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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 representing individuals and companies in relation to investigations and enforcement proceedings by the FSA and also by the Serious Fraud Office, the London Stock Exchange, HM Revenue & Customs and non-UK regulators. The Group has acted for a large number of firms and individuals under investigation for a variety of alleged misdemeanours, including manipulation of trading records, mismarking, market abuse, insider trading, systems and controls failings, loss of customer details, money laundering failings, breaches of Principles 1, 5, and 6, and others. The Group's representation of individuals has included one of the Dresdner bond traders publicly censured by the FSA in October 2009 for market abuse and the former managing credit director at Northern Rock who was sanctioned by the FSA in April 2010 for failing to control the provision of accurate mortgage arrears information.*

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THOMSON REUTERS

FSA enforcement action—themes and trends

1 Introduction

It seems hard to believe that, not so long ago, senior Financial Services Authority ("FSA") personnel were publicly declaring in print and in speeches that "we are not an enforcement-led regulator". Those days are clearly over. Today, one imagines that there is a strict prohibition at Canary Wharf against any future utterance of those words by FSA staff. Instead, the FSA's credible deterrence strategy is now well and truly established.

In this issue, we review a number of the more important FSA enforcement cases that were published between October 2008 and April 22, 2010, in order to identify the key themes and trends.

Before we look at some of those themes in more detail, there is one overriding point above all others which is borne out by many of the cases we have reviewed. Central to a large number of FSA enforcement actions is a failure in a firm's *systems and controls*—whether the "topic" of the enforcement case is fraud, money laundering or other financial crime, data protection, financial promotion, rogue traders, mismarking, transaction reporting or mis-selling. Systemic failings will be punished severely, even where customers may not have suffered any actual detriment.

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When reading some of the cases—particularly those involving particularly egregious failings—your reaction might be "that would never happen here". While this is understandable, the very nature of systems and controls failings is that they lie latent until discovered—and for many of the firms that are subject to enforcement action from the FSA, it is not until something goes wrong that the systemic weakness manifests itself. One of the functions of a compliance officer and senior management is to test whether there are any vulnerabilities in the firm's systems and controls and to address them before something goes wrong.

A number of messages emerge from the cases, of which some of the most important are:

- Firms that do not learn from their own failings or the publicised failures of others will be more severely treated. Toronto Dominion was fined £7 million having been fined £490,000 for similar failings two years previously. HSBC was fined for not protecting customer data and criticised for failing to learn from the Nationwide case which had also involved data loss.

- Individuals are in the firing line and tough action will be taken. The recent cases involving fines for former Northern Rock directors (which are not reviewed below) are but one example of the FSA handing out stiff penalties, even where the failings involve negligence or similar failings rather than deliberate acts—see for example the fine on the MLRO in the *Sindicatum* case. Individuals who do not perform their controlled functions are effectively at risk of being banned, a finding that someone is not fit and proper does not always mean they are dishonest. It should also be noted that under the amendments made to the Financial Services and Markets Act 2000 ("FSMA") by the new Financial Services Act 2010, the FSA will have enhanced disciplinary powers against approved persons. Senior management are more in the firing line than ever before.

- Firms that rely on external consultants to provide compliance support or monitoring are at risk if their senior management assume they need not understand the compliance issues and do not take responsibility for them. See for example the cases involving *Direct Sharedeal, Sindicatum* and *Wheelhouse*.

- Firms are responsible for the failings of their appointed representatives and must therefore have proper compliance monitoring in place, as it is the firm that will be fined for any failures. See for example *Falcon Securities* and *Direct Sharedeal*.

- The FSA is willing to use its powers to bring criminal prosecutions, and it must be borne in mind that Financial Services and Markets Act and other legislation in the financial services sector create a number of criminal offences. In September 2009, the FSA secured its first criminal conviction against an individual (Vijay Sharma) for acquiring a controlling interest in a regulated firm without giving the FSA the prior notice that legislation requires.

Perhaps the most surprising, and arguably unfair proceeding was brought against Semperian Limited Partnership in February this year for failure to obtain FSA consent in advance of acquiring a controlling interest in a regulated firm, even though the FSA did grant approval after the event. The judge said that Semperian had taken a "calculated risk" that the FSA would not prosecute. It is not just in the market abuse sphere that criminal actions may be brought, and it is clear that the FSA will pursue criminal actions even where the conduct is not what the layman would consider to be criminal in nature.

In the light of the above comments, in outline the cases reviewed in this issue focus on the following topical themes:

- Spearheading the FSA's increasingly aggressive enforcement stance is its fight against *market misconduct*. There have been a number of successful criminal prosecutions resulting in five sentences of imprisonment, one of which was suspended (McQuoid and Melbourne, Matthew and Neel Uberoi and Malcolm Calvert). A number of high-profile insider dealing criminal prosecutions are currently being pursued. But aside from the obvious increase in criminal prosecutions and investigations, the FSA is also "upping its game" as regards civil market abuse actions. In February 2010 we saw the largest fine so far imposed on an individual for market abuse (Mehmet Sepil). In October 2009, there was the first action in relation to market abuse in the non-equity markets (Darren Morton and Christopher Parry).

- Of course, FSA enforcement is not all about market misconduct even if the criminal insider dealing cases tend to grab the headlines. Other aspects of financial crime, such as money laundering, are also high on the regulator's agenda, in line with its statutory objective to reduce such crime. The FSA has warned that where it sees weaknesses in *anti-money laundering* ("AML") systems and controls it will act. In October 2008 the FSA took action against Sindicatum Holdings Limited for failing to follow its own AML client-identification procedures and also for failing to follow Joint Money Laundering Steering Group (JMLSG) Guidance. The FSA did not find any evidence that money laundering had actually taken place. As mentioned above, the FSA also fined the money laundering reporting officer ("MLRO") personally for failing to oversee and implement AML systems and controls (the first time it had done this). The FSA has also warned (in a speech by Margaret Cole on November 19, 2009) that it considers that an important element of AML controls is that of the identification of politically-exposed persons ("PEPs") and so firms should revisit their policies and procedures in this regard.

- Following on from the previous point, the FSA will also take action against firms if their systems and controls are inadequate to counter *the risks of bribery and corruption.* The FSA fined Aon Limited £5.25 million in January 2009 for systems and controls failures, having made 66 suspicious payments to overseas third parties in a number of high-risk jurisdictions. In future, it is not just large fines from the FSA that firms will need to worry about. The Bribery Act 2010 ushers in a number of *criminal* offences of bribery: in addition to the bribery offences that may be committed by persons in seeking to bribe other persons or foreign public officials, a firm may commit an offence by omission if an agent (e.g. a member of its staff) commits a bribery offence and the firm does not have in place adequate procedures to prevent such bribery.

- The FSA will continue to take a very dim view of *data protection shortcomings*—three HSBC subsidiaries received between them fines totalling £3.25 million for failings in their data security systems and controls even though there was no evidence that any of the lost data had been compromised. The shortcomings may be surprising, even breathtaking—such as leaving unencrypted floppy disks containing customer data on open shelves or in unlocked cabinets or sending such data through ordinary post or putting bank account details in waste paper recycling sacks—but one wonders how often, in practice, these types of things happen in busy offices.

- There were a number of high-profile cases against firms for systems and controls failings which allowed their traders to *mis-mark their positions*: Morgan Stanley & Co Plc was fined £1.4 million, Nomura International Plc was fined £1.75 million and Toronto Dominion Bank was fined £7 million. These cases highlight, amongst other things, the risks associated with firms trading increasingly sophisticated financial products: individuals on trading desks may

effectively be able to act with autonomy where there is no oversight function carried out by someone with independent expertise who is able to understand the product and the way it is traded. Given that these types of products are often illiquid, there is a risk that such traders will be able to manipulate the pricing process if the firm's price verification process is not robust enough.

- As has been seen before, the FSA will proceed against firms for *breaches of Principles* alone—see, for instance, the case involving Standard Life Assurance Limited which was fined for breaches of Principles 3 (management and control) and 7 (communications with clients) in respect of its systems and controls failings in relation to marketing materials.

Finally, following the introduction of the FSA's revised policy as regards enforcement financial penalties on March 6, 2010, it is to be expected that yet higher penalties will be imposed on firms in future in pursuance of the regulator's credible deterrence strategy. It therefore pays to be aware of the areas in respect of which the FSA is particularly focused, to assess what lessons might be learnt from past enforcement actions and, if necessary, to take remedial action.

2. Market conduct

The FSA has continued to devote significant resource to the pursuit of market conduct cases, giving these cases the highest profile and priority. The period under review has seen a considerable number of cases, including:

- a number of successful criminal prosecutions, the majority of which have been punished by imprisonment; and

- the FSA's largest fine imposed against an individual for market abuse (£965,005—reduced from £1,265,005 for cooperation—against Mehmet Sepil in February 2010).

Many of the cases appear straightforward on their facts as reported although their number and the regular announcement of new cases serve as frequent reminders that the FSA is a regulator with both teeth and determination to clean up the markets. Where clear evidence is not available, the FSA has demonstrated its willingness to pursue cases on the basis of inferences drawn from circumstantial evidence.

The less straightforward cases from which particular trends or lessons can be extracted are summarised below.

2.1 Winterflood Securities Limited ("Winterflood") and others (FSMT Decision: March 2009; Court of Appeal Decision April 22, 2010; Final Notice: April 22, 2010)

2.1.1 Penalties

In June 2008, the Regulatory Decisions Committee ("RDC") of the FSA issued decision notices finding market abuse on the part of Winterflood and two employees of Winterflood and imposed financial penalties of £4 million, £200,000 and £75,000 (reduced to £50,000 on the grounds of personal financial circumstances) respectively.

The findings were not accepted and the case was referred to the Financial Services and Markets Tribunal ("FSMT").

2.1.2 Summary

The facts related to a share ramping scheme concerning the shares in Fundamental–E Investments Plc ("FEI"). The success of the ramping scheme depended on the involvement of a market maker to intermediate the trades and ensure less visibility of the perpetrator, one Mr Eagle. It was Winterflood,

and two employees in its market making team, who (unwittingly or otherwise) provided this intermediation. The FSA concluded that the participation of Winterflood and its two employees in the arrangements was sufficient to constitute market abuse even though they had not themselves intended to distort or mislead the market. The FSMT decision supported this conclusion.

The key issues considered at the FSMT were:

- whether merely satisfying the statutory definition of market abuse is sufficient, or whether it is necessary also to prove a subjective mental element to distort or mislead the market; and
- whether the evidential provisions (as opposed to the conclusive, or "safe harbour", provisions) in the FSA's Code of Market Conduct qualify the statutory definition.

It appears to have been accepted that the test set out in the statutory definition was met.

The FSMT decided that (i) satisfaction of the statutory definition of market abuse is sufficient even in the absence of an intention to distort or mislead the markets, and (ii) the evidential provisions under consideration, which related to whether there needed to be an "actuating purpose" to mislead or distort the market, did not qualify the statutory definition.

Winterflood appealed to the Court of Appeal. On April 22, 2010, the Court of Appeal dismissed the appeal and confirmed that "no actuating purpose" is required to mislead or distort the market.

2.1.3 Lessons to be learnt

Irrespective of the outcome of the appeal, there are some important lessons to be learnt. The pattern of behaviour to which Winterflood was counterparty was visibly (to it and/or the relevant market makers) unusual and warning bells should have been ringing. The signs which were either missed or ignored included:

- the extremely high number of trades in the stock;
- the volume of trades arranged through a single party (Mr Eagle at SP Bell);
- the extensive use of rollover trades and delayed rollover trades;
- the fact that the rollover trades appeared to breach exchange rules;
- the fact that the purchases continued irrespective of market conditions;
- the positions Mr Eagle held at both FEI and SP Bell;
- the fact that there was a preference to discuss matters on untaped lines.

It is clear that the FSA expects firms to consider all relevant facts in order to assess whether there is cause for concern. Failure to do so may implicate the firm itself in the abusive behaviour.

2.2 The Dresdner bond traders—Darren Morton and Christopher Parry (Final Notices: October 6, 2009)

2.2.1 Penalties

The RDC published findings of market abuse in respect of both individuals, although (very unusually) the findings were not accompanied by fines or prohibition orders. There appears to have been no sanction against Dresdner.

2.2.2 Summary

A number of calls were received by Mr Morton, who worked at a Dresdner structured investment vehicle known as K2. The purpose of the calls was to test likely appetite for a new issue of debt by Barclays.

At no point during the calls was it certain that the issue would proceed, although the levels of uncertainty, particularly as to timing, varied as the calls proceeded.

Having received the calls, Mr Parry dealt on behalf of K2 in an existing debt security of the same issuer.

Three key issues emerged:

1. Pre-marketing calls of this nature were common in the debt markets but (in contrast to the equity markets) they were generally regarded by market participants as either not specific or not price sensitive for market abuse purposes, leaving recipients of such calls free to deal following receipt of the call. Indeed, it seems that Dresdner's view at the time was that K2 (which regularly received similar calls) was "not routinely privy to price sensitive non-public [information]". The FSA sent a clear message that this analysis was incorrect.

2. The FSA repeated its view that "price sensitivity" should be assessed by reference to whether the information would be relevant to an investor's decision to buy or sell the securities (a test for which an actual or expected price movement may not be an essential element). However, where a price movement is envisaged it should not be disregarded solely on the basis that it is expected to be temporary. If a brief peak or drop is expected while the market digests the news, this will be enough if it is otherwise "significant".

3. The market abuse defence, which excuses behaviour if the person believed on reasonable grounds that his behaviour did not amount to market abuse, was considered. The FSA stated that reliance on a combination of guidance from the Dresdner compliance department and market practice at the time was not sufficient to establish the reasonableness of a person's belief. This would appear to erect an almost impossible hurdle to jump before the defence can be relied on and would also appear to be far more restrictive than the draftsman intended.

2.2.3 The lessons to be learnt

The key lessons to be learnt from the Dresdner bond traders cases are as follows:

- It is vital that firms re-visit the analysis of their activities in the debt and other non-equity markets. Parallels should be drawn with the more considerable body of analysis in the equity markets. Firms should be prepared to justify deviations from equity market practices.

- Training should be provided which is tailored to business models: firms should not assume that staff will apply the necessary (or correct) read-across to examples designed for different business models or markets.

2.3 Robin Chhabra and Sameer Patel (FSMT Decision: October 2009)

2.3.1 Penalties

The case was determined on reference to the FSMT, which found that both individuals had engaged in market abuse. The FSA imposed a penalty of £95,000 on Mr Chhabra and £180,541 (which included disgorgement of profits) on Mr Patel. Both are prohibited from performing any function in relation to a regulated activity at an authorised firm.

2.3.2 Summary

Mr Chhabra was an analyst at Evolution Securities and Mr Patel was his friend. Mr Patel invested in shares and undertook spread betting in his personal capacity. Some of the issuers in respect of which Mr Patel placed spread bets were those covered by Mr Chhabra and, on occasions, there appeared to be a correlation between the subject and timing of Mr Patel's spread bets and knowledge of Mr Chhabra gained in the proper course of his employment, for example, where Mr Chhabra was in possession of inside information or was about to publish investment research. It was found that a number of bets were placed by Mr Patel in reliance on information which was not generally available and which had been disclosed to him by Mr Chhabra.

The case was primarily decided on findings of fact, based largely on the assessment of the reliability of inferences drawn from circumstantial evidence. However, in the course of its judgment, the Tribunal made comment in relation to the time at which Mr Chhabra would have come into possession of relevant information.

Mr Chhabra had been left a telephone message by a member of the Evolution corporate finance team. The message indicated that his corporate finance colleague needed to speak to him urgently about a company he covered. At the time of the message, Mr Chhabra was not entered on Evolution's insider list—the entry was only made after he had spoken to the corporate finance colleague and been told that there was to be a forthcoming (negative) announcement by the company. The FSMT indicated that the fact that something urgent had happened in relation to a company could in itself be information not generally available and could be regarded by a regular user of the market as relevant. Since this information was communicated in the initial message, this would have brought forward the time at which Mr Chhabra should have been treated as an insider.

2.3.3 The lessons to be learnt

In the light of the FSMT's comment, firms would be advised to review their policies and procedures relating to insider lists to ensure inside information is identified, and relevant entries made sufficiently early in the process.

2.4 Mark Lockwood (Final Notice: September 1, 2009)

2.4.1 Penalties

The FSA imposed a financial penalty of £20,000 on Mr Lockwood for breach of the Principles for Approved Persons by failing to meet appropriate standards of market conduct.

2.4.2 Summary

Mr Lockwood worked on a trading desk at a retail stock broking firm. Mr Lockwood's clients included two—client X and client Y—who knew each other well. Mr Lockwood was told early one morning by client X that he had been contacted in relation to a potential placing by Amerisur. That same morning, client Y (whom Mr Lockwood knew also dealt in Amerisur) contacted him with a view to a sale of Amerisur shares. During the course of the conversations that ensued, client Y indicated that he had also been told about the possible placing, but Mr Lockwood sought to limit the extent to which further explanations were given.

The FSA found that Mr Lockwood had sufficient information to understand that the sales by client Y were suspicious but failed to recognise the clear warning signs. As such, he not only failed to prevent the trade but also failed to submit a suspicious transaction report to the FSA.

2.4.3 Lessons to be learnt

The case underlines the responsibility on firms and relevant approved persons to be alert to warning signs, to confront any suspicions that arise and to act accordingly.

3. Systems and controls—risks of crime—bribery and corruption

3.1 Aon Limited ("Aon") (Final Notice: January 6, 2009)

3.1.1 Penalties

The FSA fined Aon £5.25 million (£7.5 million, reduced by 30 per cent for early settlement) for breaching Principle 3 by failing to take reasonable care to organise and control its affairs

responsibly and effectively in that its management systems for countering bribery and corruption associated with making payments to overseas third parties ("OTPs") were inadequate, particularly in high-risk jurisdictions.

Firms that do not learn the lessons from previous disciplinary actions will be treated more severely. In the 1990s Aon was censured and fined £300,000 by Lloyd's Disciplinary Board after two predecessor companies made suspicious payments to OTPs, including government officials. The FSA considered that Aon should have been aware of the risks associated with making payments to overseas third parties given that part of its business had previously been censured and fined in relation to very similar circumstances.

3.1.2 Summary

Aon is a wholly-owned subsidiary of the Aon group. It is one of the largest insurance and reinsurance brokers in the London Market and is authorised to carry on insurance mediation activities. As a result of its systems and controls failures, Aon made 66 suspicious payments to OTPs in Bahrain, Bangladesh, Bulgaria, Burma, Indonesia and Vietnam amounting to approximately US$2.5 million and €3.4 million.

Details of the breaches included:

- payment procedures not requiring adequate levels of due diligence into OTPs;
- failing to monitor relationships with OTPs in respect of specific bribery risks;
- not monitoring relationships or payments after they had been entered into or made;
- not providing staff with sufficient guidance or training in bribery and corruption risks; and
- failing to ensure that committees appointed to oversee bribery and corruption risks received relevant information and/or routinely assessed such risks.

3.1.3 Lessons to be learnt

The FSA's enforcement notice offers considerable insight into the FSA's expectations of firms' anti-bribery and corruption systems and controls. Firms should consider the following key messages:

- Aon had established procedures that focused on its dealings with third parties in the United Kingdom. This meant that it did not properly identify and deal with the risks associated with payments to third parties who were based overseas. Firms must consider the global reach of their business and recognise that the FSA rules and principles can be relevant to business conducted overseas as well as within the United Kingdom. The case illustrates the risks of focusing on specific issues of UK detail (in this case, whether UK recipients needed FSA authorisation) without taking a broader perspective.

- Client take-on, anti-money laundering, due diligence and other internal authorisation procedures (e.g. procedures for authorising payments to third parties) should specifically assess and address the bribery and corruption risks presented by the countries in which the firm does business. More onerous standards should be applied in relation to jurisdictions presenting higher risk. When dealing with higher risk jurisdictions, firms should question the nature and purpose of any payments made or transactions carried out. In particular, firms should consider whether there seems to be a genuine commercial purpose for a payment or transaction.

- Once a problem comes to light, firms must consider if it could indicate a deeper problem. In June 2006, upon becoming aware of potentially inappropriate payments in relation to energy business in Indonesia, Aon conducted an internal review of the matter. However, Aon made no assessment of whether there were broader weaknesses in its systems and controls until July 2007, by which time further suspicious transactions relating to business

in Bahrain had come to Aon's attention. But even then the review was inadequate, resulting in two further suspicious payments to OTPs being made.

- As part of its remedial work Aon introduced a new global anti-corruption programme with a specific policy for the use of third-party introducers. Under the policy, such introducers are only permitted where the risk of corrupt practices is low, with acceptable jurisdictions being defined by reference to an internationally accepted corruption perceptions index. The new policy on introducers is implemented at Aon by a working group, which reviews all existing and proposed third-party relationships. The group is currently chaired by Aon's CFO and comprises senior management, business, finance, legal and compliance executives and external legal counsel. Firms which make payments to third parties overseas should consider similar policies and working practices.

- Many firms operate procedures relating to various matters which involve codes of conduct and self-certification. In this case, the FSA noted that whilst a code of conduct and a self-certification process can play important roles in *contributing* to a robust control environment, they are not of themselves sufficient. They need to be supplemented by adequate training and written guidance, robust procedures and proper monitoring. These comments should be considered by firms in the context of their bribery and corruption controls and also more generally.

- Firms must ensure they have appropriately focused training (including on the firm's procedures) and testing on the understanding of that training. Aon's new controls include an external law firm providing in depth in person training to specific employees, as well as customised online training for all staff. The training uses example-based scenarios that reflect real issues that have been identified. Firms need to consider the nature of training required by different categories of employee and not adopt a "tick-box" approach to training issues.

- Bribery and corruption risks should, where relevant, be specifically considered by senior management (e.g. at meetings of the board or any relevant risk committees). Senior management should receive sufficient relevant management information to allow them to assess periodically whether the firm is managing its bribery and corruption risks effectively. Firms should ensure that any internal audit covers bribery and corruption risks. Any areas of concern should be promptly and appropriately escalated to senior management and, where appropriate, notifications to SOCA and the FSA should be made.

- Firms should be aware that, following the introduction of the Bribery Act 2010 (which is expected to come into force later this year), there are a number of *criminal* bribery offences to which financial services firms may be subject—including bribing other persons and foreign public officials. A firm may also commit an offence by omission if an agent (e.g. a member of its staff) commits a bribery offence and the firm does not have in place adequate procedures to prevent such bribery.

4. Systems and controls—risk of crime—anti money laundering ("AML")

The reduction of financial crime is one of the FSA's regulatory objectives and includes reducing the extent to which it is possible for a regulated person to be used for a purpose connected with a financial crime.

The FSA has repeatedly stressed the importance of effective AML controls and has stated that it is fundamental to the health of the financial services industry that firms establish and maintain effective systems and controls for countering the risk of facilitating money laundering or furthering financial crime.

The related *Sindicatum Holdings Limited* and *Michael Wheelhouse Final Notices* discussed below provide a salutary reminder that the FSA takes extremely seriously any failings by firms in relation to their AML controls, regardless of how small the firm is, and that it will take action against the MLRO, even where no money laundering has taken place.

4.1 Sindicatum Holdings Limited ("SHL") (Final Notice: October 29, 2008) and Michael Wheelhouse ("MW") (Final Notice: October 29, 2008)

4.1.1 Penalties

SHL was fined £49,000 (reduced from £70,000 for early settlement) for breaches of Principle 3 of the FSA's Principles for Businesses and the requirements of SYSC for failures in its anti-money laundering systems and controls.

The FSA fined MW £17,500 for failures in overseeing and implementing anti-money laundering systems and controls at SHL between October 2003 and September 2007. Although this is not the first time that the FSA has punished senior managers in respect of AML failures (Ram Melwani was fined in 2005), this is the first time that a MLRO has been fined for failure to oversee, implement and maintain AML systems and controls. MW was fined but not banned and the Final Notice states that he has undertaken further AML training.

4.1.2 Summary

SHL is a corporate advisory firm whose clients were predominantly small and medium corporates based overseas, for whom it periodically advised and arranged dealings in investments. MW was a director and joint founder of SHL and was approved by the FSA to perform the money laundering reporting function (CF11) as the money laundering reporting officer of SHL. In this role, he had responsibility for oversight of SHL's compliance with the FSA's rules on systems and controls against money laundering.

SHL had anti-money laundering and client identification procedures in its AML Handbooks (produced by an external consultant) specifying the steps to be taken to identify clients; however, there were no adequate processes or controls to ensure this procedure was followed.

Regulated activities were carried on for only 26 clients and the FSA found that the identification of 13 of these clients, who were low risk, was appropriate. Therefore, this disciplinary action arose out of the failure in respect of the anti-money laundering checks carried out on 13 "higher risk" clients.

As with previous AML enforcement actions, the FSA found no evidence that money laundering had actually taken place. The issue related to the failure to implement adequate systems and controls.

4.1.3 Lessons to be learnt

- Small firms with simple business models can end up in enforcement, even though the size and scale of their business (and of their regulatory failings) might be considered relatively small in the context of the overall industry. Although the failures related to only 13 clients, this was, in the context of SHL's business, a significant number of the firm's overall client base.

- SHL was typical of many smaller regulated firms in that it used compliance manuals produced by external consultants who also provided associated training and undertook quarterly reviews of the operation of the procedures. This process was often informal with no adequate processes for ensuring that feedback and advice were used to make necessary improvements to the firm's systems. Firms should not take comfort from the fact that they employ external consultants if they nevertheless fail to take responsibility themselves for implementing procedures and understanding the reasons for them.

- As with many cases, whilst there were procedures (in this case involving checklists), there were no processes to ensure that the procedures were followed; nor was there any follow-up from the quarterly compliance reviews. As a result of these procedural failings, SHL failed

in practice to implement the identification and verification procedures which it had. This is a classic case of a firm which had procedures, but which did not operate them.

- Company and personal documents obtained by SHL were, in some cases, in foreign languages. There was inadequate evidence to demonstrate that these documents, or translations of them, had been adequately reviewed by the MLRO in order to confirm their contents.

- Of particular interest in an AML context are the criticisms of SHL for:

  — failing to obtain sufficient evidence of verification of identity or to make and retain records of such evidence;

  — failing to consider whether some of the clients were higher risk as a result of being incorporated in less transparent jurisdictions (clients came from jurisdictions which included Lithuania, Slovenia, Russia and Hungary);

  — accepting information concerning the directors and beneficial owners from the client rather than obtaining evidence from independent sources;

  — not obtaining evidence to verify that particular individuals were in fact directors or beneficial owners;

  — where photocopies had been accepted, not retaining evidence that originals had been sighted or that the copies were true copies; and

  — failing fully and adequately to follow the JMLSG guidance or operate adequate alternative methods of identification.

- As with many small firms, MW was a joint founder and director of SHL. It is often the case that in smaller firms one of the few directors is also the MLRO, and the case illustrates that persons charged with such responsibilities must make sure that they understand their duties and that they ensure that the firm does operate compliant AML procedures.

- The action against MW serves as a warning to MLROs in small- to medium-sized firms: the failure to implement adequate controls is unlikely to be tolerated by the FSA in any circumstances, but the FSA was undoubtedly even less tolerant in this case given the relatively small number of clients needing identification and the long period of time over which the failures persisted.

- Although MW had set up a new business committee to monitor the introduction of new business and took advice from independent consultants, the FSA found that this was insufficient to ensure or improve compliance, as MW failed to ensure that client checklists were fully completed and he made no reference to any such matters in his MLRO reports. As a result, he was a cause of the failure by SHL to have effective systems and controls.

- The case illustrates the importance of applying exemptions correctly. MW applied an exemption from identification to a particular bank despite the fact that the bank was not incorporated in a country appearing on the “equivalence” list. The FSA noted that on this occasion MW had acted as the account executive collecting the identification evidence and also as the officer reviewing and signing off the account (a practice which must surely be necessary in many small firms with limited personnel). The FSA commented that “such an arrangement decreased the likelihood of this failure being identified”. While this point was not central to the FSA’s findings, it is worrying to see the regulator impliedly suggesting some kind of “four eyes” principle in this context—after all MW was the MLRO: he had oversight responsibility, and it was he who made the mistake. Although a firm must have effective systems and controls for countering the risk of financial crime and the MLRO must have a level of independence, there is no explicit requirement in SYSC or in the JMLSG Guidance Notes to ensure that the activity of data collection and the activity of review and sign off must be performed by different individuals.

The case is a warning to firms where (possibly because of the size of the firm), a single individual may be both working on a particular matter and also responsible for signing off on client acceptance and verification forms. In the FSA's view, the absence of an independent check on signing off the client acceptance procedures decreased the likelihood of failures being identified.

- Although SHL used independent compliance consultants to draft manuals, give training and conduct quarterly reviews, this process was often informal with no adequate processes for ensuring that feedback and advice were used to make necessary improvements to the firm's systems.

5. Systems and controls—data protection

The penalty imposed by the FSA on HSBC for data security weaknesses, discussed further below, is substantially higher than that imposed on Nationwide Building Society for similar weaknesses in 2007, demonstrating the increasing importance the FSA attaches to its stated objective of protecting customers from the risk of financial crime. Whilst actual data loss was an aggravating factor, the FSA made clear that defects in the relevant procedures, which routinely exposed customers to the risk of financial crime, were by themselves a cause for significant concern. With the Information Commissioner's new powers to order organisations to pay up to £500,000 for serious breaches of the Data Protection Act, in force since April 6, 2010, firms would be well advised to review their data security arrangements.

5.1 HSBC Life UK Ltd ("HSBC Life"), HSBC Actuaries and Consultants Ltd ("HSBC Actuaries") and HSBC Insurance Brokers Ltd ("HSBC Insurance") (Final Notice: July 17, 2009)

5.1.1 Penalties

The FSA fined HSBC Life £1.61 million, HSBC Actuaries £875,000 and HSBC Insurance £700,000. In all cases the firms received a discount for early settlement, without which the fines would have been £2.3 million, £1.25 million and £1 million, respectively. The fines were for systems and controls failings in breach of Principle 3 of the Principles for Businesses, relating to failures to establish and maintain effective systems and controls to manage the risks relating to data security, specifically the risk that confidential customer data might be lost or stolen.

5.1.2 Summary

The companies' businesses related to the provision of life and pension products, actuarial and employee benefit and financial planning services, and services for non-investment insurance contracts. As a result, they had significant confidential customer data relating to individual and corporate customers, sufficient for criminals to use as a starting point to commit identity theft and other frauds, such as fraudulent redemption of policies.

There were a number of serious data security failings, in many cases common to all three of the companies involved. These included data loss incidents where customer data in electronic form (CDs and floppy disks) which was sometimes password protected but not encrypted, was sent in the ordinary post to a third party and did not arrive. Amongst other security failings, for instance, HSBC Insurance routinely disposed of customer data, such as bank account details, as waste paper for recycling rather than disposing of it securely.

5.1.3 Lessons to be learnt

- It is essential that firms undertake comprehensive risk assessments relating to customer data in their possession. Whilst all the HSBC entities had carried out reviews these were inadequate, for example:

— there was a failure to identify the risks posed by sending personal data to third parties either by e-mail attachments or by portable storage devices;

  – in HSBC Life the reviewers did not examine the finance department. It was sending CDs to reinsurers by post—one of the data losses which occurred originated from that department sending policy data on CD by post to a reinsurer;

  – HSBC Insurance Brokers failed to identify certain physical security risks, such as documents not being secured in offices, and the risks associated with the communication or transfer of customer data.

- It is clear that the FSA expected firms to take account of the Nationwide case and ensure that customer data on portable media (such as USB devices, CDs and DVDs) was encrypted. It will certainly expect firms to review their position in the light of the HSBC cases.

- A firm's data security procedures need to be robust enough to prevent customers being exposed to the risk of financial crime, especially in respect of day-to-day working practices that can affect data security. Procedures are not robust if staff cannot access or understand them. The HSBC procedures were inadequately organised and presented. Staff had to find a number of different documents in different locations on the intranet to understand the procedures in full, and the procedures themselves were conflicting.

- Firms must provide training both at an induction stage and in refresher training which adequately addresses data security risks. The HSBC training was principally focused on the data protection legislation and did not sufficiently address the financial crime risks of inadequate data security. It also failed to take account of the potential for non-sensitive personal data to be used to further financial crime. It was not specifically tailored to specific departments or staff roles and did not address specific working practices. HSBC Life used email reminders for various procedures, some of which related to data security, but the FSA noted that the effectiveness of this system was diluted by there being in excess of 150 different reminders in regular circulation. Many firms may be at risk because their procedures focus on Data Protection Act compliance and the handling of sensitive customer data, without paying attention to the financial crime risks that can also arise with more general customer data.

- Procedures need to be clear and detailed. For example, in the case of HSBC Actuaries, its procedures stated that "Staff must ensure that confidential information cannot be readily accessed, opened or browsed without detection by unauthorised individuals." But staff were not required to encrypt customer data sent externally and, even if they had wanted to do so, there was no mechanism in place to enable them to do so. Staff members were instructed to follow a "clear desk" principle, but there was no practical guidance on how to follow this (e.g. it was not specified whether confidential information needed to be removed from desks each evening and kept in locked cabinets overnight). Procedures should provide for compulsory encryption on relevant electronic data transfers and give clear instructions to staff on when and how to apply encryption and physical security; offices should include lockable cabinets and clear instructions should be given on when to use them.

- Where customer data is handled by external parties (including couriers and waste disposal firms), appropriate due diligence checks should be carried out on those entities.

- If problems are encountered, swift action has to be taken. HSBC Actuaries was criticised for taking three months from notification of the data loss incidents before it began to implement a procedure enabling staff to encrypt data.

- Firms should consider whether their internal structures need revision. For example, the HSBC companies introduced various changes after the problems were identified. HSBC Life introduced an information security forum as a sub-committee to the formal risk

committee structure and established a "business information risk officer" whose job is to assess the firm's performance against a number of specific information risk indicators. HSBC Actuaries ensured that its compliance department regularly communicated amendments to its "Business Instruction Manual" to staff by e-mail and introduced "data protection champions" who cascade information from compliance to employees and who are the first source of contact for day-to-day data security queries.

6. Systems and controls—mis-selling

There have been a number of mis-selling cases and some key lessons arising from those are summarised below. The cases include the first enforcement action following the FSA review of the marketing and distribution of structured products, particularly those backed by Lehman Brothers—see RSM Tenon Financial Services below in respect of which Margaret Cole commented "the FSA will continue to take tough action where it finds evidence that firms are giving unsuitable advice to investors".

Clamping down on high-risk share mis-selling is high on the list of the FSA's priorities. On September 16, 2009, the FSA announced that it had ordered 11 firms out of the "penny share" market until they had overhauled their business models and proved that they no longer posed a risk to consumers. These firms exerted inappropriate pressure on elderly customers to buy shares and failed to explain the risks involved. See also the Final Notices issued in respect of Pacific Continental Securities UK Limited and Pacific's senior management on January 28, 2009, the Final Notices in respect of Hythe Securities Limited and Meenaz Mehta on April 14, 2010, and the Final Notices in respect of Will & Co Stockbrokers Limited, Park Row Associates Limited and Falcon Securities discussed below.

Pension switching advice has also featured with AWD Chase de Vere Wealth Management Limited, a large independent financial advisory firm, being fined £1.12 million for serious systemic weaknesses in its compliance systems and controls in relation to its pension transfer, pension annuity and income withdrawal business. On April 16, 2010, Robin Bradford (Life and Pension Consultants) Limited was fined £24,500 for poor pension switching advice. The FSA published the findings of its follow-up work to improve the quality of pension switching advice on April 10, 2010. Whilst the FSA has said that it has seen great improvement in the market, with many firms reviewing past sales and procedures to deliver improved outcomes for customers, it also considers that there remain a number of firms still giving high levels of unsuitable advice. The FSA has made clear that it will continue to focus on the high-risk firms through intensive supervision and will not hesitate to take tough action against any firms whose conduct falls below the FSA's standards.

6.1 Wills & Co Stockbrokers Limited ("Wills") (Final Notice: February 16, 2010); Park Row Associates ("Park Row") (Final Notice: February 23, 2010); RMS Tenon Financial Services Limited ("Tenon") (Final Notice: February 24, 2010)

6.1.1 Penalties

The FSA fined Tenon £700,000 for significant failings in its advice and sales processes relating to Lehman-backed structured products, and for having poor systems and controls to prevent unsuitable advice in its structured products and pension switching business (the maximum 30 per cent discount was given).

Wills and Park Row were given public censures, but only because of their financial state and the fact they were winding down. Otherwise, fines of £1.5 million and £2.4 million would have been imposed on Wills & Co and Park Row respectively. Park Row also agreed to pay customer redress, estimated at between £5 million and £7.8 million, with the support of its parent company, Royal Liver Assurance Limited, and to undertake a customer contact programme relating to the sale of

high-risk products to identify whether customers were not treated fairly because they received, or were at risk of receiving, unsuitable advice.

The FSA fined Peter Sprung, Park Row's former chief executive, £49,000 (after a 30 per cent discount for cooperation and early settlement) and withdrew his approval to perform a controlled function at Park Row. He also undertook not to perform a significant function at any firm for five years. The FSA issued public statements of misconduct against Wills & Co's compliance director (Katherine Prichard) and sales director (Darren Lansdown), who were responsible for ensuring that remedial work required by the FSA in 2007 was implemented. Both undertook not to seek to hold significant influence functions for five and three years respectively and agreed to resign their current directorships in respect of Wills & Co and other group companies.

The Wills and Park Row cases were instances of extremely poor conduct over prolonged periods, and included failures to respond adequately to previous regulatory actions. Whilst it must be hoped that there are not many firms with similar profiles, the cases do illustrate certain recurring themes in relation to suitability of advice.

6.1.2 Summary

The Wills case followed action taken by the FSA in September 2009 against a number of penny shares dealers after finding that older people were being targeted by high-pressure sales tactics. It is clear that the FSA will not tolerate such sales techniques. Wills made recommendations and sales to its customers, primarily by telephone. The case was regarded as particularly serious because it followed previous enforcement action. The action taken against key individuals emphasises the responsibility of directors to set an appropriate culture and approach to treating customers fairly and to correct failings which have been identified. The FSA will take robust action against directors personally when they fail in these responsibilities.

In the Tenon case, the FSA found that, in relation to its sales of Lehman-backed structured products, Tenon failed to treat some of its customers fairly and breached Principles 3 and 9 of the FSA's Principles for Businesses and certain rules of the Conduct of Business Sourcebook. Tenon also breached Principle 3 in relation to its pension switching business.

Tenon was not only fined but was also required to conduct a past business review of all of its sales of structured products to assess the suitability of its recommendations and to provide appropriate redress (including interest on capital invested) to both customers who received unsuitable advice and to those who received advice that Tenon cannot demonstrate was suitable. The cost of this exercise could be significant: the Final Notice against Tenon states that the products which may be subject to redress are estimated to be £1.8 million.

The Park Row case concerned the fact that the firm was unable to demonstrate that its files properly evidenced the suitability of sales when advising customers about pensions, investments, mortgages, structured products and annuities. Park Row sold high-risk products and gave some customers unsuitable advice and others were at risk of being given unsuitable advice. It had failed to address the issues despite receiving internal and external reports, including from the FSA, which highlighted concerns.

6.1.3 Lessons to be learnt

- Firms which provide advice to retail clients need to ensure that they have up-to-date personal and financial information from the customer before making recommendations.

- Wills' terms of business stated that it was the customer's responsibility to update information supplied to the firm. The FSA makes clear that it nevertheless remained Wills' responsibility to ensure that each and every recommendation was suitable and criticised the firm for assuming that there had been no change in a customer's circumstances just because the customer had not given notice of any such change, particularly when it was some time since a client information form had been updated. This is a warning to firms to prompt clients regularly to update information and to have procedures, where oral advice is given, to check with the customer that there have been no changes to the profile notified.

- Customer files must properly demonstrate that the advice given to customers is suitable and firms must have adequate procedures to monitor suitability of advice. Some of Park Row's advisers were known to select products with the highest paying commission and even though Park Row was on notice of this, it failed to conduct any further investigations in order to establish the magnitude of this problem and whether the systems and controls were adequate to detect its future occurrence. Tenon failed to record the customers' annual income, investment timescales, existing savings, existing investment portfolio and liabilities and therefore could not demonstrate the suitability of its advice because it had recorded insufficient personal and financial information on customers' files. Tenon's ability to record and use customer information properly was adversely affected by the fact that its different offices used different processes and procedures for collating and recording customer information. Information was not collected on one file but was often spread over a number of different files relating to different transactions conducted by the firm on behalf of the same individual. Firms which have more than one office or different divisions within an office need to ensure that they have a coherent process for recording customer information.

- Firms which sell structured products must assess fully the risks of the particular structured products they sell and ensure advisers consider those risks and portfolio concentration risk when providing advice to customers. For example, Tenon's recommendations conflicted with, or did not adequately take into account, the customer's investment objectives and/or financial circumstances, did not match their attitude to risk and often resulted in an excessive concentration of the customers' overall savings and investment portfolio in the one recommended structured product.

- Particular care needs to be taken when advice is given to clients by telephone or in person. Wills' advisers were criticised for giving unbalanced accounts of past performance of stocks, for making unsubstantiated comments about future performance of stocks and for misleading clients by the way in which they referred to fees and charges. Firms which rely heavily on interaction between advisers and clients on the telephone or in meetings need to take particular care to demonstrate both the training that they give to their advisers and the monitoring of the statements that are actually made to customers.

- Particular care needs to be taken with risk warnings given orally. In the Wills case, there were occasions when the risk warning was given only after the sale had been agreed by the customer. In other transactions, although the warning was given, it was then undermined by further statements made by the adviser. It is also unwise, when making recommendations by telephone, to rely on the fact that there may be risk statements in terms of business. Although Wills' terms of business stated that all equity investments involve the risk of losing all or part of the investment, part of the criticism of its "unacceptable sales practices" was that in none of the transactions reviewed by the FSA was the customer informed during the sales call that they could lose all the capital they had invested in the stock. The clear implication from the notice is that where positive statements are made regarding an investment during an advisory telephone call, this must be balanced at that time by reference to the risks of acquiring the investment, which in that case included the case of losing the entire investment. This was part of a general theme concerning the fact that the recommendations given were not balanced and did not contain any stock-specific risk warnings. Some of the stocks sold by Wills were admitted to trading on AIM or PLUS and the public documents for those stocks set out in detail the risk factors for investing in those companies. Wills was further criticised for not mentioning to customers the risk factors listed in the documents when advising them on a call.

- Sales procedures need to be structured to avoid the risk that customers feel pressured to make investment decisions. If customers are advised to trade outside normal market size for a recommended security firms must communicate clearly the implications of such trades. The implication is that where normal market size is exceeded, it might impact on the liquidity/future selling price of the security.

- Wills took principal positions in securities being sold. Its unacceptable sales practices included the fact that its advisers did not communicate clearly the mark-up being received by Wills on the securities being sold.

- Management information on complaints should include underlying information to enable an assessment of whether the complainant had been treated fairly at the point of sale and complaints procedures should take account of previous decisions of the FOS.

- Firms need to ensure that they appropriately identify communications with clients. Tenon treated certain communications as being direct offer financial promotions. In fact, they contained recommendations and were therefore advisory direct offer financial promotions, but were sent out without the firm conducting a suitability assessment.

- Compliance monitoring of sales calls needs to take into account the nature of the sales process, volumes of sales and the nature of risks sold. Wills' compliance monitoring was wholly inadequate with the compliance function monitoring only between 6 per cent and 16 per cent of calls that resulted in a transaction.

6.2 Falcon Securities (UK) Limited ("Falcon") (Final Notice: January 29, 2010)

6.2.1 Penalties

The FSA imposed a public censure on Falcon for breaches of the FSA Principles for Businesses by its appointed representative Montague Pitman Stockbrokers Limited ("MPS") in relation to serious failings arising from MPS's advice on the sale of higher risk small cap shares to clients. Had it not been for the fact that Falcon was in administration, a fine of £240,000 would have been imposed.

6.2.2 Summary

On February 1, 2007, Falcon appointed MPS, which shared the same offices as Falcon and is majority owned by Falcon's parent company, as its appointed representative. MPS was a retail stock broking business primarily dealing with private individuals, advising them on traded stocks. Falcon was therefore responsible for MPS's compliance with FSA requirements. Key MPS managers reported directly to the Falcon board.

The conduct of Falcon, in relation to MPS as its appointed representative, fell below the standards expected. Falcon failed to ensure that MPS employed appropriate sales practices when dealing with clients. The case shows the importance of proper compliance monitoring of the activities of an appointed representative. It also has comments on the provision of risk information to customers and appropriate remuneration systems. These latter aspects are relevant for any firm involved in advising and arranging transactions.

6.2.3 Lessons to be learnt

- Any firm which has appointed representatives is on clear notice that the FSA expects it to have rigorous management information to enable it to carry out robust monitoring and supervision of its appointed representatives.

- The case highlights the difficulties involved in ensuring that risk information is properly presented when contact with a client is principally by telephone. Clients were provided with generic risk warnings about shares. Advisers had sales scripts which contained mandatory risk warnings as well as a list of risks which were specific to the stock being sold. But Falcon failed to ensure that MPS actually communicated these risks fairly. In this case, either the stock-specific risks were not communicated at all, or the risks were undermined by MPS seeking to caveat the risk. As a result, many calls only covered the benefits of shares. It is not sufficient to have procedures—a firm must have methods of ensuring and monitoring that they are actually followed.

- Advisers were paid a basic salary plus commission which was based on levels of sales. It was recognised that this risked advisers pursuing sales at the expense of client suitability. As a result, Falcon operated a fining policy which meant that advisers lost commission for certain compliance failures identified by the compliance monitoring process. The monitoring process revealed that a number of advisers were being repeatedly fined each

month for the same breaches, but it appears that Falcon took no action despite the fact it should have been apparent that its procedures were not preventing misconduct.

- The case also highlights the importance of ensuring that account opening forms are properly completed. Falcon is criticised for the fact that in a very large number of cases there was missing information on the KYC forms and that the firm had not recorded any explanation of why it was appropriate to continue without them. It is quite often the case that a firm's procedures require the completion of a form. This is a useful reminder of the fact that, whilst there can be cases where it is legitimate for a form not to be fully completed, a firm needs to ensure that it records why that is the case.

- Payments from third parties fall within the inducements regime. Where such payments are permitted they still have to be disclosed to clients. Although Falcon inserted the following wording in a contract note:

  > "Falcon may have received a commission from a third party in relation to this transaction"

  the FSA found that this was insufficient to inform clients of the extent of the inducement received. They considered that this information could have affected a client's assessment of a recommendation. This is an area of significant regulatory focus as highlighted in the recent MiFID review, and firms need to ensure that they are providing adequate disclosures to clients in relation to inducements.

6.3 Direct Sharedeal Limited ("DSL") (Final Notice: February 17, 2010)

6.3.1 Penalties

The FSA fined DSL £101,500 (after applying the 30 per cent discount for early settlement) for breaches of Principle 3 (Management and control), Principle 6 (Customers' interests) and Principle 10 (Clients' assets) for failures in relation to the appointment, supervision and monitoring of its appointed representatives and in relation to the activities of one of its appointed representatives, First Colonial Investments ("FCI").

6.3.2 Summary

DSL was a stockbroker whose main service was providing a dealing platform, settlement and custody services to allow its clients to trade in spread bets, contracts for difference, and share dealing. It had appointed representatives who all targeted their business at retail clients. One of these appointed representatives, FCI, was a stockbroker specialising in recommending and selling higher risk investments issued by smaller capitalised companies to retail clients. This was undertaken mainly by telephone. FCI's sales methods involved high-pressure telephone sales and DSL failed to ensure that it complied with FSA rules. FCI also held client money contrary to FSA rules.

The day-to-day compliance monitoring of DSL and of its appointed representatives was itself outsourced to a third party. The improper sales techniques were possible because DSL did not carry out sufficient due diligence before the appointment of, or during an ongoing relationship with, its appointed representatives to ensure their suitability and did not identify and mitigate risks relating to the competence, suitability and approval of FCI's senior management and sales advisers.

6.3.3 Lessons to be learnt

- DSL did not carry out proper due diligence before appointing its appointed representatives or undertake close and continuous supervision of them. It prolonged the date of its decision to terminate the relationship so as to increase the likelihood of its receiving monies that were owed to it by the appointed representative. As a result, higher risk securities were sold to retail clients by using unacceptable sales practices.

- The case emphasises the importance of ensuring that where there is an appointed representative, there is proper and continuous compliance monitoring of the activities of that appointed representative. DSL had outsourced its compliance function. The Final Notice remarks that firms may use third-party services to assist them in the efficient running of their business but that ultimate responsibility for compliance cannot be outsourced and remains with the firm's senior management. The case again emphasises the risks of senior management taking comfort just because they have appointed an external consultant. In this particular case, although DSL's agreement with its compliance consultant provided for monthly compliance monitoring reviews of the appointed representative, DSL failed to pick up that during various periods there were in fact no compliance visits taking place.

- Compliance monitoring was inadequate, as some of the core monitoring was carried out by an employee of the appointed representative and the compliance consultant mainly reviewed the written reviews produced by this employee. This failed to bring to light the fact that the calls taking place were often extremely inadequate.

7. Mortgages—handling of arrears (TCF)

In June 2009, the FSA completed its latest review of mortgage lending. It found continued weaknesses in the way specialist lending firms and third-party administrators are handling mortgage arrears and repossessions. Four firms have been referred to enforcement for investigation and several more firms are being assessed for referral. In many cases, the FSA found a high incidence of mortgages moving straight into arrears and potential breaches of responsible lending rules. The FSA has said that all firms investigated will be required to take action to remedy failures identified in the arrears review. The FSA has also made clear that it will deal robustly with firms who do not treat customers fairly, particularly customers in a vulnerable position, such as those with mortgage arrears. Although focused on specialist lending, the FSA has made clear that the same message applies equally to other mortgage lenders. To help firms with their mortgage arrears and repossession handling, the FSA has also outlined some examples of good and poor practice (see *http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/mortgage_arrears_1/index.shtml* [Accessed April 22, 2010]).

Commenting on the GMAC case described below, Margaret Cole said:

> "This case shows credible deterrence in action. It is an excellent example of what the FSA's more intrusive approach can achieve for consumers, and it reflects what we said in our mortgage market review … about unfair mortgage arrears charges. Mortgage lenders and third party administrators should read this final notice and the mortgage market review and take action in the interests of their customers."

The GMAC case is important because it is an indication of the increasingly severe approach that the FSA will take to firms for failures in their mortgage account handling, particularly with accounts that are in arrears.

7.1 GMAC-RFC Ltd (Final Notice: October 28, 2009);

Kensington Mortgage Company Limited ("Kensington") (Final Notice: April 12, 2010)

7.1.1 Penalties

The FSA fined GMAC £2.8 million in breach of Principles 3 and 6 of the FSA's Principles for Businesses and of certain rules in the Mortgages and Home Finance: Conduct of Business sourcebook for failing to treat fairly its mortgage customers in arrears or facing repossession and for failing to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk-management systems. The fine would have been £4 million but GMAC received a

30 per cent discount for early settlement. GMAC is also to carry out a customer redress programme the estimated cost of which is up to £7.7 million, plus interest, for both regulated mortgage contracts and buy-to-let contracts.

Kensington was fined £1.225 million (discounted from £1.75 million for early settlement) and must carry out a customer redress programme, the estimated cost of which is up to £1.066 million.

7.1.2 Summary

GMAC-RFC Ltd ("GMAC") is a non-bank lender in the prime, sub-prime and buy-to-let mortgage sectors which arranges and administers regulated mortgage contracts. From October 31, 2004 to November 30, 2008 it administered 188,543 regulated mortgage contracts with a total balance of approximately £24.6 billion. The disciplinary action focused on failures in its arrears-handling processes to comply with MCOB or properly to implement TCF.

Kensington was found to have breached Principle 3 in failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk-management systems, to have breached Principle 6 by failing to treat certain customers fairly and had breached various rules in MCOB. The failings related to the handling of customers with a mortgage with Kensington who were in arrears. The failings meant that Kensington did not treat customers fairly in handling their mortgage arrears, focused on collecting payments over a short period of time rather than establishing suitable arrangements to pay based on the customer's individual circumstances, and did not have an appropriate cost-based approach to the calculation of certain charges.

7.1.3 Lessons to be learnt

- Relevant firms need to ensure that they can justify the fees they charge both in relation to the nature of the fee and its amount. GMAC was required to provide redress to customers who were charged specific charges that were not a reasonable estimate of the costs of the additional administration required in respect of their mortgage account as a result of being in arrears. Kensington's charges, which were found excessive or unfair, were fees for returned direct debits charged on each representation of the direct debit, fees for cancelled direct debits, imposition of an early repayment charge on mortgage balances which included arrears fees and charges within that balance. Firms need to use a cost-based approach to the calculation of arrears charges to be able to demonstrate that they are reasonable compared to the actual cost incurred.

- Following the case, GMAC ceased to charge arrears fees where there is a performing arrangement to pay. The redress package provided to customers related to charges (solicitor's instruction fee, non-payment by direct debit fee, early repayment charge on arrears fee balances) that had been imposed by it on customers in connection with arrears handling and repossessions.

- Firms need to ensure that they are getting the right management information about arrears handling. The GMAC information focused on outcomes in terms of quantitative measurements (such as average number of days to get a court order), but did not provide any qualitative assessments of performance or TCF. Firms should ensure that their management information in relation to mortgage accounts does not only focus on the performance of the mortgage book and the profitability of the business, but that it also includes sufficient management information to enable senior management to monitor TCF outcomes, for example, by including information in relation to the uphold rates on "Arrangements to Pay", the reasons for failed Arrangements to Pay, the average success rates of applications in repossession proceedings and the reasons for any such applications failing. All of this material is essential in order to monitor whether the firm is meeting its TCF obligations.

- Firms need to ensure they are using management information—for example, GMAC did not carry out any analysis of why its repossession proceedings only had an average success rate of 33 per cent and therefore was not able to identify whether customers were being treated fairly.

- Firms should ensure that their policies fully reflect the requirements of MCOB concerning the handling of customers in arrears. Arrears-handling policies must ensure that advisers consider all appropriate arrears tools and proactively offer various options which are available to the customer, rather than waiting for the customer to request them. Firms must adopt a reasonable approach to the time over which shortfalls should be paid, taking into account where feasible, a plan that is practical in terms of the customer's circumstances. Flexibility is required and firms should ensure that they consider customers' individual circumstances and use repossession only as a last resort. In the Kensington case staff failed to discuss with customers all options available to them with regard to repaying payment shortfalls, failed to take account of the customer's individual circumstances in agreeing periods over which the payment shortfall could be paid and repossessed properties without first exhausting all attempts to resolve the situation.

- Staff within the arrears department must be given proper TCF training and this extends to any temporary staff handling arrears cases. Firms should review the activities of mortgage services staff to ensure that they have a proper understanding of, and implement, the TCF requirements when dealing with customers in arrears and in relation to repossessions. Kensington's training literature encouraged staff to focus on obtaining maximum payments from customers rather than on TCF issues.

- Firms need to monitor and be satisfied with the size of their compliance team, taking into account the demands on it. In a six-month period, the Kensington compliance team reduced from seven full time staff to 1.5 full time and 0.5 administrators, naturally resulting in a significant decline in the level of compliance monitoring. Firms can expect that they will need to justify to the FSA any decline in the numbers of their compliance personnel which does not correspond to decline in the level of work.

8. Systems and controls—lack of control over employees: mis-marking, pricing and unauthorised transactions

There have been a number of cases arising out of the mis-marking of books by traders to conceal losses and/or circumvent price-verification processes, all of which caused their employer firms to have to restate published or reported figures. The cases reveal inadequate procedures for obtaining independent prices for illiquid products, poor coordination and confusion between supervisors, and inadequacies in control functions which permitted traders to exploit and exert influence over the pricing process.

Firms should be aware that the FSA takes such failings extremely seriously. It has warned on a number of occasions of the risks surrounding mis-marking of financial instruments and the actions of rogue traders. It has made it clear that:

- There are significant risks associated with illiquid financial instruments which are difficult to value and special care is needed with them and with the pricing of derivatives and other complex products.

- Firms must ensure that individuals with a potential incentive to mis-mark are properly controlled.

- Firms must ensure that their operational and compliance areas are appropriately resourced to cope with business volumes and market volatility. The FSA has repeatedly said that if a firm does not have the resources to supervise an activity adequately it should not undertake it.

- Firms must have controls to manage and preferably avoid the inherent conflicts of interest when the same person makes investment decisions and also plays a key role in the pricing of the same investments, particularly where his remuneration may be linked to investment performance.

The cases show the importance of ensuring that product control functions are independent, that they do not (whether through laxity, close relationships or work pressures) become susceptible to influence from or reliant on the front office for assistance, and that independent price verification procedures are thoroughly and regularly reviewed for potential weaknesses both in design and in their operation. The cases highlight the importance of a strong middle office, trained to be independent and to investigate and escalate concerns and to challenge practices which go against firm policy.

8.1 Nomura International Plc ("Nomura") (Final Notice: November 16, 2009)

Morgan Stanley & Co International Plc ("Morgan Stanley") and Matthew Piper ("MP") (Final Notices: May 13, 2009)

Toronto Dominion Bank—London Branch ("Toronto Dominion") (Final Notice: December 15, 2009)

8.1.1 Penalties

Nomura was fined £1.75 million (discounted from £2.5 million for early settlement) for failures in its systems and controls which resulted in serious failings in relation to the marking of its books in its International Equity Derivatives Business.

Toronto Dominion was fined £7 million (discounted from £10 million for early settlement) for failing to have adequate systems and controls in place in relation to trading book pricing and marking within its credit products group. The size of the fine partly reflects the fact that Toronto Dominion had already been the subject of previous FSA enforcement action for systems and control failings concerning the pricing of financial products which was concluded only two years previously, with a fine of £490,000.

Morgan Stanley was fined £1.4 million (discounted from £2 million for early settlement) for failures in its systems and controls which led to mis-marking on its investment grade trading desk, part of its credit trading line of business. The employee concerned, MP, was prohibited from performing any functions in relation to any regulated activity on the grounds that he is not a fit and proper person and was fined £105,000.

8.1.2 Summary

- The Morgan Stanley case was yet another case of a proprietary trader in complex instruments mis-marking his positions, which mis-marking was facilitated by the firm having inadequate procedures to cope with the complexity of the business and significant inadequacies in the control functions which were responsible for reviewing end-of-month marks and validating traders' profit and loss figures. MP was based on Morgan Stanley's investment grade trading desk where his book consisted of certain illiquid financial products. Between December 2007 and May 2008, MP mis-marked his index and option positions to the sum of $120 million to conceal losses he had accrued.

  MP also deliberately excluded Morgan Stanley's valuation review group from a key part of Morgan Stanley's control process, sought to hide his losses by manipulating the process by which traders challenged valuations used by the firm's valuation review group ("VRG") and took further steps to avoid detection when the VRG raised questions on certain of his positions.

  Following a review of MP's positions, Morgan Stanley reported in its second quarter results on June 18, 2008 that it had made a "$120 million negative adjustment to marks previously taken in a trader's books that did not comply with Firm policies". This adjustment was solely due to MP's actions.

- Failings within the product control and front office which persisted for a prolonged period of time resulted in the mis-marking of books in Nomura's international equity derivatives business. A mis-marking incident in the Hong Kong single stock book resulted in a

negative valuation adjustment of £10.8 million and correlation marks across the books were reassessed resulting in a further negative adjustment of £5.5 million.

- Following the departure of a trader (the "Trader") in the credit products group ("CPG") business of Toronto Dominion and the subsequent inspection of his trading books, certain pricing issues were discovered which ultimately led to a downward valuation of CAD$96 million to the books and corresponding announcement to the market on July 4, 2008.

  All CPG trading positions were subject to a month-end independent price verification ("IPV") process, which should have resulted in the elimination of inaccurate marks. During the relevant period, responsibility for IPV checking of the Trader's products rested with the global middle office (the "GMO"). A review commissioned by Toronto Dominion discovered a number of failings which either contributed to the pricing issues not being detected or which might have increased the chance of detection.

8.1.3 Lessons to be learnt

It is essential that the procedures for price verification and similar control functions are not undermined by the way in which they involve traders. Firms should design their procedures on the assumption that if a trader can manipulate them to his advantage he will do so. For example:

- The Nomura front office was given advance notice of stocks that were to be included in the month-end IPV process. This enabled traders to mark correctly stocks that were to be tested and mis-mark other stocks.

- The obtaining of external data, if done by the trader himself, needs specific control. Prices obtained via traders whose books have been verified are not independent. In Nomura, the front office obtained the broker quotes for the purposes of the IPV process. In Toronto Dominion, contrary to the IPV policy, the global middle office accepted market quotes forwarded by the trader as being independent. Indeed they specifically requested him to obtain quotes for use in the IPV process. This arose because they did not sufficiently challenge the trader's explanation that some quotes, particularly for "off-the-run" CDO index and tranche positions, could only be obtained by the trader himself. Firms need to consider whether their middle office staff have sufficient status and ability to challenge traders who give explanations that cause deviations from standard policy, or a procedure for ensuring that such issues are escalated.

- In Morgan Stanley the mark review process enabled traders to challenge valuations. There was insufficient experienced management oversight of the challenge process. This increased the chances of manipulation through choice by the traders as to which valuations to challenge. The Morgan Stanley trader only corrected valuations which he could demonstrate were too low and did not correct those that he knew to be too high.

Firms need to be aware that staff turnover and inadequate training of middle office can lead to problems and that middle office staff need training in the importance of being aware of warning signs and appropriately escalating them. For example:

- In Toronto Dominion there were warning signs in that the trader frequently asked to communicate directly by telephone rather than e-mail with several individuals copied in, and appeared to be anxious about the monthly results and often forwarded quotes and telephoned very late at night.

- In Morgan Stanley the trader was required to copy the valuation review group on his e-mails to the external price providers so that it could oversee the process, but he took steps to restrict their access by ceasing to copy them into his exchanges and they did not challenge their exclusion at a sufficiently senior level, thus not appropriately escalating the matter.

- Collateral disputes may be an indication of a problem. In Toronto Dominion there were a number of collateral disputes that occurred on the trader's books, but collateral disputes

were not incorporated into management reporting and the fact that the collateral management team had inadequate product knowledge meant that they did not effectively challenge the reasons given for the collateral disputes by the trader.

- Firms must ensure that there is clarity as to supervisory responsibility in respect of traders. In Morgan Stanley there were reporting line changes, and a lack of clarity as to the respective roles of those who had supervisory responsibility.

Procedures which are inadequately designed or which are not changed to reflect additional risks caused by changes in market conditions also featured as key contributors to the problems faced by the firms. Firms should ensure that their product control procedures do not have similar defects which render the IPV process potentially ineffective at deterring or detecting mis-marking. For example:

- In Nomura, the IPV process with respect to volatility marking was inadequate due to the small selection of stocks tested, the fact that price testing did not focus on illiquid underlying stocks despite the fact that such stocks carry more risks of mis-marking, and product control did not use the P/L reports to assist in selecting stocks for testing by, for example, monitoring to see if P/L movements should lead to testing as part of the month-end process. Product control failed to carry out any basic sense checks, which would have revealed that long and short positions for the same stock had been marked with very high and very low volatilities.

- In Nomura, the product control team extrapolated data to create its own "independent prices" to test volatility marks for areas for which independent marks could not be obtained. The FSA regards this as a weak form of independent price verification and criticised Nomura for failing to differentiate positions verified directly from those verified by extrapolation, which they considered gave false comfort as to the extent and integrity of the price verification work.

- Firms need to ensure that their systems and controls keep pace with both the complexity and growth of their business and that they respond quickly to changing conditions in relevant markets. Nomura's business had grown in terms of size and products traded, particularly to include exotic products, but its systems and controls around book marking were not commensurate with the size of the division and the range of the products. Morgan Stanley failed to respond to an increase in volatility and a decrease in liquidity in the credit markets by adjusting its existing systems and controls in a way that would have enabled it to detect the mis-marking of illiquid products.

- Firms must be aware that where there is a decline in the availability of external prices (or no availability at all), particular vigilance must be applied to the controls and checks in the verification process. For example, in the Morgan Stanley case in the absence of external data or other valuations for certain of the positions it developed a stress test, but this itself was inadequate, wrongly applied and inaccurately described in the reports disseminated to senior management.

8.2 Alexis Stenfors (Decision Notice: March 16, 2010)

8.2.1 Penalty

Mr Stenfors was prohibited from performing any function in relation to any regulated activity on the grounds that he is not a fit and proper person. The Final Notice states that the FSA is minded to revoke the prohibition order at any time after five years from the Final Notice, in the absence of any new evidence that Mr Stenfors is not fit and proper.

8.2.2 Summary

Mr Stenfors was a trader on the short-term interest rate trading desk of the London branch of Merrill Lynch International Bank Limited, an Irish bank.

For a period of approximately one month in early 2009, Mr Stenfors had deliberately mis-marked positions on his trading books, overvaluing them by approximately US$100 million. The bank was reprimanded by the Irish Financial Regulator and required to pay a fine of €2.75 million. The fine related to its failure to have in place well-defined lines of supervisory responsibility and for having inadequate month-end independent price-verification processes.

8.2.3 Lessons to be learnt

- All traders should be made fully aware of their responsibilities to mark to market and of the consequences of failing to do so. Firms should ensure that the importance of and reasons for marking to market are known to their traders, as well as the escalation process to be followed if for any reason the trader has difficulties with marking to market.

- The FSA has no tolerance for attempts to mitigate based on stress and/or market conditions. Traders must use escalation procedures when they are in difficulty with pricing. Mr Stenfors stated that his conduct was mitigated by an enormous workload and prolonged lack of holiday that contributed to him being mentally exhausted, and exceptional market conditions that made it very difficult for him to obtain marks for his positions. The FSA did not consider these to be mitigating factors as he was a senior and experienced trader and did not alert his managers to the difficulties he was having.

9. Systems and controls—lack of control over employees—internal fraud

9.1 UBS AG ("UBS") (Final Notice: August 5, 2009) and Andrew Cummings ("Cummings") (Final Notice: November 13, 2009)

Seymour Pierce Limited ("Seymour Pierce") (Final Notice: October 8, 2009)

9.1.1 Penalties

The FSA fined UBS £8 million (reduced from £10 million for early settlement) for failing to conduct its business with due skill, care and diligence and failing to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk-management systems. The customers to whom losses were caused have been compensated by UBS who paid out in excess of $42.4 million.

Cummings was a client adviser in UBS's wealth management business approved for the FSA controlled function of "Investment Adviser". The FSA prohibited him from performing any functions in relation to any regulated activity and fined him a total of £35,000 (reduced from £100,000 due to his poor financial circumstances and a 30 per cent discount for early settlement) for failing to act with integrity. It was accepted that he did not initiate the circumstances that led to his misconduct and that he did not personally conduct the unauthorised transactions or personally arrange the purported loans. The FSA took account of the fact that he was under significant pressure when asked to sign various letters by a senior colleague and that he stood to make no personal gain from his actions.

Seymour Pierce was fined £154,000 (reduced from £220,000 for early settlement) for failure to organise and control its affairs responsibly and effectively, with adequate risk-management systems, thereby failing to prevent employee fraud on the firm and its clients.

9.1.2 Summary

The wealth management arm of UBS provides services to non-UK resident high net worth individuals, including access to UBS Investment Bank, through which individuals can trade in foreign exchange and precious metals.

Through an investigation triggered by the concerns of an employee, UBS discovered that certain of its employees had undertaken unauthorised foreign exchange and precious metals trading across 39 customer accounts. The trades used customers' money without authorisation and allocated the resulting profit or loss to other affected customers' accounts. Customers with significant liquid funds were persuaded to "lend" funds to other customers who had incurred losses as a result of unauthorised trades. Cummings signed seven "UBS Guarantee Letters" approving purported loans totalling $10.5 million between UBS customers, knowing that such letters had not been authorised by UBS. The documents purported to represent that the loans had been arranged in the normal course of UBS business and were guaranteed by UBS.

At Seymour Pierce, an employee was able to steal approximately £150,000 from the firm's internal and private client accounts in 36 separate transactions over a three-year period. The majority of the transactions were facilitated by unauthorised changes to static data on client accounts and/or the mis-use of dormant client accounts.

9.1.3 Lessons to be learnt

The cases are good examples of how, in some cases, employees are not merely negligent, but carry out deliberate acts which they know to be wrong. There were numerous failings in systems and controls which allowed the unauthorised transactions and concealment of losses to take place. Some issues arising from these cases that firms may wish to consider are:

- The provision of retained mail facilities for clients puts these clients at a higher risk of internal fraud as, because they may not be receiving timely statements and updates, they are less likely to discover unauthorised activities. Customers who used the retained mail facility were those who suffered from the unauthorised transactions at UBS. If firms provide these facilities, their procedures need to take these risks into account.

- Dormant accounts also increase fraud risk because they are not likely to be monitored by the clients who hold them (whether they are institutional or private client accounts). Internal fraud management procedures should take account of this increased risk. The FSA considers an account to be dormant if there has been no trading activity for at least two years or it is otherwise known to be inactive. Seymour Pierce had a number of legacy private client accounts which it had been unable to close because it could not locate and obtain instructions from the relevant clients. It allowed the accounts to be left open on the relevant systems without putting in place a process for monitoring any activity on them.

- Firms should consider whether their control environments are appropriate to prevent or detect internal fraud. For example:

  — The UBS model placed significant reliance on its employees being honest and on its desk heads carrying out their supervisory obligations, without there being other steps that would mitigate against the risk that such persons would act incompetently or dishonestly. Trusting employees to carry out their duties properly is not of itself an adequate control.

  — In UBS, a client adviser could accept an instruction and execute a trade without any independent check or review taking place, thus there were no effective controls which ensured that transactions were undertaken in accordance with a client mandate.

  — Firms should have controls to prevent or detect the transfer of funds from a client account to a general suspense account and to review the suspense account for unusual transactions—in the UBS case its procedures failed to detect these matters.

  — Particular controls are needed in respect of employees who have the power to change static data on a client account, such as a client's name and address and payment instructions. The settlement team at Seymour Pierce had the ability to make changes to static data on the settlement system which they used. There was therefore a material risk that they could improperly alter such data (which is indeed

what occurred). In particular, firms should ensure that they are able to monitor changes to payment instruction static data on client accounts. Changes to static data on accounts should be accessible to those in control positions (compliance/risk/internal audit as appropriate) and not only available to those persons who have the power to make the changes.

— The frauds on Seymour Pierce itself were facilitated by the absence of an independent reconciliation process between trades executed by the front office against those booked by the settlement office. Firms should ensure that they have appropriate reconciliation procedures.

— The UBS wealth management business could execute FX transactions with UBS FX traders without providing details such as the account number for up to 24 hours, which gave the desk head a discretion as to which clients would suffer the losses or profits. FX trades that had already been executed and booked could be cancelled and rebooked to another customer. All of these failings in the control environment contributed to a failure to detect the unauthorised transactions.

- Firms need to consider whether duties within their front office are properly segregated. At UBS, the front office was able to input, change and approve FX trades with no effective challenge from the back office. There was no formal documented training and competency scheme for the back office. Front office and back office did not "own" issues relating to risk and control, perceiving them to be a matter for UBS risk and compliance functions. Firms should ensure that their front and back offices understand that they have a significant responsibility and accountability for risk and control matters.

10. Transaction reporting

The FSA has repeatedly emphasised the importance of firms making accurate and complete transaction reporting: this is because the primary function for which the regulator uses transaction reports is to detect and investigate suspected market misconduct. The cases outlined below highlight how systemic failings in internal procedures can result in breaches of transaction reporting rules on a large scale.

10.1 Barclays Capital Securities Limited and Barclays Bank Plc (Final Notice: August 19, 2009)

Credit Suisse (Final Notice: April 8, 2010)

Instinet Europe Limited ("Instinet") (Final Notice: April 8, 2010)

Getco Europe Limited ("GEL") (Final Notice: April 8, 2010)

10.1.1 Penalties

In recent months, a number of firms have received significant fines for their transaction reporting failures:

- Barclays Capital Securities Limited and Barclays Bank Plc were fined a total of £2.45 million.
- Credit Suisse Securities (Europe) Limited, Credit Suisse (UK) Limited, Credit Suisse International and Credit Suisse AG were collectively fined £1.75 million.
- Instinet Europe Limited was fined £1.05 million.
- GEL was fined £1.4 million.

All of the above firms had settled early and received a Stage 1 discount of 30 per cent on the fines that the FSA would otherwise have imposed.

10.1.2 Summary

- Barclays' failings included: inaccuracies in batch reporting, incorrect trade times reported for 24.6 million transactions, the use of incorrect codes to identify the relevant client or counterparty in respect of 7 million transactions, a failure to identify the underlying instrument in 2.2 million transactions, a failure to identify whether the transaction was a buy or a sell in relation to 3.8 million transactions and, in the case of 17 million transactions, a failure to report at all.

- For over a year, Credit Suisse failed to report 30 million LSE transactions having mistakenly assumed that its external approved reporting mechanism ("ARM") was doing so on its behalf. Credit Suisse had failed to respond to some operational bulletins from its ARM as a result of which the external ARM stopped transaction reporting on its behalf. There were also errors in its reporting of non-LSE transactions—such as reporting some transactions in pence rather than pounds, identifying exchange or MTF trades as "off-exchange" and using Greenwich Mean Time during British Summer Time.

- Instinet had failed to take adequate steps in the lead up to MiFID to ensure that its transaction reporting was compliant. Due to not having in place formal procedures and controls, it failed to report over 22 million transactions in accordance with the FSA reporting requirements.

- GEL engaged a third party to clear and settle its transactions executed on the London Stock Exchange, and as part of the arrangement a third party was to ensure that the transactions were reported to the FSA via an External ARM. GEL relied on a verbal assurance from the third party that the LSE transactions were continuing to be reported after the introduction of MiFID in accordance with their previous arrangements. It believed that its transaction reporting was taking place as it was paying an inclusive fee for clearing, settlement and transaction reporting, but it did not request transaction reporting data from the FSA nor obtain any other form of confirmation to ensure that its transactions were being accurately reported.

10.1.3 Lessons to be learnt

The following key messages emerge from the transaction reporting cases summarised above:

- Transaction reporting is not simply an administrative formality and should not be treated as such by firms. As the FSA regards timely and accurate transaction reporting as essential to enable it to meet its statutory objectives of maintaining market confidence and reducing financial crime, a failure to get it right will be treated seriously by the FSA and it will impose heavy fines.

- Firms must ensure that their reporting is accurate. In the Credit Suisse case, unit prices were wrong (using pence instead of pounds) and a number of exchanges and MTFs were identified as off-exchange rather than by the use of their market identifier code. Firms need to ensure that they are covering all relevant securities: for instance, Instinet failed to make reports for trades in certain Global Depositary Receipts in over 237,000 cases.

- Firms also need to take care with the accuracy of the reporting of the time of transactions. Credit Suisse used Greenwich Mean Time rather than British Summer Time during British Summer Time, which affected 6.1 million transactions. Instinet had been using US Eastern Time for some transaction reports rather than local London time. In the case of GEL, some transaction reports did not accurately reflect the three-week period when the usual time difference between the United States and the United Kingdom changed because of different start and finish dates for daylight saving.

- Where there is a high volume of trading, an overlooked systemic failing will have a significant effect for as long as it remains undetected—potentially across millions of transactions. It should be noted how seemingly mundane errors such as those summarised above (such as

incorrect use of codes, the use of pence instead of pounds and the use of GMT rather than BST) will be significant if repeated over a long period of time.

- Firms must ensure that they have proper arrangements in place and that they have monitored that they are actually working. Both Credit Suisse and GEL relied upon an external ARM to report transactions and they each assumed—mistakenly—that their appointed ARM was making reports to the FSA and both failed to ensure that the FSA was actually receiving the reports. If firms are relying on third parties to report transactions or to ensure that they are reported, they are not relieved of their own regulatory responsibility to make transaction reports.

- Where legislative changes will have an impact upon a firm's day-to-day compliance obligations, it is imperative that it devotes sufficient resources to enable it to comply with the new requirements when implemented. For instance, Instinet failed to take adequate steps in the lead up to the implementation of MiFID to ensure that its transaction reporting was compliant and this was despite the fact that the FSA had given advance warning of the issues. Furthermore, when instituting a system or process change (such as that required for the implementation of MiFID or other rule changes), firms should exercise particular care to ensure that transaction reports will remain accurate after those changes come into effect.

- Firms should take heed of warnings when made, whether internal or external. For instance, in Barclays' case the serious weaknesses in its systems and controls had been identified by an internal compliance review in 2006 but the firm failed to respond properly and institute the necessary remedial measures. If an internal review identifies significant problems, the firm's procedures should be such that these issues are appropriately escalated to relevant senior personnel and acted upon. In addition, the FSA is generally intolerant of transaction reporting failures given that there has been a "heightened awareness" of these issues for some considerable time now, before, on and after the implementation of MiFID. Firms must have regard to the transaction reporting user pack ("TRUP") (especially when it has been subject to an update) and must also take note of any transaction reporting issues raised in the FSA's Market Watch newsletters.

- Firms should institute and maintain regular quality control and sample testing of transaction reports to ensure their accuracy. The samples should be sufficiently large to ensure that they are representative.

- In addition, compliance reviews should be scheduled. Firms should ensure that, when they undertake a review of compliance with rules in a particular area, the review is complete, or that any areas which are not covered are highlighted to senior management. For example, in the Instinet case, the review of compliance with transaction reporting had limited scope, did not cover the requirements of all relevant rules and was incomplete in its conclusions.

- Firms should allocate responsibility for and oversight of transaction reporting processes clearly and effectively.

- Firms should train all relevant staff regularly.

11. Financial promotion

11.1 City Gate Money Managers Limited (Final Notice: July 20, 2009)

11.1.1 Penalties

City Gate was fined £42,000 for failing to ensure that the financial promotions which it approved on behalf of its appointed representatives set out the key features and risks of the relevant investment. It received a 30 per cent Stage 1 discount for early settlement.

11.1.2 Summary

City Gate is an independent financial adviser which appointed a number of firms as appointed representatives ("ARs"). Two of these ARs, Bridford Optimum Returns Limited ("BORL") and Bridford Money Management Limited ("BMML") marketed and sold life assurance policies. All of City Gate's ARs were required to submit all proposed financial promotions to City Gate for review and approval before issue. A number of documents were sent to City Gate by BORL for approval as financial promotions—these related to a particular scheme which BORL and BMML intended to market. In very broad outline, the scheme offered customers a guaranteed return of at least 6 per cent over a fixed one-year period and the promotions claimed that both the customers' capital and the return of 6 per cent would be guaranteed by a bank. City Gate was not provided with any evidence that there was such a bank guarantee and essentially relied upon a statement by one Neil Marlow, who was a director of BORL and BMML, that such a guarantee would be forthcoming.

11.1.3 Lessons to be learnt

The key lessons to be learnt from the City Gate case are as follows:

- The approval of a financial promotion for another person is not a "rubber stamping" exercise—it requires the approving firm to conduct appropriate due diligence to determine whether or not the promotion is fair, clear and not misleading.

- Where a firm is approving a promotion, it is important to require the promoter to provide an explanation of the purpose of the financial promotion and the nature of the intended audience and to provide evidence to back up any factual statements made in the promotion. City Gate did not seek any such explanation nor any evidence of any factual statements made in the promotion—in particular, it did not seek evidence in relation to the purported bank guarantee and was content to rely on a statement from a director of the two ARs that such a guarantee would be forthcoming.

- If a firm is to approve financial promotions for others, it must have a process in order to be able to distinguish between promotions for higher risk products and those for lower risk products. City Gate did not have such a process and consequently it dealt with the promotions in relation to the proposed scheme in a simplistic and informal manner. The scheme was in fact complex and risky and demanded more stringent and detailed review than was given.

- It is essential that a firm is able to evidence the basis upon which it has approved financial promotions by keeping accurate and up-to-date records. Although City Gate did have a financial promotions register in place, this was not kept up to date and a number of financial promotions in relation to the relevant scheme were not recorded in the register. To compound matters, the register also contained details of three documents which were not financial promotions and which should therefore not have been recorded. It is always important to ensure that clear records are kept evidencing the process which has been adopted. As regards financial promotions, it is *not* sufficient simply to record the fact that it has been approved or rejected: a clear record of the reasons for the decision must be kept. City Gate did not have any formal procedures which required its compliance staff to record the reasons for approving or rejecting a financial promotion.

11.2 Standard Life Assurance Limited (Final Notice: January 20, 2010)

11.2.1 Penalties

Standard Life Assurance Limited ("SLAL") was fined £2,450,000 for systems and controls failings as regards the marketing materials used for the promotion of a Pension Sterling Fund, a unit-linked fund, which was designed to provide enhanced returns whilst maintaining low volatility. Standard Life agreed to settle at an early stage of the FSA's investigation and therefore received a 30 per cent reduction in the penalty that would otherwise have been imposed.

11.2.2 Summary

The Pension Sterling Fund was intended primarily for the investment of pensions and was marketed to customers approaching retirement who were looking to protect a tax-free lump sum. The fund had originally been invested in bank deposits and other very short-dated instruments, the balance of the underlying investments had changed over time and by July 2007 the majority of the fund was invested in floating rate notes ("FRNs"). Despite this, the marketing material issued in relation to the fund implied that the entire fund was invested in cash. From September 2007 onwards, there had been a number of complaints from consumers regarding the nature of the fund and its underlying investment strategy and concerns had also been raised by employees of SLAL and those of its affiliated investment manager.

11.2.3 Lessons to be learnt

The key lessons to be learnt from the SLAL case are as follows:

- It is important that systems and controls are in place to ensure that any marketing material issued accurately reflects the investment strategy for a relevant product and that this is not a static exercise. In the SLAL case, it was clear that the firm's procedures had not taken account of the investment strategy of the fund or the fact that there had been a shift in the investment profile of the fund from deposits and short-dated instruments to riskier and more illiquid FRNs.

- If a product is targeted at a particular investor base—in the SLAL case it was consumers nearing retirement—it is important that the relevant marketing sets out the nature of the product clearly and is appropriately "calibrated". In this case, the customers were misled as to the nature of the underlying investments made by the fund and as to the risks associated with the product. The fact that the fund was predominantly invested in FRNs meant that there was a heightened risk of unexpected losses being incurred by the fund (and, in fact, the value of the fund did fall by 4.8 per cent on one day in January 2009). Given the nature of the target investor base and the fact that capital security was important to such investors, the fact that there was in fact a risk of capital losses was inconsistent with the FSA's Treating Customers Fairly requirements.

- Where a firm relies on an external data producer to produce materials it is essential, as with all outsourcing, that the firm conducts an appropriate degree of oversight. In SLAL's case, an external data producer produced Standard Life branded factsheets for all of SLAL's funds. Although the standard template that formed the basis of the factsheets was approved by SLAL's compliance department, the firm failed to ensure the accuracy of the data actually used within the factsheets.

- When issues are raised regarding inadequate marketing materials, it is important that the firm takes appropriate and timely remedial action. In SLAL's case, notwithstanding the fact that a number of consumers and members of staff queried the way in which the fund was being marketed, the firm did not follow through and escalate the matter to senior management. Furthermore, an internal audit report concluded that the firm's systems and controls regarding marketing materials required improvement—but although plans were initiated they were subsequently postponed.

12. Change of control

12.1 Vijay Kumar Sharma (September 2009) and Semperian Limited Partnership (February 2010)

12.1.1 Penalties

On September 9, 2009, Mr Sharma was fined a total of £3,000 for acquiring a controlling interest in a regulated firm without obtaining the required prior approval of the FSA in breach of FMSA. (He

was also fined an additional £3,000 for making false and misleading statements to the FSA.) This was the FSA's first criminal prosecution for a failure to comply with the statutory change of control regime.

Less than six months later, on February 17, 2010, Semperian Limited Partnership was convicted of an offence under FSMA for acquiring control of an authorised firm without securing the necessary approval from the FSA and was fined £1,000.

12.1.2 Summary

Under Pt XII of FSMA a person who proposes to become a controller of an FSA authorised firm (or increase an existing controlling intent through certain thresholds) must wait to obtain prior consent from the FSA or for the FSA's assessment period to expire.

Mr Sharma was the sole director of mortgage broker Exetra (UK) Limited. He acquired a controlling interest in the firm and did not notify the FSA until after the acquisition. The FSA also alleged that he failed to supply facts material to the FSA's assessment of his fitness and propriety. Delivering his verdict, District Judge Purdy suggested that Sharma had declined to notify the FSA in the knowledge that any application would not be approved. His view was that the sentence would act as a deterrent to others. In July 2009, the FSA exercised its powers under s.45 of FMSA to vary Exetra's permission to prohibit from carrying on regulated activities.

Unlike Mr Sharma, Semperian did give the FSA notice of its intention to acquire control in an authorised firm, but proceeded to complete the deal and acquire control three weeks later, without waiting for FSA consent. Semperian was convicted of an offence under FSMA for acquiring control of an authorised firm without securing the necessary approval from the FSA.

The maximum fine at the time of the relevant offences was £5,000. Following changes to Pt XII of FSMA in March 2009, there is no maximum when the offence is tried on indictment. Individuals assuming control of an authorised firm without the necessary prior FSA approval can also be sentenced to up to two years' imprisonment.

12.1.3 Lessons to be learnt

The cases send a number of very clear messages to potential controllers about the importance of complying with the statutory change of control requirements:

- A failure to comply with the statutory requirements is a *criminal* offence.
- The FSA has signalled a clear intention to pursue such cases through the courts. Responding to the verdict in the Semperian case, Margaret Cole, the FSA's Director of Enforcement, warned firms against pursuing their commercial interests without regard to their regulatory responsibilities. She emphasised the FSA's willingness to take action against those firms which seek to "ride roughshod" over the change of control requirements.
- The relatively small fines meted out to Mr Sharma and Semperian should not mislead one into thinking that this is a small-impact offence. Following changes to the law on March 21, 2009 such cases can now be tried on indictment, as well as summarily, meaning that the courts have the power to impose an unlimited fine. Criminal fines in future are likely to be a great deal higher than those imposed upon Mr Sharma and Semperian—and the FSA has given a warning to this effect—and there is, of course, always the risk of imprisonment.
- The offence will be committed if the potential controller goes ahead with the acquisition either before receiving the FSA's consent or the assessment period (broadly speaking, three months) lapses. In the case against Semperian, the Deputy District Judge commented that the firm had taken a "calculated risk" that the FSA would not prosecute. In the light of the two recent prosecutions and the fact that future fines are likely to be substantially higher, this is not a matter in respect of which potential controllers should be taking a calculated risk.

Next issue

Compliance Officer Bulletin

Issue 77 – OTC Derivatives and Clearing

Author: Hannah Meakin, Norton Rose LLP

Coverage:

- Why have OTC derivatives come under so much scrutiny from politicians and regulators since the financial crisis?
- What do these ideas about mandatory exchange trading, central counterparty clearing and trade repositories actually mean?
- Does the UK see eye to eye with the changes proposed by the European Commission?
- How has the debate on OTC derivatives triggered the first steps to a European directive on clearing?
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