated by firms and there will be little tolerance for failing to pick up information in circumstances where it should easily be available.
- It is notable that RBS Group had started a group-wide review of AML systems and controls which had been due to encompass those of Coutts, but this had been suspended in the light of the FSA's impending visit. This case sends a warning to *all* firms to consider whether and to what extent a review of their own systems and controls is overdue.

4. Client assets

4.1 Towry Investment Management Limited ("Towry") (Final Notice: September 14, 2011)

4.1.1 Penalties

Towry was fined £494,900 for client money failings and for breaching Principle 10 of the FSA's Principles for Businesses (which requires firms to arrange adequate protection for clients' assets when it is responsible for them) and Principle 11 (which requires firms to deal with their regulators in an open and cooperative way and to disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice).

The fine included a 30 per cent discount for early settlement, without which it would have been £707,000.

4.1.2 Summary

Towry is an independent discretionary investment management firm providing services to private individuals and pensions and employee benefits advice to small and medium-sized enterprises. It operated client money bank accounts under the normal approach to segregation, so that all client money received was paid into those accounts.

Following a thematic CASS visit to the firm in November 2010, and a subsequent investigation, the FSA discovered a number of breaches by Towry of the CASS rules:

- It did not perform client money calculations or reconciliations accurately or in a timely manner.
- Prior to July 2009, Towry had performed its internal reconciliations and client money calculations on a monthly basis, rather than a daily basis.
- After July 2009, Towry outsourced some of its client money accounts to a third party, but was then reliant on that third party to provide the reports to enable Towry to perform the necessary reconciliations and client money calculations; on a number of occasions the report was not provided and so Towry was unable to fulfil its CASS obligations.
- In January 2010, the FSA sent a Dear CEO letter, attaching the FSA's CASS Report, to the CEOs of regulated firms, including Towry. The Dear CEO letter asked the CEO to respond confirming that the letter and attached report had been properly considered and that the firm was in compliance with its obligations as regards the protection of client money and assets. Towry responded to the Dear CEO letter saying that it was in compliance with its CASS obligations, failing to identify the breaches in relation to its performance of reconciliations and client money calculations.

- Because of the failings, Towry's records were inadequate to enable it to distinguish client money held for one client from client money held for another client and, to the extent that it did not remove excess funding, from Towry's own money.
- Towry also failed to ensure that client money was properly segregated from its own money (i.e. by funding any shortfalls of client money from its bank account to the client money bank accounts or withdrawing any excesses from the client money bank accounts to its bank accounts).

4.1.3 Lessons to be learnt

- Firms that hold client money should ensure that they carry out client money calculations and reconciliations in accordance with the requirements of CASS at all times—internal reconciliations must be done on a daily basis for instance. (Prior to July 2009, Towry had performed its internal reconciliations and client money calculations (and therefore any funding of shortfalls or withdrawals of excesses) on a monthly, rather than a daily, basis.
- Firms which outsource some or all of their client money accounts to a third party should ensure that the outsourcing arrangement provides them with sufficient powers to be able to procure that they receive the reports as often as required.
- Responses to Dear CEO letters and other FSA requests should be treated seriously and carefully, with appropriate senior management engagement—in the case of Towry, key members of the firm's senior management had not seen the Dear CEO letter or the reply (which was e-mailed by Towry's compliance function only four business days after the FSA had sent the letter). In fact, it was not until nearly six months later, at the July meeting, that the board saw the Dear CEO letter and CASS Report—and since the response to the FSA was not included in the board papers, the Board remained unaware of the fact that it had been sent.
- Failures such as Towry's will not be tolerated—the FSA will punish systemic failings that expose clients to the *risk* that they might lose their money or face a delay in recovering their money were the firm to go insolvent. It is irrelevant that the risk (i.e. insolvency) does not or is not likely to crystallise.

4.2 Integrated Financial Arrangements Plc ("Integrated Financial") (Final Notice: December 5, 2011)

4.2.1 Penalties

Integrated Financial was fined £3.5 million for significant client money failings over a period of more than eight years.

The fine included a 30 per cent discount for early settlement, without which the FSA would have imposed a fine of £5 million.

4.2.2 Summary

Integrated Financial is the operator of a "wrap platform", an online system which allows independent financial advisers ("IFAs") to buy, sell and transfer investments within and across different product tax wrappers: the wrap platform therefore enables the IFAs to consolidate their clients' portfolios in a tax-efficient way under a single administrative umbrella. The investments in question included unit trusts, OEICs, exchange-traded funds and equities.

During the relevant period (December 2001 to June 2010), Integrated Financial received money on behalf of its clients which was "client money" for the purposes of the FSA's rules. The average amount of client money held during the relevant period was £508 million.

During its thematic client money visit to Integrated Financial in May 2010, the FSA identified the following weaknesses in the firm's client money processes:

- The firm failed to perform client money calculations to ensure that its client money resource was at least equal to its client money requirement—shortfalls arose because the firm would effectively allow clients a "credit line" to trade (e.g. by allowing a client to trade on the basis of an uncleared cheque

deposit or to use uncleared proceeds of asset sales to buy and pay for other assets, in either case where there were otherwise insufficient funds in the client's account). The effect of this approach was that client money would be used to cross-fund the activities of other clients.

- CASS 7.8.1R provides that, when a firm opens a client bank account, it must give notice to the relevant bank requesting the bank to acknowledge in writing that (amongst other things) all money standing to the credit of the account is held by the firm as trustee. Critically, if the bank acknowledgment is not received within 20 business days after the firm sent the notice, the firm is required to withdraw all money standing to the credit of the account and deposit it in another client bank account with another bank *as soon as possible*. Integrated Financial's failings in respect of this rule requirement were as follows:
    - as regards one client money bank account, the firm did not receive the acknowledgement of trust letter from the relevant bank until nine business days *after* the 20 business days' deadline had passed;
    - in respect of another client money bank account, while the firm did receive a letter from the bank within the 20 business day period, the letter did not identify the account as a client money account and so did not distinguish the account from any bank account containing money belonging to the firm;
    - in respect of two client money bank accounts, the letters from the relevant banks did not confirm that all money standing to the credit of the account was held by the firm as trustee.
- The firm's organisational arrangements were insufficient to ensure that the client money rules were complied with—failings in the systems and controls procedures meant that the firm was unaware that it had failed in meeting certain client money rules and the governance framework was ineffective in identifying and reporting client money risks. Matters were compounded by the fact that the firm's compliance function did not undertake any detailed compliance monitoring of the extent to which the firm was complying with the client money requirements.

4.2.3 Lessons to be learnt

- As with the *Towry* case, the FSA will punish firms where client money is placed at *risk* over a period of time (regardless of whether the risk actually crystallises). Hence, when the firm failed to receive an acknowledgment of trust letter from one bank until nine business days after the 20 business days' deadline, the FSA did not simply view this as a minor technical breach of CASS 7.8.1(2)R for missing a deadline—instead, it highlighted the fact that £706 million of client money was placed at risk for a further nine days without the acknowledgment of trust being in place.
- Firms should consider sending "chasing letters" to relevant banks before the expiry of the 20 business days' deadline. If an acknowledgment of trust letter is not received within the 20 business days' deadline firms should move quickly, in accordance with the rule requirement, to withdraw the money and place it in another client bank account.
- It is not simply a question of ensuring that an acknowledgment is received from the relevant bank within 20 business days of the notification being sent: firms must also ensure that the *wording* of the acknowledgment actually tracks the rule requirement—for instance, there must a clear acknowledgment of the fact that money in the account is held by the firm as trustee and that the account is distinct from any account with the same bank holding the firm's own money. This is to ensure that, in the event of the firm's insolvency, the client money would be "ring-fenced" from the firm's own money and would not form part of the estate of the firm.
- A compliance officer should not place undue reliance upon internal and external audit findings with regards to whether a firm is in compliance with client money requirements—and a "clean bill of health" from auditors should not be taken as relieving the compliance officer from the duty to conduct detailed compliance monitoring.
- It is imperative that firms have adequate systems and controls in place to ensure that the firm is complying with the client money rules and to detect circumstances in which there may be a breach

so that swift remedial action may be taken by the firm itself. In the case of Integrated Financial the business was actually unaware that it was not complying with certain CASS requirements—this systemic failing meant that the breaches persisted for over eight years, during which time huge sums of money were potentially at risk (ranging from £19 million to £1,255 million).

5. Failure to have adequate risk-management systems

5.1 Bank of Scotland Plc ("HBOS") (Final Notice: March 9, 2012)

5.1.1 Penalties

HBOS was issued with a public censure. The FSA found that, although a financial penalty proportionate to the failings would have been merited (and would therefore have been very substantial), due to the exceptional circumstances of HBOS being owned in a large part by the UK government, and the fact that public funds had already been used to deal with the consequences of the misconduct, a fine would effectively be charged to the UK taxpayer.

The FSA has therefore issued a public censure to ensure details of the firm's misconduct can be viewed by all, and act as a lesson in risk-management failings.

5.1.2 Summary

Between January 2006 and March 2008, HBOS failed to comply with Principle 3 of the FSA's Principles for Businesses (management and control), as HBOS did not have the systems and controls that were appropriate to the level of risk that its corporate banking division ("CBD") was taking.

During this period, CBD had a specific focus on high-risk, sub-investment grade lending. Over this time, the transactions increased in size, complexity and risk, leading to a high-risk portfolio, with highly concentrated exposures to property, and to significant large borrowers. This strategy was highly vulnerable to a downturn in the economic cycle, and the high level of risk required a commensurately robust level of oversight to manage the risks in the portfolio. Market conditions worsened during the course of 2007. Despite this the CBD continued to pursue its aggressive growth strategy, even setting out to increase its market share as other lenders started to pull out, rather than re-evaluating its business and the risks it was facing. The FSA considered the breaches to be particularly serious in light of this behaviour.

HBOS did not have a level of control and oversight that was robust enough to achieve effective assessment, management and mitigation of the risks in the portfolio. The CBD strategy was high risk, and as such required commensurate risk-management systems and controls.

The FSA found:

- issues as to the quality, reliability and utility of the available management information on CBD;
- serious deficiencies in the control framework which provided insufficient challenge to the CBD;
- a deficient framework for managing credit risk, which meant a lack of focus on the need to manage risk across the whole portfolio;
- a distribution framework that did not operate effectively in reducing the risks in the portfolio; and
- deficiencies in the process for promptly identifying and managing transactions that showed signs of stress.

From April 2008, it become apparent that high-value transactions were showing signs of stress, and yet HBOS was slow to mitigate the risk by moving them to its high-risk area within CBD.

There was a significant risk this would impact on HBOS's capital requirements, and that the full extent of the stress within the portfolio was not visible to the group's board or auditors. While the auditors agreed that the overall level of provisioning was acceptable, in relation to the CBD the provisions were regarded as optimistic rather than prudential, and HBOS disregarded warnings from divisional risk function and the auditors to this effect and continued to pursue its aggressive growth strategy at a time during the economic cycle when a prudent approach should have been identified.

This demonstrated issues with the oversight of CBD by HBOS group control functions, including issues with the quality and scope of assurance work undertaken by group internal audit.

The FSA also found that the culture of CBD was focused on revenue rather than on risk-adjusted returns (which the FSA considers a more sophisticated measure of reward as it takes into account the level of risk involved in a transaction). Targets incentivised various behaviours including an increased appetite for lending, an attitude of optimism at the expense of prudence, and regarding risk management as a constraint on the business rather than integral to it.

This very serious misconduct led to the circumstances in which the UK government acquired approximately 43.4 per cent of the ordinary share capital of Lloyds Banking Group Plc, following its takeover of HBOS. The FSA is currently undertaking a public interest report into the cause of the failure of HBOS.

5.1.3 Lessons to be learnt

- Banks must manage their businesses by ensuring systems and controls are appropriate for and commensurate with the levels of risk involved in their operations. In large firms, it is important that there is central oversight and control over individual divisions which is robust enough to be able to rein in any potentially damaging activities and to prevent them from effectively acting with autonomy.
- The conduct illustrates how a failure to meet the regulatory requirements can end not just in massive costs to an individual firm, but substantial and far-reaching effects on shareholders, taxpayers and ultimately the economy as a whole.

6. Complaints handling

6.1 Bank of Scotland Plc ("BoS") (Final Notice: May 23, 2011)

6.1.1 Penalties

The FSA fined BoS £3.5 million for the mishandling of complaints about retail investment products. The fine included a 30 per cent discount for early settlement, without which it would have been £5 million.

BoS also agreed to carry out a review of its handling of complaints in respect of the retail investments. So far it has paid redress of £3.5 million, but it is expected that a further £15 million will be paid once the reviews have been completed.

6.1.2 Summary

Between July 2007 and October 2009, BoS received 2,592 advice-related complaints about its sales of certain retail investment products. Many complaints were from older customers with little or no experience of investment products. The FSA found that, in handling the complaints, BoS breached Principle 3 (management and control), Principle 6 (pay due regard to the interests of customers and treat them fairly), and rules in DISP and SYSC in that BoS failed to:

- ensure that complaints were investigated properly by complaint handlers taking account of all relevant information;
- ensure the complaints were assessed competently and fairly, resulting in poor decisions being made about whether investments were suitable for the customers who complained;
- have an adequate process in place to analyse trends in its complaints decisions, including those made by the Financial Ombudsman Service ("FOS"), so handlers were not aware of emerging issues; and
- carry out timely and effective root-cause analysis to identify and remedy issues in its processes so as to improve its processes sooner.

As a result, a significant number of complaints were rejected when they should have been upheld, which meant that customers were not treated fairly.

The FSA regarded the conduct as serious because:

- a significant number of complaints were wrongly decided;

- significant numbers of actual and potential customers were placed at risk;
- a large proportion of the complaints were made by inexperienced customers, and those over 60;
- despite FOS overturning 46 per cent of BoS's decisions to reject at an early stage during the affected period, BoS failed to take prompt action to address these concerns;
- the misconduct continued for more than two years; and
- BoS failed to make improvements to its processes in a timely manner.

6.1.3 Lessons to be learnt

- This action highlights the importance of effective root-cause analysis being undertaken early enough to enable firms to act sooner to improve their processes based on emerging themes. The FSA noted that if BoS had carried out effective root-cause analysis in a timely manner, it would have identified much sooner the improvements that needed to be made to its procedures. BoS placed too great a reliance on its low uphold rate for complaints, despite being aware of the rate at which FOS was overturning them, that its root-cause analysis needed to be strengthened and the impact of volatile market conditions in 2008 at which point its advice-related complaints doubled.
- Complaints handlers were influenced by internal guidance to keep the reasons for upholding complaints deliberately vague by recording them as "unclear" so as not to point out failings on the part of sales staff.
- There were also weaknesses in the psychometric risk-profiling tool designed to assess customers' attitudes to risk, as this would have indicated those customers who demonstrated a "cautious" attitude to risk, and to whom, therefore, the products should not have been sold.
- This followed a thematic review by the FSA in 2009, detailed in a report published April 2010. The FSA published in 2011 new complaint-handling rules following this enforcement action as part of a package of measures to drive up standards within the industry.
- The FSA regards it as a serious failure for firms to fail to treat particularly vulnerable customers fairly, and will step in to ensure that they are adequately protected in the future.

7. Mis-selling

7.1 Credit Suisse (UK) Limited ("Credit Suisse UK") (Final Notice: October 25, 2011)

7.1.1 Penalties

The FSA fined Credit Suisse UK £5.95 million in relation to systems and controls failings in relation to sales by its private bank of structured capital at risk products ("SCARPs"). The penalty included a 30 per cent reduction for early settlement without which it would have been £8.5 million.

Credit Suisse UK agreed to undertake a review of its sale of SCARPs, and to pay redress to those customers who had been advised to purchase an unsuitable product to ensure they did not suffer financially as a result.

7.1.2 Summary

Between January 1, 2007 and December 31, 2009, Credit Suisse UK sold SCARPs to its private banking retail advisory customers. Although there are many different SCARP structures with different risk profiles, they share one feature in common in that they all expose customers to the potential loss of all or part of the initial capital invested, and customers need to understand the nature of the risks of investing in such products. The FSA found that, in selling the SCARPs, Credit Suisse UK breached Principle 3 by failing to take reasonable care to establish and maintain effective systems and controls in respect of the suitability of its advice. In particular, Credit Suisse UK:

- failed to have in place adequate systems and controls in relation to assessing customers' attitudes to risk;

- failed to take reasonable care adequately to evidence that the SCARPs it recommended to customers were suitable, given the assets and investments held by those customers at the time;
- failed to have in place adequate systems and controls surrounding the levels of issuer and investment concentration in customers' portfolios; and
- did not effectively monitor its staff to ensure that they took reasonable care to ensure the suitability of their advice.

As a result of these failings, customers were exposed to an unacceptable risk of being sold a SCARP which was unsuitable for them.

The FSA viewed these breaches as particularly serious because:

- a significant amount of customers' money was put at risk: during the relevant period 623 customers invested £1.099 billion in 1,701 SCARPs;
- Credit Suisse UK is one of the leading private banks in the United Kingdom, and its practices set an example to the market; and
- the misconduct spanned a period of three years.

7.1.3 Lessons to be learnt

- Firms must ensure that they have adequate systems and controls in place in order to determine and understand their customers' attitude to risk.
- Staff should be effectively monitored to ensure they take reasonable care as to the suitability of their advice. Failure to monitor transactions, staff and systems will not be tolerated by the FSA.
- Credit Suisse UK is one of the largest private banks in the United Kingdom, and there is little doubt that this case serves as a warning to others as to what is expected of a firm's practices and procedures regarding suitability.
- The FSA noted that customers, who are reliant on their financial assets as a source of income, will look to firms to give appropriate professional advice, and so firms need to take care to provide such advice, tailored to the customer's individual needs and circumstances. In order to do this, adequate systems and controls need to be put in place, and this is even more important when such complex investment products are being sold to retail customers. Monitoring must also be robust. An internal report identified that reviews performed by Credit Suisse UK's management, some of which were relevant to suitability, were sub-standard in 44 per cent of cases.
- Inadequate wording in initial documentation which may not be clear to inexperienced investors is likely to mean that the firm may not correctly or accurately understand the customer's attitude to risk and so result in unsuitable products being sold to them. For instance, Credit Suisse UK's procedures required a new customer to complete a Client Acceptance Booklet ("CAB"), assisted by a relationship manager, but the main responsibility for completion rested with the individual customer. This was the primary method whereby Credit Suisse UK gathered and recorded a customer's attitude to risk and its investment objectives. However, the FSA found that terms in the CAB which assisted Credit Suisse UK in determining a customer's risk profile may not have been clear to inexperienced investors. There were issues as to the inadequacy of recording changes to the risk profile that occurred during the relationship. There was also an inadequate link between the customer's attitude to risk as outlined in the CAB, and its investment objective.
- This led to the situation where the review by the skilled person found that for 17 of the 24 transactions tested, there was insufficient evidence of the customer's overall portfolio being considered when determining if the product was suitable for that particular customer.
- The action demonstrates that the consequences of failing to implement proper systems and controls to ensure customers invest in suitable products are serious, and a proper assessment of a customer's needs is absolutely crucial when selling such complex products.

7.2 Coutts & Company ("Coutts") (Final Notice: November 7, 2011)

7.2.1 Penalties

The FSA fined Coutts £6.3 million for failings in connection with the sale of the AIG Enhanced Variable Rate Fund ("Fund"). The fine included a 30 per cent discount for early settlement, without which it would have been £9 million.

In consultation with the FSA, Coutts also agreed to carry out a past business review, overseen by an independent third party, in relation to all of its sales of the Fund to customers who remained invested at the time of the Fund's suspension on September 15, 2008 and will pay redress to those who suffered loss as a result.

7.2.2 Summary

Between December 2003 and September 2008, Coutts advised on investments in the Fund to 427 high net worth customers, with a total value of investments in the Fund by Coutts customers totalling £1.45 billion. The Fund was provided by ALICO, a UK branch of a wholly owned subsidiary of AIG Inc.

The Fund invested in financial and money market instruments. However, unlike a standard money market fund, it sought to deliver an enhanced return by investing a material proportion of the Fund's assets in asset-backed securities (primarily backed by UK residential and commercial mortgages), floating rate notes, and assets which had terms to maturity of between three and five years. This was designed to smooth out fluctuations in the market value of assets to achieve steady and increasing returns, which would be better for customers than those on typical bank deposit accounts.

During the financial crisis of 2007 and 2008, the market value of the Fund's assets fell below their book values. Following a period of initial adverse press comment about AIG, on September 15, 2008 there was a sudden drop in AIG's share price, coinciding with the news that Lehman Brothers had applied for US Ch.11 bankruptcy protection in the US.

As a result of this, a large number of investors sought to withdraw their investments and there was a run on the Fund. ALICO was unable to meet all the withdrawal requests immediately, and so suspended the Fund preventing customers from withdrawing all of their investment. A total of 247 Coutts customers with investments of £748 million were invested in the Fund on September 15, 2008. Coutts received complaints from 93 of those customers who were invested in the Fund at its suspension.

The FSA found that Coutts breached Principle 9 by failing to establish and maintain an adequate sales process for the Fund and, subsequently, its compliance review of those sales, thereby failing to take reasonable care to ensure the suitability of its advice in relation to the Fund for its customers, who were entitled to reply upon its judgment.

Particular failings included the following:

- Coutts generally informed customers that the Fund was a cash fund that invested in money market instruments, and could be seen as an alternative to a bank or building society, whereas a significant proportion of the assets did not match this description and so customers may have misunderstood the risks they were assuming.
- It recommended the Fund to some customers when it exposed them to greater risks than they appeared prepared to accept. Coutts also advised many customers to invest a large proportion of their assets in the Fund, and so their investments may not have been properly diversified.
- Coutts failed to have an adequate sales process in place for the Fund. Although it was appropriate that Coutts relied on another member of its group to carry out due diligence on the Fund, Coutts did not take the additional necessary steps to understand the Fund's features and risks to consider how they should have been taken into account in the sale of the Fund. Coutts' advisers did not have adequate training on the Fund as to its features and risks, the sales documentation did not adequately describe the Fund and its risks, and the firm failed to monitor the Fund effectively.

- Coutts failed to respond appropriately to changing market conditions in 2007–08 when there was a greater risk of the Fund suspending redemptions and customers suffering a loss. Even when made aware of these issues, Coutts failed to make the necessary changes to the way it sold the Fund, and did not ensure that its advisers provided a fair explanation of the risk to reassure existing customers who were raising enquiries.
- It failed to deal with questions raised from December 2007 regarding its past sales of the Fund.
- It also failed to undertake an effective compliance review between October 2008 and July 2009 of its sales of the Fund following suspension and customer complaints, as the review failed to adequately address suitability and disclosure issues, and was not completed in a timely manner. The quality of the checklist used was highlighted as "poor" for the purposes of compliance personnel carrying out the review, and led to only 10 clients being considered entitled to redress.

The FSA considered the breaches to be particularly serious as:

- Coutts failed to take reasonable care to establish and maintain an adequate sale process, and ensure the suitability of its advice;
- Coutts failed to take prompt and appropriate action to address questions raised by a senior member of staff; and
- the failings existed for more than four and a half years.

7.2.3 Lessons to be learnt

- Firms giving investment advice must ensure they make suitable recommendations and clients must understand the nature of the products they invest in and the associated risks.
- The Dear CEO letter issued by the FSA in June 2011 requesting an urgent review by firms of client files and suitability procedures, highlighted the significant and widespread failings in this area regarding "enhanced" investment products sales in particular, and the FSA, as with previous cases, was not impressed that Coutts had failed to respond to this by adapting its procedures to reflect these concerns.
- It is important to reflect on, and to respond to, changing market conditions, and what that means for advice to customers on an ongoing basis. The fact that Coutts gave "safe as bank account" advice in respect of investment in the Fund, even after market warnings in late 2007/early 2008, was unacceptable, and not suitable advice even prior to the change in the economic climate. The lesson here is that processes must be assessed regularly, and particularly in response to any significant change in market conditions for the impact this may have on the advice given to customers as to the suitability of products.
- While it may be appropriate and acceptable to rely on a third party to carry out certain aspects of due diligence, it is not by itself enough and the firm must take additional steps to consider the proposed product and all of the risks that it may entail in order to establish an adequate sales process.
- It is important that once issues are raised in relation to past sales, these are dealt with expeditiously. In the case of Coutts concerns were raised by a senior member of staff from December 2007 to February 2008 to the effect that customers may have been exposed to material liquidity risk and concentration risk and that advisers may not have been aware of this and/or not communicating the higher risk profiles to customers. However, Coutts did not take prompt or effective action to address these concerns. Firms must be alert to potential failings in the past, and must be seen to respond to them swiftly and substantively, carrying out effective past compliance reviews when necessary.
- The problems raised during this enforcement action pointed to a deep-seated systemic problem with widespread inadequacies at all levels, especially in respect of compliance and training.

7.3 HSBC Bank Plc ("HSBC") (Final Notice: December 2, 2011)

7.3.1 Penalties

The FSA fined HSBC £10.5 million for inappropriate investment advice provided by a subsidiary, NHFA Limited ("NHFA") to elderly customers. This fine included a 30 per cent discount for early settlement, without which it would have been £15 million.

HSBC is undertaking a past business review to determine if customers (or their families) are entitled to redress, and it expects that the cost of this to be £29.3 million.

This represents the FSA's largest ever fine to date against a firm for retail failings.

7.3.2 Summary

NHFA was a firm that HSBC acquired in July 2005, and until May 2010 was separately authorised and regulated by the FSA. HSBC closed NHFA to new business in July 2011. NHFA specialised in the provision of independent financial advice to people requiring long-term care products to pay for their care costs.

Between July 2005 and July 2010, NHFA advised 2,485 customers to invest in asset-backed investment products (typically investment bonds) which were used to fund long-term care costs for elderly customers. Such investments are typically recommended for a minimum period of five years.

The FSA found that the sales by NHFA resulted in a breach of Principle 9 in that there was a failure to take reasonable care to ensure the suitability of the advice given to customers entitled to rely upon its judgment.

In particular, the FSA found that NHFA failed to:

- provide a consistent approach to assessing customers' attitude to risk or use a suitable risk-profiling questionnaire;
- consider the use of other suitable forms of investment other than investment bonds;
- consider the tax status of customers and potentially more tax-efficient and suitable alternatives;
- assess the life expectancy of a customer at the point of sale to determine whether it was less than the minimum recommended term of the investment, therefore making the product inherently unsuitable;
- give customers the right advice with a combination of withdrawal and product charges leading to a faster reduction of capital than if customers had received the correct advice; and
- provide customers with adequate suitability letters. The letters provided by NHFA used standard wording, rather than being tailored to individual customers' circumstances. They focused unduly on benefits and provided insufficient warnings as to risks, and contained a number of inaccuracies.

The FSA regarded the failings as particularly significant as:

- The typical customer was elderly (average age of 83) and particularly vulnerable and reliant on their investments to fund care costs, and so had limited means and opportunity to make up any financial loss from an unsuitable sale. A review by a third party of a sample of customer files found unsuitable sales had been made to approximately 87 per cent of customers involving these types of investment.
- NHFA was the leading supplier in the United Kingdom of independent financial advice on long-term care products to help pay for care costs, with a market share of 60 per cent, and HSBC is a major global financial services provider with a prominent position in the retail consumer market.
- The misconduct occurred over approximately five years.
- A significant number of customers may have suffered financial detriment, as during the affected period, 2,485 customers invested approximately £285 million in asset-backed products, meaning the average amount invested per customer was approximately £115,000.

As a consequence of these failings, NHFA customers were exposed to an unacceptable risk of mis-selling, and a significant number of asset-backed investments were in fact mis-sold.

7.3.3 Lessons to be learnt

- The case highlights the need for regulated businesses to ensure that where they acquire new businesses they implement appropriate systems and controls to manage and oversee their activities effectively, or otherwise they risk regulatory breaches, customer detriment and overall reputational damage. The compliance function of the acquiring business needs to ensure that it gains an understanding of the new business quickly and effectively. It was not until a compliance monitoring

review by HSBC in 2009–10 (some four years after the acquisition) that the serious systemic issues were finally identified.

- NHFA was trusted by its vulnerable and elderly customers, and it breached this trust by selling them unsuitable products. Such a breach of trust, notably in relation to those customers most in need of suitable advice due to their particular vulnerabilities, undermines confidence in the financial services sector as a whole and can do considerable damage to the reputation and integrity of institutions that customers rely on to give them appropriate and professional advice.
- There is a high risk of customer detriment if management fails to implement adequate procedures for monitoring the quality of sales and identifying issues relating to the suitability of advice given.
- The FSA had recently published a series of high-profile communications highlighting the requirement upon firms to treat customers fairly, emphasising the need to ensure the suitability of sales to customers for particular products, and implementing appropriate controls during the sales process. It was therefore in light of this communication to firms about the FSA's concerns in this area that it took a dim view of these issues not being addressed by a firm in such a prominent position as HSBC.

7.4 Combined Insurance Company of America ("CICA") (Final Notice: December 16, 2011)

7.4.1 Penalties

The FSA fined CICA £2.8 million for failing to embed a culture which recognised the importance of treating customers fairly. The fine included a 30 per cent discount for early settlement, without which the fine would have been £4 million.

CICA agreed to carry out a past business review, through an independent third party, to identify any customer detriment and to provide appropriate redress.

7.4.2 Summary

Between April 2008 and October 2010, CICA sold accident and sickness insurance products to retail customers via self-employed agents, who made sales on an advised basis. CICA had 542,133 policyholders during the relevant period and received £47 million in premiums. CICA's target customers were self-employed individuals, small business owners and manual workers (who were unlikely to have considered purchasing such insurance products before).

The FSA had conducted a risk assessment in August 2006 and identified a number of concerns around CICA's compliance function, suitability of advice and treatment of customers. In January 2008, the FSA conducted a visit to ascertain the extent to which CICA had embedded the FSA's treating customers fairly ("TCF") policy, and further issued a new risk mitigation programme in March 2008 to address some of its concerns over systems and controls in respect of its sales force and complaints handling. The FSA continued to monitor CICA through further a supervisory visit in August 2008.

On August 20, 2010, the FSA required CICA to undertake a skilled person (s.166) report on its governance and controls. In light of the initial data produced, CICA agreed to cease writing new business from October 26, 2010.

The FSA found that CICA breached Principle 3 (management and control) and Principle 6 (customers' interests) by failing to establish effective controls and governance to identify and manage the risk of customers being treated unfairly and being advised to purchase regulated products which were not suitable for them. The FSA identified systematic TCF failings across its business, including the sales process, claims handling and complaints handling, in particular:

- recruitment processes focused on quantity rather than quality of recruits, with no minimum qualification requirements for agents and references were not always obtained;
- CICA did not put in place adequate systems and controls to ensure its sales agents had the necessary skills and knowledge to provide suitable advice to customers;

- CICA did not ensure its sales agents recorded all relevant information when advising customers on product suitability;
- the remuneration structure was commission-only based on sales volume and not enough on quality of sales, which was high risk;
- CICA failed to monitor its claims-handling process;
- CICA failed to take effective action against sales agents who were subject to customer complaints or breached company rules;
- CICA failed to have effective systems and controls in respect of its complaints-handling procedure; and
- throughout its business CICA failed to put in place effective governance and controls to identify and manage the risk that customers would be treated unfairly, and failed to take effective action when issues arose.

The FSA considered the failings as particularly serious as:

- the breaches revealed serious weaknesses in management systems and internal controls across CICA's business;
- CICA put all of its customers at risk of being treated unfairly; and
- TCF is a priority for the FSA, and the FSA has repeatedly stressed the importance for regulated firms to focus on this.

7.4.3 Lessons to be learnt

- As outlined in other enforcement actions, insufficient discussions by senior management of the root cause of issues, and failure to make effective use of customer feedback to improve a firm's business and systems are systemic problems that need to be addressed.
- The size of the penalty indicates the vital importance that the FSA continues to ascribe to TCF compliance, the need for deterrence and to encourage TCF-compliant behaviour. Between 2004 and 2007 the FSA published a considerable amount of material on the importance of TCF. The widespread failures by CICA reflected a culture which did not recognise the importance of TCF and therefore created a significant risk that customers would not get a fair deal. The FSA was concerned that CICA may therefore have made unsuitable sales of policies, which would have resulted in a benefit for CICA and a potential loss for its customers.

8. Provision of information to clients

8.1 Santander UK Plc ("Santander") (Final Notice: February 16, 2012

8.1.1 Penalties

The FSA fined Santander £1.5 million for breaching Principle 2 (Skill, care and diligence) and Principle 7 (Communications with clients) and COBS 6.1.16R in relation to the disclosures it made as to the availability of the Financial Services Compensation Scheme ("FSCS") when selling its structured products.

8.1.2 Summary

Two products were available to customers, the Guaranteed Capital Plus and the Guaranteed Growth Plan. Money invested in these plans was used by the structured product plan provider/manager, Abbey National PEP & ISA Managers Limited ("ANPIM"), to buy shares in a protected cell of a Guernsey company, Guaranteed Investment Products 1 PCC Limited ("PCC"). The PCC invested the proceeds of the share sales into financial instruments provided by Abbey National Treasury Services Limited ("ANTS"). The structured products were covered by a guarantee from Abbey National Guarantee Company ("ANGC"), a wholly-owned subsidiary of Santander. Under this guarantee investors would receive back the original capital sum they had invested together with a specified minimum capital return; in other words, the guarantee was designed

to provide the investors with protection in the event that the PCC shares did not perform sufficiently well to meet the minimum return guaranteed to investors. There was an agreement between ANGC and Santander under which the former could require the latter to subscribe for additional shares in ANGC in the event that this was needed to enable ANGC to pay out under the guarantee.

While Santander disclosed the fact that the strength of the guarantee depended ultimately upon the solvency of Santander and its subsidiaries, its disclosures regarding the availability of FSCS were not clear. In particular, from October 1, 2008 until January 6, 2010, Santander did not clearly disclose to clients the circumstances in which the FSCS would *not* be available (i.e. where the PCC underperformed so that it could not meet the guaranteed minimum, ANGC did not have sufficient money to meet the guarantee and had to call on Santander to subscribe for additional shares and Santander was unable to do this because of its insolvency). In short, the FSCS would not cover failure to pay the guaranteed minimum.

8.1.3 Lessons to be learnt

- Although the structure that Santander had created was complex, it was ultimately sanctioned for a simple failure to make a clear disclosure to clients.
- The relative complexity of the products was no defence—it was Santander that decided to create the structure to sell the products to the retail customers and it was therefore Santander's responsibility from the outset to ensure that it understood the scope of FSCS cover and then explain that scope to the customers. Furthermore, the wording of that disclosure had to be viewed from the perspective of an average (and relatively unsophisticated) retail banking customer.
- Central to the FSA's concerns was the time it took Santander to take remedial action in relation to the inadequate disclosure:
  - the FSA found that Santander had identified concerns about the scope of FSCS cover for its structured products as early as October 2008 (when, because of the financial crisis, it received an increase in the number of queries in relation to the availability of the FSCS);
  - at the beginning of 2009, the internal legal team queried the scope of FSCS cover for the structured products—clarification from the FSCS was sought, although the issue was not resolved;
  - in April 2009 the FSA asked Santander to confirm the precise scope of FSCS cover for the structured products; and
  - in June 2009 (eight months after Santander first became concerned about the scope of FSCS cover), Santander concluded that any client claims in relation to ANGC's obligations under the guarantee would not be covered by the FSCS—but even then it was not until January 6, 2010 (15 months after the issue first arose) that revised wording, clarifying the circumstances in which FSCS cover would not be available, was provided to customers.
- The case against Santander (although very specific on its facts) therefore provides a salutary lesson to in-house legal and compliance departments about the importance of not "sitting on" problems but instead taking control of an issue of potential concern once it has been identified. Firms should ensure that the processes of analysing the legal or regulatory issues and (if required) imposing remedial measures take place on a timely basis and are not allowed to become protracted. The FSA made the point that, of the £2.7 billion of structured products sold from October 1, 2008 to January 6, 2010, £1.2 billion were actually sold *after* Santander had categorically concluded, in June 2009, that the ANGC guarantee would not be covered by the FSCS, and before the remedial disclosure was made in January 2010.

9. Breach of the Listing Rules

9.1 BDO LLP ("BDO") (Final Notice: May 26, 2011)

9.1.1 Penalties

The FSA censured BDO for its failings as a sponsor to Shore Group Plc's ("Shore") proposed acquisition of Puma Brandenburg Limited ("Transaction"), for failing to act with due care and skill as a sponsor, and for failing to deal with the FSA in an open and cooperative way.

This is the first exercise by the FSA of its power under s.89 of FSMA to censure sponsors in relation to the Listing Rules. (There is currently no power under FSMA to impose a financial penalty on a sponsor, although it should be noted that the FCA's powers under the Act as amended by the Bill currently progressing through Parliament will be significantly enhanced.)

9.1.2 Summary

BDO was approached to advise on the Transaction in May 2009, and was made aware that it might constitute a reverse takeover due to the significant size of the Puma Brandenburg. Shore's shares were traded in the Official List and traded on the LSE.

The Listing Rules state that a suspension of the listed company's shares will often be appropriate in these circumstances (i.e. a reverse takeover), unless the UK Listing Authority ("UKLA") is satisfied that there is sufficient information in the market about the proposed transaction.

The Listing Rules also make it clear that sponsors should work closely with the UKLA to meet their obligations. However, instead of liaising with the UKLA, BDO specifically agreed with Shore not to contact the UKLA until *after* the announcement, and reworked the class tests in an attempt to avoid classifying the Transaction as a reverse takeover (with the likely suspension of the listing), despite recognising that this was unlikely to succeed.

These failings meant that BDO did not satisfy the requirements for a sponsor to act with due care and skill (LR 8.3.3R), and did not deal with the FSA in an open and cooperative way (LR 8.3.5R).

The FSA found that:

- BDO failed to liaise with the UKLA at any time prior to the announcement, having decided so at the outset (in a letter of engagement), and did not reconsider this approach as further information emerged, nor revise its advice at any stage;
- BDO reworked the class test several times, the results of which clearly indicated that it was a reverse takeover;
- the fluctuating results of the test reworkings, and BDO's position in its class test letter to the UKLA maintaining its stance that it was a class 1 transaction, indicated a failure to provide the objective oversight required of a sponsor;
- by focusing on trying to avoid the suspension of Shore's shares, BDO failed to show the objective oversight required by a sponsor; and
- it was (as BDO accepted) an error of judgment not to liaise with the UKLA until after the announcement, and not to review this approach at any stage of the process.

The FSA found the following to be aggravating factors:

- BDO placed too much focus on its client's preferences, and not its objective oversight in avoiding contacting the UKLA until after the announcement;
- the class tests and possible suspension should have made it clear that issues needed to be discussed with the UKLA. These were clear indications that the Transaction was a reverse takeover rather than a class 1 transaction (and BDO was aware of this);
- having agreed at the outset not to contact the UKLA, BDO failed to revisit its approach subsequently; and
- the Listing Rules make it clear that sponsors should work closely with the UKLA.

In mitigation, the FSA accepts that BDO have introduced changes since this Transaction, improved their systems and controls and no evidence has been found by BDO taking a similar approach on other transactions. BDO cooperated with the FSA investigation and did not appeal the censure.

9.1.3 Lessons to be learnt

- This action emphasised the need for the objectivity of a sponsor to override client requests/ requirements as sound and expert guidance is needed from a sponsor due to the important decisions

taken for investors and the potential impact this may have on the market. The censure sends a clear message about the importance the FSA/UKLA attributes to the objectivity and oversight of the sponsor role. Sponsors should note the enhanced disciplinary powers that the FCA will have against them under the new regulatory architecture.

- The UKLA has made it clear that it expects high standards from sponsors and a high degree of cooperation and engagement from sponsors and issuers. It has also issued specific guidance in relation to suspensions in the event of reverse takeovers. The FSA went into detail to show that it would ordinarily have expected BDO to have contacted the UKLA in light of this substantial amount of material, and that BDO should have been well aware of the rationale behind the suspension of shares required in such circumstances.

10. Breach of the Disclosure and Transparency Rules

10.1 Sir Ken Morrison ("Sir Ken") (Final Notice: August 16, 2011)

10.1.1 Penalties

The FSA fined Sir Ken £210,000 for failing to disclose his reduced shareholding and voting rights in WM Morrison Supermarkets Plc ("Morrison"). This fine included a 30 per cent discount for early settlement, without which it would have been £300,000.

The FSA applied the new Decisions Procedures and Penalties Manual, as the most substantial breaches occurred after their introduction when the value of the share transactions was much higher.

10.1.2 Summary

On March 28, 2008, shortly after Sir Ken's retirement, Morrison announced that Sir Ken had gifted shares into various trusts, and going forward had a "notifiable holding of voting rights" of 6.38 per cent.

On March 1, 2011, Morrison made a further announcement that, between 2009 and 2010, Sir Ken had reduced his shareholding with his associated voting rights falling from 6.07 per cent to 0.9 per cent. This accounted for four occasions when his voting rights would have become notifiable, but had not been so notified.

This failure by Sir Ken to notify Morrison resulted in the company being unable to update the market in accordance with the Disclosure and Transparency Rules ("DTR"), and that the company's published annual report of January 31, 2010 was incorrect as regards his shareholding.

Sir Ken explained the failure to notify Morrison as being due to him being unaware of his duty to do so.

The FSA regarded the breaches as being particularly serious because:

- Sir Ken had a prominent position within the industry;
- there was a significant delay in making the eventual notification;
- failure to comply with the rules in DTR 5 (which are designed to enhance transparency and provide investors with timely information) damages overall investor confidence in the markets; and
- despite the fact that Sir Ken's conduct was not found to be reckless or deliberate, and he did not benefit financially from the breaches, it would be expected that someone in his position would take legal advice on his obligations when selling his shares.

10.1.3 Lessons to be learnt

- Significant shareholders' disclosure of shareholdings in a timely and accurate way is fundamental to a properly informed securities market, and the FSA will make an example of those not complying with their obligations.
- Persons in such prominent positions need to remain aware of their ongoing obligations, and *take appropriate legal advice*. The FSA seemed to be unimpressed with the assertion that Sir Ken was unaware of his obligations in this regard, as it would be highly unlikely that someone of his wealth and in his position would not take either specific or ongoing legal advice in relation to disposals of his shareholdings and any follow-on requirements relating to such disposals.

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COMPLIANCE OFFICER BULLETIN

The regulatory environment in which financial institutions operate has been one of constant change and evolution in recent years, not only as a result of the FSA's own regulatory initiatives, such as the move to more principles-based regulation, but also as a direct consequence of the need to implement European directives within the United Kingdom, and domestic and international responses to the credit crisis.

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