



Compliance Officer Bulletin

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FSA Enforcement Action – Themes and Trends

“Our priority in our enforcement strategy is to achieve “credible deterrence” To achieve credible deterrence, wrongdoers must not only realise that they face a real and tangible risk of being held to account, but must also expect a significant penalty.”

Hector Sants, Chief Executive Officer's Overview to the FSA Business Plan 2008/09

1 Introduction

“Credible deterrence” is the FSA's new mantra in relation to enforcement matters – it is oft-repeated in speeches given by FSA enforcement staff. Margaret Cole, the FSA's Director of Enforcement, has stressed the “front line” role played by the Enforcement Division in achieving credible deterrence in order to bring about “real changes in behaviour to protect consumers and to guard against abuse in the markets” (*Enforcement Law Conference, 18 June 2008*). This represents a marked change in FSA policy with regards to the role played by Enforcement, signifying a new era of enforcement-led supervision of the financial services industry. In the light of current market conditions and the dramatic

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collapse in confidence in the UK (and global) financial markets, the FSA's determination to "clean up" the markets – and to be seen to be cleaning up the markets – is only going to increase.

In the May 2007 and June 2007 issues of the *Compliance Officer Bulletin* we reported on a number of FSA enforcement actions that had occurred during the preceding year, drawing out some lessons to be learned by firms about the FSA's enforcement focus. In this issue we have reviewed the FSA enforcement cases published between June 2007 and September 2008, and report on the FSA's apparent priorities during that period. Not surprisingly, some themes on which we have previously reported clearly remain important to the regulator. However, a number of new themes have also emerged as enforcement priorities.

In summary, the cases reviewed in this issue, taken together with the FSA's public pronouncements, highlight the following themes and trends:

- The fact that only two civil market abuse cases were concluded in the period under review (*Shevlin* and *Harrison*) should not fool anyone. The fight against market misconduct remains at the forefront of the FSA's enforcement priorities. A number of criminal insider dealing prosecutions have been commenced and a number of investigations are underway. In recent months the FSA has repeatedly emphasised its determination to bring *criminal* prosecutions for insider dealing and market manipulation and to pursue the *individuals* involved (as well as or instead of their firms).
- This determination to pursue individuals is not just confined to the fight against market misconduct. The FSA has clearly signalled an intention to take increasingly aggressive enforcement action against individuals and, if successful, to impose larger fines and, where appropriate, to make Prohibition Orders banning them from the financial services industry. In line with this, there is a continuing emphasis on senior management responsibility.
- As part of its "credible deterrence" strategy, the FSA has also signalled its intention to increase fines. While fines are necessarily determined on the facts of each case, and direct comparison between individual cases is not always possible, we have already detected an upward trend in the level of fines and this is to be expected to continue. Amongst other issues considered in determining the penalty to be imposed, Final Notices now expressly include a section headed "Deterrence".
- A significant number of the cases we have reviewed involve some kind of failure in firms' systems and controls. While other breaches may be involved, the failure on the part of firms and their senior management to ensure that appropriate systems and controls are established is at the heart of many of the FSA's enforcement cases. This is because such failures demonstrate a *systemic* weakness in the firm which has led to (or which if left unchecked could lead to) serious vulnerabilities.
- The ever-increasing emphasis on principles-based regulation (and the corresponding move away from supervision and enforcement by way of detailed rules) continues to be reflected in many of the more significant cases during the period under review. Many of the cases cite a breach of one or more Principles as being the sole, or predominant, reason for the action.



- The vast majority of cases continue to be settled without referral to the Financial Services and Markets Tribunal: the early settlement discounts offer a significant incentive to firms to settle (although the FSA case-selection criteria may also have something to do with this). In some ways this is unfortunate because only a small proportion of issues end up being tested by the rigorous and “judicial” FSMT process (see the *Fox Hayes* case). Consequently, a body of reference cases is slow to build in relation to the very many areas where the rules are unclear and could usefully be tested or clarified.
- A number of the cases reviewed in this issue relate to failings in relation to which the FSA had previously conducted themed reviews and/or published guidance or warnings (such as in relation to the sale of regulated mortgages and payment protection insurance). The fact that there has been a “public warning” in relation to the relevant issue has weighed particularly heavily against the firms involved and it is likely that the FSA will continue to be unforgiving in such cases. Firms should invest time in benchmarking their activities against the published expectations of the FSA and seek to remedy any shortcomings as soon as possible.
- Firms which have been slow to remedy failings once identified have also been particularly criticised – especially (but not only) where there is a risk of customer detriment – as have firms which did not detect the failings for themselves.

Finally, the cases reveal that the FSA will not tire of some very familiar themes, among them, record-keeping failures and firms which develop policies but then fail to ensure that they are properly implemented and monitored. Firms have been warned!

2 Market misconduct

As outlined in the introduction, the FSA remains focused on tackling market abuse and has produced a number of publications outlining its strategy. As the cases below demonstrate, the FSA will take action and impose heavy penalties on those individuals whom it believes have behaved in ways which undermine the stability of the market and have abused the trust placed in them. These penalties may be imposed where the evidence is circumstantial in nature and in cases where individuals did not deliberately commit market abuse.

2.1 John Shevlin (Final Notice: 1 July 2008)

2.1.1 Summary

John Shevlin was an employee of the Body Shop and was responsible for the provision of IT support at the head office in London. From May 2005 onwards he had maintained accounts with IG Markets (and a couple of other brokers), through which he had entered into a number of contracts for differences (“CFDs”) in relation to shares in various companies, including the Body Shop. A CFD is a derivative product whereby the investor essentially “bets” on whether a share price will be higher or lower than a designated price, without actually buying or selling the underlying share. The price of the CFD is determined by reference to the underlying share price.

From 16 December 2005 to 10 January 2006, emails were circulated amongst senior executives within the Body Shop containing details about the company’s performance and how it was not going to meet its forecasted profit target. Further emails were circulated stating that the expected date for the Christmas trading announcement would be brought forward from 13 January 2006 to 11 January 2006. In addition, from 8 January 2006, emails were circulated containing a draft text of the announcement. Mr Shevlin had been given passwords which would enable him to gain full access to the email accounts of the relevant Body Shop executives.

On 10 January 2006, Mr Shevlin established a CFD “short” position over 80,000 Body Shop shares with IG Markets: this particular CFD transaction was therefore a “bet” that the share price would fall. In order to finance the trade, Mr Shevlin borrowed £29,000, an amount which exceeded his annual salary: he falsely stated to the bank that the money was for home improvements.

As the email exchange between the senior executives had discussed, the Christmas announcement was indeed made on 11 January 2006 and stated that the company had underperformed and had missed its operating profit forecast. The share price fell 18 per cent after this news, a fact that was used by the FSA to show that, had the information contained in the announcement been generally available beforehand, it would have been likely to have had a significant effect on the price of Body Shop shares.

On the same day, once the announcement had been made, Mr Shevlin closed out his CFD trade over the 80,000 Body Shop shares. The total net profit he realised was £38,472.

The FSA found that Mr Shevlin had engaged in market abuse within the meaning of Section 118(2) FSMA 2000 by trading on the basis of inside information he had obtained from email accounts of senior executives. The FSA conceded that it did not have any evidence to show conclusively that Mr Shevlin did in fact have access to the inside information or that he had actually logged onto the email accounts of certain senior executives to access that information. However, it stated that it was able to draw inferences and conclusions from the “cogent and compelling” circumstantial evidence of the case – i.e., the fact that Mr Shevlin had the opportunity and ability to access the senior executives’ email accounts; that he had arranged for a substantial loan to effect the CFD trade immediately before the surprise announcement; that the CFD trade was large in size relative to both the overall trading volume in Body Shop that day (26.7 per cent) and to his previous CFD trades; and that he had assumed an unusual level of financial risk compared to his previous trades.

2.1.2 **Setting the penalty**

The FSA fined Mr Shevlin £85,000. The FSA considered his breaches to be serious for the following reasons:

- he held a position of trust at the Body Shop;
- his behaviour was, in the FSA’s view, deliberate;
- behaviour such as Mr Shevlin’s undermines investor confidence and damages the market;
- Mr Shevlin made about £38,000 profit;
- Mr Shevlin did not admit to the behaviour and did not voluntarily disgorge his profit.

The following were deemed to be mitigating factors:

- Mr Shevlin cooperated with the FSA by attending two voluntary interviews;
- he had not been found to have engaged in market abuse on any previous occasions;
- he was not an FSA approved person;
- he does not work for the Body Shop anymore, having lost his job.

2.1.3 **Key points**

- Although the FSA was successful in its action against Mr Shevlin, the case highlights one of the problems which the FSA is likely to face in many, if not all, market misconduct cases i.e. a lack of hard, conclusive evidence. In the *Shevlin* case the FSA’s action was based upon “cogent and compelling” circumstantial evidence and, in the light of that evidence, the representations made by Mr Shevlin – that he based his trading decisions on his own research – were not compelling.
- Mr Shevlin’s reference to the Tribunal was dismissed on 13 June 2008 because he failed, on more than one occasion, to file his evidence on time. Therefore there was no opportunity to see how a case founded on such circumstantial evidence would have fared there.



- Mr Shevlin was not a high net worth individual, his salary at the time of the trade being approximately £28,000 – in relative terms (and compared to the financial penalty imposed on Mr Harrison (see below)) the £85,000 fine therefore appears substantial and was obviously intended to have deterrent effect particularly to those outside the regulated sector.

2.2 Steven Harrison (Final Notice: 8 September 2008)

2.2.1 Summary

Mr Harrison was a portfolio manager at Moore Europe Capital Management Limited, managing the assets of the Moore Credit Fund. He was registered as an FSA approved person holding controlled function 27 (investment manager). The FSA found that Harrison had engaged in market abuse under Section 118(2) FSMA (insider dealing).

Rhodia SA (“Rhodia”) is an international company with equity listings on Euronext France and on the New York Stock Exchange and with bonds listed on the Luxembourg Stock Exchange. During September 2006 Credit Suisse had a series of meetings with Rhodia regarding a potential refinancing involving the repurchase of some of its debt. By the end of September 2006, Credit Suisse knew that such a refinancing was imminent. This was not widely known to the market which expected that Rhodia would refinance within the following six to nine months.

On 28 September 2006, Credit Suisse contacted Mr Harrison in order to obtain some information about the pricing of the refinancing. In the process Mr Harrison was given inside information concerning the imminent refinancing of certain Rhodia bonds, including the proposed timing, structure, size and likely pricing range. The calls between Credit Suisse and Mr Harrison were not recorded so the FSA could not conclusively determine the precise information that was passed to Mr Harrison. Later the same day, Mr Harrison instructed a colleague to buy up to ten million Rhodia 10.50 per cent Senior Notes due 2010 (“the 10.50 bonds”), knowing that there was to be an imminent refinancing by Rhodia which would involve their tendering for those bonds at a premium. In the event only two million 10.50 bonds were bought by the Moore Credit Fund (at a price of €118.75).

On 2 October 2006, Rhodia announced a cash tender offer for certain specified bonds, including the 10.50 bonds, and a concurrent issue of new floating rate notes to finance this. On 16 October 2006 Rhodia announced the pricing of the tender offer – the 10.50 bonds would be repurchased at €120.952. The Moore Credit Fund duly accepted the tender for the bonds on 17 October 2006 and in doing so made a profit of approximately €44,000.

The FSA held that Mr Harrison had engaged in market abuse by requiring or encouraging another to engage in behaviour which, if he had engaged in it himself, would have amounted to market abuse.

2.2.2 Setting the penalty

Mr Harrison was fined £52,500, representing a 30 per cent reduction from the proposed fine of £75,000 for early settlement. He agreed not to perform any regulated activity as an authorised person or other trading activities for a 12 month period from 1 August 2008.

In setting the penalty the FSA had regard to the following factors:

- Mr Harrison was an experienced industry professional and an approved person;
- Mr Harrison’s conduct was not deliberate, but he ought to have realised that the information he received constituted inside information and this knowledge should have restricted his behaviour;
- Mr Harrison made no personal profit, had no previous disciplinary record and cooperated with the FSA’s investigation in attending three voluntary interviews;
- although Mr Harrison did not profit personally, the fund he managed made a profit of approximately €44,000.

2.2.3 Key points

- This is the first market abuse case concerning the credit markets.
- Mr Harrison did not realise any profit personally and at the time did not even consider that he was in possession of inside information. This is an important point. The fact that conduct is not deliberate and is without a personal profit motive does not mean that a market abuse offence has not been committed. Mr Harrison was punished because he *ought* to have realised that the information he was given was inside information even if Credit Suisse did not identify it as such. As Margaret Cole said in the press release issued on publication of the Final Notice against Mr Harrison: “This case highlights the importance of city professionals taking care to recognise inside information when they see it and not to misuse it. Hedge fund managers and people in similar roles are often legitimately provided with inside information in the course of their business. The FSA expects people entrusted with such responsibility, in the credit markets as much as in any other regulated markets, to observe high standards of conduct and not to take advantage of their privileged access to inside information.”
- Committing a market abuse offence as an approved person is likely to increase the level of penalty which the FSA seeks to impose – since there is a higher regulatory responsibility and a commensurately higher position of trust.
- It is important to note that the FSA’s sanctions armoury is not confined to financial penalties alone. The one year ban on performing any controlled functions which was imposed on Mr Harrison will clearly have a significant effect on him – he will not be able to perform his usual job.

3 Systems and controls

A significant number of FSA enforcement cases will necessarily involve systems and controls failings since any lapse in the firm’s business will ultimately point to a breakdown in its procedures. Weaknesses in systems and controls often lead to other issues and rule breaches across the firm. A number of the cases referred to under other headings therefore also involve a breach of Principle 3 (systems and controls). Those covered in this section arise primarily in relation to:

- mis-pricing of positions (*Toronto Dominion* and *Credit Suisse*);
- failings in systems for the production of documents to policyholders (*Liberata*);
- sale of regulated mortgages (in particular, sub-prime mortgages) (*Thinc* and *Robin Knox*);
- failings in the mechanisms for the appointment of third-party call centres (*UNAT*); and
- inadequate mechanisms for monitoring and administering mortgage retentions (*GE*).

3.1 Toronto Dominion Bank (London branch) (Final Notice: 16 November 2007)

3.1.1 Summary

Toronto Dominion Bank is a Canadian bank operating in London through a branch (“TD Bank”). Over a period of almost two years, a senior fixed income trader based in London (Simon Brignall – see below) hid losses on his trading book by a combination of mis-pricing and the entering of fictitious trades. This behaviour went undetected by TD Bank throughout the period and was only uncovered when the trader admitted his actions. The losses which had been hidden by these practices reached a peak of C\$11,000,000, but had decreased to C\$8,800,000 (approximately £3,800,000) by the time that the positions were closed. The losses were suffered by TD Bank alone – no losses were suffered by clients or other third parties.



The FSA fined TD Bank £490,000 for systems and controls failings in breach of Principle 3 in relation to the relevant trading book. In particular, TD Bank was held to have:

- had an absence of systems and controls able to ensure that independent price verification was performed on the trader's book;
- failed to implement effective escalation procedures for when a high number of trade input errors occurred on the trader's book; and
- lacked effective trading supervision.

Details of the breaches included:

- *Absence of systems and controls ensuring independent price verification.* The trader was responsible for valuing his own positions which should have been done by reference to London closing prices. While the firm had documented policies relating to the independent verification of prices input by traders, the underlying procedures which were necessary for the implementation of these policies had not been created. There was therefore no independent verification of prices entered by the trader, thus enabling him to mis-mark the prices to disguise his losses.
- *Failure to implement effective trade break escalation procedures.* The trader's behaviour resulted in a high number of trade input errors occurring on his book. Initially, TD Bank had no escalation procedure for investigating or resolving these issues. However, on becoming aware that trade input errors were occurring on the trader's book which were taking an excessive length of time to correct an escalation procedure was documented, but was not properly implemented or followed.
- *Lack of effective trading supervision.* The lack of supervision occurred at a number of levels. There was insufficient supervision both by local personnel and from North America. This resulted in indications of the trader's misconduct, which would have been apparent had effective supervision taken place, going unnoticed. In addition, the firm's holiday policy which required a trader's book to be actively managed by someone else during a fixed period of absence each year was not properly implemented, resulting in an additional lost opportunity for TD Bank to be alerted to the trader's misconduct.
- *Failures regarding operational statistics.* Front office management did not receive operational information which would have highlighted some of the difficulties occurring on the trader's book. Examples of relevant information include statistics on deal cancellation, corrections and late trades and reasons for such cancellation, correction or late trade (e.g. trader error, operational error etc).
- *Lack of standardised broker reconciliation process.* The firm's reconciliation process was not standardised across all business lines. In the FSA's view, this contributed to the trader's misconduct remaining undetected for such an extended period.

3.1.2 Setting the penalty

The FSA considered this to be a serious case. Key reasons were:

- the behaviour was allowed to continue undetected for almost two years;
- the techniques used by the trader were unsophisticated and should therefore have been readily discoverable; and
- the lack of systems and controls rendered TD Bank vulnerable to financial crime.

The FSA took account of the following in mitigation:

- once discovered, TD Bank brought the trader's conduct to the attention of the FSA and agreed to settle at the earliest possible time (the maximum 30 per cent discount was given);
- no client or other third-party suffered any loss; and
- TD Bank immediately commissioned an internal report and management responded promptly to the failings identified.

3.1.3 Key points

- The case identified serious failings in systems and controls, which were inadequate to identify even the very unsophisticated loss concealment techniques used by the trader.
- The case is useful in identifying tools that may be used by firms to avoid this type of "rogue trader" scenario. The remedial steps implemented (or to be implemented) by TD Bank include the following: reviewing and amending trade break escalation procedures; requiring staff to attend fraud/trade irregularities training; the establishment of a committee to discuss front and back office trading procedures; the appointment of a senior operations person to liaise between the local front office and the remote back office; the independent verification of valuations; enhanced supervision of staff (including updating job descriptions); and assessing the feasibility of implementing electronic trading systems.
- Some procedures had been documented but not implemented by all relevant departments. The case therefore serves as a useful reminder to ensure that procedures, once adopted, are both implemented and monitored.
- The fine was mitigated by settlement and the willingness and speed with which TD Bank set about identifying and correcting its failings.
- In a separate Final Notice also published on 16 November 2007 the FSA found the relevant trader, Simon Richard Brignall, not to be a fit and proper person and banned him from performing any regulated activity.

3.2 Liberata Financial Services Limited (Final Notice: 8 April 2008)

3.2.1 Summary

Liberata Financial Services Limited ("Liberata") is a third-party administrator which provides services to authorised firms in the life and pensions sectors. A core service is the production and timely dispatch of documents to policyholders, many of which are important to allow policyholders to make informed decisions about their investments. Over an extended period (January 2005 to April 2007) there were significant failings in Liberata's systems for the production of documents to policyholders. Approximately 30,000 policyholders did not receive documents containing important information about their savings, investments and pension products. Of these policyholders, 161 suffered financial loss as a result of documents not having been issued, amounting to £17,584.

The FSA fined Liberata £525,000 for failures in its systems and controls for producing and issuing documents to life and pensions policyholders (in breach of Principle 3) and for failure to conduct its business with due skill, care and diligence (in breach of Principle 2). In particular Liberata was held to have:

- wholly inadequate procedures for investigating and resolving error messages produced by its automated document production system;
- failed to take reasonable care to monitor the production of documents;



- failed to act on warnings identified in management information and audit; and
- having identified that some policyholders had not received documents, failed to investigate whether others had been similarly affected.

3.2.2 Setting the penalty

The FSA considered this to be a serious case because:

- the failings persisted over a significant period of time and related to a core aspect of Liberata's business;
- although it did not consider that Liberata had acted in a deliberate manner, it nonetheless determined that the firm had acted recklessly in failing to consider warnings in its management information; and
- a significant number of policyholders were put at risk of financial loss and, having identified this risk in relation to some, Liberata failed to identify all those who may have been affected.

The FSA took account of the following in mitigation:

- Liberata cooperated fully with the FSA, including proactively identifying relevant information and agreeing facts quickly;
- once the issue was identified, Liberata appointed external consultants to review its document production system, analyse the potential impact on policyholders and ensure that all outstanding documents were provided;
- a comprehensive review of, and improvements to, Liberata's systems and controls was then undertaken and implemented; and
- a remedial plan was implemented which ensured that all those who suffered loss were identified and compensated.

3.2.3 Key points

- The case identified a number of serious failings in systems and controls in breach of Principle 3, but the FSA's finding that the firm had been reckless would have contributed to the conclusion that there was also a breach of Principle 2 – a failure to act with due skill, care and diligence.
- The firm relied heavily on an automated document production system. If the system could not produce a document it generated an error report. Insufficient training was given to enable staff to understand the reasons behind the error reports (which in some cases were produced for very simple reasons) or to resolve them. The case highlights an over-reliance on technology alone by some firms – the running of all systems must be reviewed regularly and training and procedures must be put in place to ensure that staff understand the systems being used.
- The case also stresses the importance, once failings have been identified, of undertaking a thorough assessment of the full extent of the failings – an incorrect assumption appears to have been made by Liberata that those issues which had been identified by a selective review were the only issues which needed to be addressed. The more general issues were therefore allowed to persist.
- The case also provides an example of insufficient note being taken of routine management information – which, on closer inspection, would have provided warnings that all was not well.

3.3 Thinc Group Limited, Thinc Assured Network Limited and Thinc Network Services Limited (“Thinc”) (Final Notice: 15 May 2008)

3.3.1 Summary

Thinc is an FSA authorised firm which arranges and advises on regulated mortgages. Between 1 January 2006 and 30 September 2007, Thinc acted as broker in the sale of regulated mortgages (£76.9 million of which represented loans to customers with impaired credit ratings) and gave advice in respect of 840 sub-prime mortgage cases. In September 2005, the FSA had published its findings of its thematic review of the sub-prime mortgage market, including its concerns that firms needed to make and retain sufficient records to ensure that they were able to demonstrate the suitability of their advice in relation to sub-prime mortgage products. The FSA visited Thinc in 2007 and reviewed a sample of customer files relating to advised sales of sub-prime mortgages. All sub-prime files reviewed by the FSA lacked information that was fundamental to demonstrating the suitability of Thinc’s advice.

The FSA fined Thinc £900,000 for:

- failing to ensure the suitability of its advice given to customers in respect of its sales of regulated mortgage contracts in the sub prime market (in breach of Principle 9); and
- failing to organise and control its affairs responsibly and effectively and lacking adequate risk management systems in respect of its sub prime mortgage business (in breach of Principle 3).

In particular there was a failure to:

- obtain sufficient financial information from the customer, for example, to determine the affordability of the product;
- demonstrate that sale of a sub-prime mortgage (which was often more expensive for the customer) was justified; and
- demonstrate that the particular mortgage sold matched the stated needs and circumstances of the customer and in some circumstances the suitability letter did not correspond to the product advised upon or bought.

Additional failings included:

- promised remedial action was ineffective and did not lead to an improvement in standards;
- inadequate record-keeping;
- inadequate checking of files by the compliance department and failure to follow up on proposed action; and
- no improvement in sales practices after the FSA’s visit.

3.3.2 Setting the penalty

The FSA considered this to be a serious case. Key reasons were:

- the failings occurred after the FSA had published its concerns about the need for adequate record-keeping to demonstrate the suitability of advice;
- Thinc acted as principal for a large network of IFAs and was responsible for ensuring that its representatives complied with their regulatory requirements;
- its conduct could have had an adverse effect on the customers concerned; and



- the failings continued after the FSA visit as the remedial action implemented by Thinc was ineffective and Thinc's sales practices and the compliance regime did not improve.

The FSA took account of the following in mitigation:

- Thinc was not found to have mis-sold sub-prime mortgages to its customers;
- Thinc had received few complaints about its regulated mortgage business during the period;
- Thinc had been open and cooperative with the FSA and agreed the facts quickly thus enabling the matter to be settled at an early stage of the proceedings, (the maximum 30 per cent discount was given); and
- Thinc had agreed to implement a comprehensive remedial plan.

3.3.3 Key points

- The compliance team failed to follow up on remedial action proposed after the FSA visit. Unless remedial action is put into practice and proves effective, this is likely to work against a firm and potentially lead to enforcement action.
- The remedial action which, having faced enforcement action, Thinc agreed to (and which was taken in account as a mitigating factor) included the appointment of an independent third-party to review its sub-prime business conducted during the period to determine any customer detriment and to identify any compensation necessary; the restructuring of its mortgage advice sales processes for all mortgage business; the re-training of sub-standard mortgage advisers (and, if appropriate, their dismissal); the overhaul of its compliance checking processes for all mortgage business; and the restructuring of its compliance department.

3.4 UNAT DIRECT Insurance Management Limited (Final Notice: 19 May 2008)

3.4.1 Summary

UNAT DIRECT Insurance Management Limited ("UNAT") is an FSA authorised company which is an indirect wholly-owned subsidiary of American International Group Inc ("AIG"). A main part of UNAT's business is to arrange the sale of an associated insurer's general insurance products (in particular, personal accident insurance policies) to consumers through third-party call centres. UNAT identified that using external call centres to sell general insurance products posed a higher risk to its business and its customers than other third-party relationships (as call centres have direct contact with customers) and implemented a more stringent due diligence procedure for the appointment of call centres, to determine whether they were suitable to carry out such sales to consumers. This procedure sought, among other things, to identify whether each call centre complied with regulatory matters. Though the procedure in itself was adequate to mitigate this risk, for a period of more than two years, UNAT did not carry out the procedure properly in respect of nine call centres. This meant insufficient due diligence was undertaken prior to their appointment, leading to a potential risk that they did not comply with their regulatory requirements and potentially customers would not be treated fairly.

The FSA fined UNAT £640,000 for systems and controls failings in breach of Principle 3 in relation to the appointment of third-party call centres who sold products on their behalf. In particular, UNAT was held to have:

- failed to implement effective controls to prevent staff from instructing call centres to start selling general insurance to consumers before all aspects of the due diligence process had been completed and found to be satisfactory, including the resolution of compliance issues arising out of the appointment process; and
- failed to provide adequate management information to senior management to enable them to satisfy themselves that the call centres had been appointed in accordance with UNAT's appointment procedure and were suitable to conduct sales.

UNAT stipulated that call centres should be directly authorised by the FSA because they would then be required to monitor their own work to appropriate standards. Notwithstanding this stipulation, two of the nine call centres appointed during the relevant period were not authorised: one was an appointed representative (and no enquiries were made of its authorised principal) and the other was neither authorised nor an appointed representative.

3.4.2 Setting the penalty

The FSA considered this to be a serious case. Key reasons were:

- though UNAT recognised that call centres were a potential source of great regulatory risk to it and its customers, it did not carry out proper enquiries of the call centres that it used;
- UNAT did not carry out adequate due diligence to be satisfied that the call centres complied with regulatory requirements, which led to a risk that customers who bought policies from the call centres would not be treated fairly;
- if firms do not take proper care in selecting third-party call centres to sell their products to consumers, confidence in the general insurance products sales market could be undermined;
- the breach persisted for over two years; and
- over 150,000 insurance policies were sold by the nine call centres during the period.

The FSA took account of the following in mitigation:

- UNAT carried out an internal review and then commissioned a City law firm to review the systems and controls it had in place for the appointment of call centres and to make appropriate recommendations for their improvement;
- UNAT stopped general insurance sales through external call centres until the recommended systems and controls had been implemented, which resulted in a significant loss of income;
- UNAT had worked with the FSA to ensure that no customer suffered loss as a result of these issues (by providing a comprehensive restitution package) and that the risks involved in its relationships with third-party call centres were appropriately managed and controlled;
- UNAT notified the FSA promptly of the issues, cooperated fully during the course of the FSA investigation and agreed to settle at an early stage (a 20 per cent discount was given).

3.4.3 Key points

- The case identified serious failings in systems and controls and again reminds firms to ensure that such procedures, once adopted, are both implemented and monitored. UNAT clearly appeared to have a sophisticated awareness of compliance issues and recognised where the regulatory risks lay; however, UNAT failed in the practical implementation of its own standards and procedures.
- The case highlights that the FSA considers the selling of insurance products via third-party call centres as high risk and will impose significant fines on firms whose management and control of such risks fall below acceptable standards. It also shows that the FSA will not hesitate to use a financial penalty to promote high standards of regulatory conduct and to deter firms who have breached regulatory requirements from committing further contraventions.
- The fine was mitigated by settlement and the willingness and speed with which UNAT set about identifying and correcting its failings. Even so, the fine imposed on UNAT is substantial and is clearly designed to send a message to the industry.



3.5 Robin David Knox (Final Notice: 3 July 2008)

3.5.1 Summary

Mr Knox was the managing director of Mortgage and Property Services Limited (the “Firm”), a mortgage broker authorised to advise on and arrange regulated mortgages and which advised principally on sub-prime re-mortgages. Over a three-year period, from its date of authorisation, the Firm’s advisers made 500 recommendations to customers to enter into regulated mortgages. Mr Knox was authorised to perform CF1 and CF8 controlled functions and was responsible for ensuring that the Firm complied with regulatory requirements. Over the period in question, he failed to put in place adequate systems and controls to monitor and record the standard of advice provided by the Firm’s advisers, which allowed unsuitable mortgages to be recommended to the Firm’s customers. The FSA also had serious concerns about the quality of the Firm’s advice to customers and engaged an independent expert to review fifty client files. Twenty-seven of these files showed that advice given either *had been or may have been* unsuitable.

The FSA brought action against Mr Knox personally as an approved person (director and apportionment and oversight officer) and fined him £17,500 for failing to comply with Principle 7 for Approved Persons, withdrew his individual approval and made a prohibition order against him, prohibiting him from performing *any* function in relation to *any* regulated activity. In particular, Mr Knox was held to have:

- failed to put in place adequate systems and controls (as required by the regulatory system) to monitor and record the standard of advice provided by the Firm’s advisers, to ensure the suitability of the recommended mortgages to customers; and
- failed to meet the minimum regulatory standards of competence and capability (by failing to implement appropriate systems and controls) and therefore was not “a fit and proper person” to carry out any functions in relation to any regulated activities.

Shortcomings were also identified in relation to the advice Mr Knox personally gave to customers.

Examples of particular failings found include:

- shortcomings in relation to affordability assessments (Mr Knox inappropriately relying on the customer’s own declaration of affordability);
- no separate assessment of income was made in relation to self-certification applications;
- recommendations of what was often a more expensive sub-prime mortgage to clients with no evidence of poor credit history;
- in relation to consolidation of existing debt into the mortgage, inadequate consideration as to appropriateness and inadequate explanation of the implications;
- insufficient disclosure of the firm’s fee and the implications of adding it to the amount of the loan; and
- record-keeping failures.

3.5.2 Setting the penalty

The FSA considered this to be a serious case. Key reasons were:

- the failings persisted for three years; and
- the conduct affected approximately 500 clients who were *at risk* of receiving unsuitable advice which might have exposed them to possible financial loss and some customers had *actually* received unsuitable advice.

In mitigation, the FSA took account of the fact that Mr Knox agreed to:

- settle at the earliest possible time (the maximum 30 per cent discount was given);
- write to all customers to alert them to the possibility that they had received unsuitable advice from the Firm; and
- cancellation of the Firm's Part IV permission.

3.5.3 Key points

- The case identified serious systems and controls failings in checking the suitability of advice given to customers in relation to sub-prime mortgage sales.
- The case illustrates that the FSA will consider systems and controls failings as serious where the nature and scope of them lead to the risk of customers being treated unfairly, pose a severe risk to consumers and lenders and could affect confidence in the market generally. In such cases the FSA is likely to impose the most stringent penalties i.e. both withdrawal of an individual's approval and the most severe prohibition order available.
- Prohibition orders may vary from prohibiting an authorised person from carrying out a *specific* function in relation to a *specific* regulated activity to prohibiting an authorised person from carrying out *any* function in relation to *all* regulated activities, depending on the circumstances of each case. The case is useful as an indicator of the factors which the FSA considers so serious as to merit the imposition of the most stringent type of prohibition order.
- The case is a useful reminder that the FSA may impose harsh penalties to promote high standards of regulatory conduct and to deter approved persons from acting in a similar way.

3.6 Credit Suisse International and Credit Suisse Securities (Europe) Limited (Final Notice: 13 August 2008)

3.6.1 Summary

Credit Suisse International and Credit Suisse Securities (Europe) Limited are the UK operations of Credit Suisse, an international financial institution ("Credit Suisse"). Credit Suisse has an investment banking division, and, within that, a Structured Credit Group (the "SCG"). The breaches in this case which occurred between September 2007 and February 2008 concerned the pricing of asset-backed securities, in which the SCG held proprietary positions. In February 2008, Credit Suisse announced that some of these securities had been incorrectly priced and that it would be repricing them. The amounts involved were significant. The pricing errors were the result in part of intentional misconduct by traders at Credit Suisse. Senior management at Credit Suisse commissioned a review of the causes of the write-down.

The FSA fined Credit Suisse £5,600,000. The firm was held to have (i) failed to conduct its business with due skill, care and diligence (in breach of Principle 2) and (ii) failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems (in breach of Principle 3).

The systems and controls for the management and supervision of the SCG and the pricing of products held by the SCG were inadequate because:

- The complex matrix structure used by the SCG with its multiple reporting lines created uncertainty as to supervisory responsibilities. This problem was made worse by the differing locations of the SCG supervisors.
- The pricing of many of the positions held by SCG were not subject to sufficient scrutiny or challenge. The absence of a pricing methodology applied uniformly across different trading books made it difficult to identify and resolve price-testing variances.



- The complexity of the spreadsheets used to book CDO business in the SCG prevented effective supervision and control.

In addition:

- Credit Suisse did not ensure that supervisors had the necessary knowledge to supervise the SCG properly.
- Errors in price-testing procedures were common, and made across different locations.
- Certain Credit Suisse traders were able to prevent adequate control of their pricing of securities by exploiting their technical expertise, which was not shared by those who were responsible for supervising them. Too many of those in supervisory and control positions were junior staff, ill equipped to challenge front office staff.
- Control and supervisory functions at Credit Suisse were subject to frequent reorganisations and reassignments, meaning that traders were able to delay the explanations they provided and such explanations were insufficiently scrutinised.

3.6.2 **Setting the penalty**

The FSA has publicly stated that there is a particular need to price complex products such as asset-backed securities accurately, and to monitor those individuals who might have an incentive to mis-price, especially in adverse financial conditions. The FSA's Financial Risk Outlook noted that those who trade these assets are often also responsible for pricing them. Firms must be aware that investment professionals whose incentive arrangements are linked to how their investments in such assets perform face an inherent conflict of interest, which must be managed appropriately.

The FSA considered that the seriousness of this matter merited the imposition of a significant financial penalty, for the following reasons:

- there is a high risk that market confidence will be damaged by write downs in the value of securities;
- Credit Suisse's own review of the matter revealed that the shortcomings in the supervision of the SCG were serious;
- as the SCG traded complex products, made valuations which were unclear to those who supervised it and used significant leverage, it should have been a priority area at Credit Suisse for effective supervision;
- Credit Suisse is a highly profitable global business which should have extremely effective systems and controls to match the high levels of risk with which it operates.

The FSA took the following mitigating factors into account:

- Credit Suisse agreed to settle at an early stage of the FSA's investigation and qualified for a Stage 1 discount (30 per cent);
- Credit Suisse did detect the pricing errors and made prompt public disclosure of these as soon as it could. It then commissioned its own review of why the write down occurred. Internal disciplinary action was taken in respect of certain individuals;
- remedial action was taken with the support of Credit Suisse's senior management;
- the positions were proprietary;
- Credit Suisse kept the FSA informed of these issues and subsequent developments.

3.6.3 Key points

- The scale of the errors and the size of Credit Suisse were not the only reasons for the FSA imposing such a significant fine. In this case the FSA demonstrated (as it has also demonstrated since) its willingness to act resolutely to protect market confidence – particularly in the shaken debt markets.
- The case also operates as a timely reminder to complex international groups that their systems and controls must not become so involved as to be unworkable in practice. In addition, the fact that other members of the group may be relied on to provide some of the systems and controls does not mean that the UK entity is no longer responsible for that aspect – it remains responsible and must be satisfied with the adequacy of the arrangements.
- This case, in common with the other cases during the course of the past year, has as its subject matter an issue which had been raised publicly by the FSA as a key area of risk before the failings took place. Firms should expect the FSA to be unforgiving where FSA warnings have not been heeded.

3.7 GE Money Home Lending Limited (Final Notice: 22 September 2008)

3.7.1 Summary

GE Money Home Lending Limited (“GEMHL”) is a mortgage lender. Between 31 October 2004 and 26 November 2006 GEMHL entered into 684 “retention” regulated mortgage contracts (with a gross loan value of approximately £67.7 million). The principle of a retention mortgage was that GEMHL would retain a portion of the full mortgage loan until certain conditions, for example, repairs to the property, had been satisfied by the borrower. The retained portion would either be paid to the borrower on completion of the repairs or, if not completed at the end of a set period (typically six months), the amount of loan would be reduced by the retention amount. GEMHL did not, however, have systems and controls in place to monitor and administer the retention monies or to monitor completion of retention periods. As a consequence, some borrowers were overcharged interest on the retention monies and the retention monies, together with accumulated interest, were not always properly paid to borrowers or applied to the outstanding mortgage loan once the retention conditions had been fulfilled. This also led to redemption amounts being incorrectly calculated.

The FSA fined GEMHL £1,120,000 (discounted from £1.6 million for early settlement) for:

- failing to conduct its business with due skill, care and diligence (Principle 2); and
- failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems (Principle 3).

In particular:

- The retention amounts were held by panel solicitors pending distribution. GEMHL had no formal arrangements for the review of retention amounts held by solicitors. GEMHL’s own records were unreliable and it therefore often had to rely on the records of panel solicitors instead.
- At various points, from before the time when mortgage business became regulated in 2004 until 2006, the absence of sufficient controls and therefore the risk of error and detriment to customers, was identified by GEMHL. The failings were allowed to continue without remedy.
- In addition to failings in the management of retentions and sums owed by clients, GEMHL had identified “a definite lack of transparency” in its customer documentation in that it was not sufficiently clear to customers that interest would be charged on the retention monies prior to their release to the customer. This deficiency was not remedied for some mortgage types.



3.7.2 Setting the penalty

The FSA considered this to be a serious case. Key reasons were:

- as a result of the firm's failings, borrowers were not treated fairly – the effect of the retention clause may not have been transparent to all borrowers, retention monies and accumulated interest were not always properly paid to them or applied to the outstanding mortgage loan, they were sometimes overcharged interest on the retention monies and remediation was not promptly provided;
- a large number of borrowers, including some with impaired or non-standard credit profiles, were put at risk of financial loss; and
- the failings persisted over a significant period, despite the firm identifying them in 2004.

The FSA took account of the following in mitigation:

- GEMHL agreed to settle at an early stage of the FSA's investigation and qualified for a Stage 1 (30 per cent) discount.
- The firm reported the issue to the FSA.
- The firm conducted a remediation programme to ensure that customers who suffered financial loss as a result of the retention failings were properly compensated.
- The firm commissioned an external review of the issue and shared the report with the FSA.
- The firm stopped using the retentions mechanism.

3.7.3 Key points

- Aside from showing the obviously vital need for firms to establish appropriate systems and controls for conducting business, the case emphasises the importance of maintaining a comprehensive and transparent internal review process and ensuring it is followed to conclusion. Some failings were identified, but not escalated and rectified. Further, the remedies that were implemented were not applied to all aspects of the firm's business.

4 Financial crime – data security controls

As outlined in the previous section, a significant number of FSA enforcement cases involve a finding of inadequate systems and controls, so that there will be a breach of Principle 3 alongside other rule breaches. One area of systems and controls which has emerged as a discrete enforcement “theme” – and which overlaps with the fight against financial crime – is that of data security. Although the FSA enforcement cases reviewed below took place in December 2007 and June 2008 respectively, this is not a new concern on the part of the FSA. In November 2004 it published a paper entitled “Countering Financial Crime Risks in Information Security” which set out the regulator's findings having reviewed industry practices and standards in information security risk management relating to electronically-held data. The FSA's principal finding was that while crystallised losses were at that time low, information security issues generally posed a material risk to the FSA's objective to reduce financial crime.

As we reported in the June 2007 issue of the *Compliance Officer Bulletin*, the FSA has previously taken enforcement action against firms with inadequate systems and controls to manage the risks relating to information security (see the Final Notices in respect of *Capita Financial Administrators Limited* (March 2006) and *Nationwide Building Society* (February 2007)).

Of course, the loss of personal data by institutions supposed to look after that information is not confined to the financial services industry – recent failings by high-profile institutions (including

government departments) get significant media coverage. Against this background of increasing concern over the safety of personal information and the risks of fraud and identity fraud, the FSA's focus on data security controls in the financial services sector has notably sharpened over the last year or so. Following the *Norwich Union* case (see below) – which is required reading for the senior management of all large financial services firms – the FSA published another report in April 2008 entitled “Data Security in Financial Services – Firms’ controls to prevent data loss by their employees and third-party suppliers”. The April 2008 report concluded that poor data security is a “serious, widespread and high-impact risk” to the FSA’s objective to reduce financial crime and that standards in financial services firms need to be improved significantly. The importance of the topic is being reinforced through a concerted FSA information campaign. Further enforcement action in this area is to be expected.

4.1 **Norwich Union Life (Final Notice: 17 December 2007)**

4.1.1 **Summary**

The FSA’s action was against five separate Norwich Union life assurance companies: CGNU Life Assurance Limited, Commercial Union Life Assurance Company Limited, Norwich Union Annuity Limited, Norwich Union Life and Pensions Limited and Norwich Union Life Services Limited. These companies form part of the Aviva group of companies. For convenience, the Final Notice referred to the five companies collectively as “Norwich Union Life”.

Norwich Union Life operates a number of call centres through which customers can request changes to records of their personal details, such as home addresses and bank account details. From April 2006, Norwich Union Life became the target of a number of actual and attempted frauds. Telephone callers contacted Norwich Union Life call centres impersonating genuine customers. By using information obtained from public sources (such as name, date of birth and address details), these callers were able to satisfy Norwich Union Life’s caller identification procedures and consequently obtain access to personal account information and request changes to personal details. Over a short period, Norwich Union Life was subject to 74 successful frauds, with a value of approximately £3.3 million and a further 558 cases of attempted fraud. Confidential customer information was disclosed to the fraudsters in almost all of these cases.

The FSA fined Norwich Union Life £1.26 million for systems and controls failings in breach of Principle 3 which were disclosed by the identity thefts. In particular, the FSA held that Norwich Union Life failed to take reasonable care to:

- undertake an adequate assessment of the financial crime risks which it faced;
- establish adequate procedures and controls to manage those risks; and
- respond to the frauds in an appropriate and timely manner once they had become apparent.

4.1.2 **Setting the penalty**

The FSA considered this to be a serious case for the following key reasons:

- the five companies of Norwich Union Life form one of the largest life insurance businesses in the UK, with a total of 6.8 million customers: therefore, aside from the actual cases of fraud identified, the risk of loss to a large customer base was high;
- Norwich Union Life’s controls continued to be inadequate to prevent the data losses even after the nature of the criminals’ methodology was known and warnings had been given by its compliance department, although Norwich Union Life knew by the end of July 2006 that criminals were using publicly available information about customers (such as names, addresses and dates of birth), it did not change its caller identification procedures at that point;
- on discovering the frauds in July 2006, Norwich Union Life took action to identify, inform and protect all current and former directors of Aviva group companies who were policyholders but did not take equivalent action to protect policyholders not connected to the business; and



- Norwich Union Life's failures arose during a period of heightened industry awareness of financial crime issues with increased media coverage and an FSA information campaign.

The FSA took account of the following factors in mitigation:

- Norwich Union Life had reinstated the value of any life policies fraudulently surrendered.
- Norwich Union Life cooperated fully with the FSA in the course of its investigation and with other agencies, including supporting the police to assist them in identifying and arresting the fraudsters concerned.
- Norwich Union Life has since conducted an internal review to identify incidents of fraud and appointed a third-party to carry out a review of its response to the fraud incidents and to review further the adequacy of caller identification procedures.
- Norwich Union Life has improved its anti-fraud procedures following that internal review.

4.1.3 Key points

- The case demonstrated fundamental failings in systems and controls, particularly in light of Norwich Union's possession of sensitive financial and personal information about its customers, which exposed its substantial customer base to a high risk of identity theft and financial loss. As the FSA stated in the Final Notice: "These customers are entitled to rely on Norwich Union Life to take reasonable care to ensure the security of customer information and funds entrusted to it."
- Some firms may read the facts of the case with a degree of complacency, arguing that no criminal would be able to access their personal customer information with such alarming ease. However, while the Norwich Union Life failures were undoubtedly egregious, there are lessons to be learned by any organisation – particularly by any large organisation which deals with customers through call centres. A salutary lesson which emerges from the case is that it will not help a firm to avoid enforcement action if, for instance, the compliance department have identified problems and weaknesses and have even recommended particular remedial action but the implementation of those remedial measures has not been effected in practice. Furthermore, while the methodology of the criminals in the Norwich Union Life case was simple this was no doubt because, in view of the weakness of the firms' caller identification procedures, it did not need to be complicated. Firms need to be alive to the risks of their systems and controls, however robust, being circumvented by increasingly sophisticated criminal techniques.
- The FSA was clearly unimpressed with the fact that, even when the problem was identified, Norwich Union Life failed to address the financial crime risks in a timely and appropriate manner. The fact that when it did start to take action by the end of July 2006 it moved first to protect policyholders who were Aviva group directors and former directors in preference to customers generally was no doubt particularly aggravating to the FSA. Action to protect all customers was not started until September 2006.
- To paraphrase what the FSA said in the Final Notice, Norwich Union Life "failed to read the warning signs" – this will always be an aggravating factor. The failures occurred during a period of heightened awareness of financial crime issues, reflected by the FSA's publications on preventing financial crime, high profile articles in the press and relevant guidance from the Government and industry groups at the time. The parent organisation, Aviva, had also identified fraud and identity theft as important issues.

4.2 Merchant Securities Group Limited (Final Notice: 13 June 2008)

4.2.1 Summary

Merchant Securities Group Limited (“Merchant Securities”) is a stock-broking firm with approximately 850 retail and institutional customers whom it advises and for whom it arranges deals in investments. Its retail customers are mainly high net worth individuals.

In 2007, the FSA made thematic visits to a number of firms, including Merchant Securities. The purpose of the thematic visit to Merchant Securities was to gather information on how the firm assessed and managed its data security risks and how it safeguarded customer data. During its visit, the FSA identified a number of Merchant Securities’ business practices which exposed customers to the risk that customer data held by the firm might be compromised. However, in contrast to the Norwich Union Life case summarised above, the FSA did not find any evidence that customer data had actually been compromised in practice.

The FSA fined Merchant Securities £77,000 for systems and controls failings in breach of Principle 3 in relation to financial crime, specifically the security of customer information. In particular, the FSA held that Merchant Securities failed to take reasonable care to:

- adequately assess the risks associated with its procedures for verifying the identity of its customers over the telephone and failed to implement adequate procedures; for instance, reliance was placed on advisers being able to identify customers by recognising their voices and by talking to them informally about personal matters, but since each adviser had approximately 150 customers and only had frequent contact with 20 per cent of them, this was an inadequate approach;
- adequately assess and mitigate the risk that customers’ account access information could be intercepted or lost where such information was included in written communications with its customers;
- adequately assess and mitigate the risk of unauthorised access to its back-up tapes when the tapes were stored outside office premises (the tapes were unencrypted and stored overnight at the home of a member of staff); and
- implement adequate controls to mitigate the risk of customers’ personal data being transmitted outside Merchant Securities by failing to monitor and control the use of instant messaging and web-based email.

4.2.2 Setting the penalty

The FSA considered this to be a serious case for the following key reasons:

- the breach of Principle 3 was identified by the FSA following a thematic visit and not by Merchant Securities;
- as with Norwich Union Life, Merchant Securities failed to heed the “warning signals”: the failings took place during a period in which there was heightened public awareness of information security breaches and during this time, the FSA had published a series of Final Notices regarding enforcement action taken against firms for failures relating to actual compromise of customer personal data; and
- in light of this, Merchant Securities should have been aware of the ways in which business practices could place customer information at risk and should have known that its inadequate procedures could have led to actual data compromise.

The FSA took account of the following factors in mitigation:

- there was no evidence of any actual compromise of customer data; and



- Merchant Securities has since taken steps to review and improve its systems and controls in relation to data security.

4.2.3 Key points

- While there was no evidence of actual compromise of customer information, the FSA still saw the systems and controls failings as serious enough to merit enforcement action. The risks that customer information might be compromised was high – the inadequacy of Merchant Securities “systems” meant that the customer data could have easily been compromised had the firm been targeted by criminals.
- As with the *Norwich Union Life* case, the *Merchant Securities* case serves as a warning to firms to be alive to the warning signs – FSA papers, speeches and published enforcement cases have, over the last few years, made it clear that data control and the fight against financial crime generally are high priority issues.
- It is interesting that the *Norwich Union Life* and *Merchant Securities* cases followed in relatively quick succession (December 2007 and June 2008); taken together they show that the FSA is determined to ensure that its message of deterrence is read and understood across a broad spectrum of financial services firms. All firms, however large or small, must ensure that their systems and controls adequately preserve the security of customer information.

5 Mortgage mis-selling

The FSA’s Business Plan 2008/09 announced a comprehensive review of the mortgage regime, which will in part reflect issues identified through its on-going thematic work. The FSA has stated that it will continue to take action against brokers who cannot demonstrate that their mortgage recommendations are suitable for customers. The FSA’s stance on this is uncompromising. In the FSA press release following the *Rana* decision (see below), Jonathan Phelan, FSA head of Retail Enforcement, said: “Where we have concerns about the quality of mortgage advice given, we will continue to require mortgage brokers to undertake reviews of past business, often at considerable cost to them, to identify and remedy any unsuitable advice”. The cases described in this section highlight the FSA’s focus on ensuring that fundamental regulatory requirements are met by mortgage brokers, with the emphasis placed firmly on information-gathering in relation to customers’ personal circumstances and comprehensive record-keeping throughout the whole advice process.

Both the *Mortgage House* case and the *Countrywide* case, which were decided within days of one another, cover very similar ground, with the failings of the two separate firms being almost identical.

5.1 Mr. Peter Scott, trading as “The Mortgage House” (Final Notice: 15 May 2008)

5.1.1 Summary

Peter Scott traded as “The Mortgage House” (“Mortgage House”), a mortgage broker. Mortgage House employed one other adviser at a different location. Mortgage House was visited by the FSA in 2007 as part of the regulator’s “self-certification and affordability of mortgage contracts” project. It was subsequently referred to the FSA’s Enforcement Division who carried out a review of a sample of 15 client files.

The FSA fined Mr Scott £11,900 (representing a discount of 30 per cent for early settlement from £17,000) for breaches of Principles 3 (Management and control) and 9 (Customers: relationships of trust) of the FSA’s Principles for Businesses and the rules in Chapter 4 of MCOB between 31 October 2004 and 15 May 2008. The FSA found no evidence to suggest that the breaches were deliberate, but concluded that there was a risk, in every file reviewed, that the client had been given unsuitable advice.

The FSA found that there had been a number of breaches by Mortgage House. In particular, Mortgage House was found to have failed to obtain and/or record information about its clients' needs and preferences or about their financial circumstances so that it was unable to show that the mortgages it recommended were affordable and therefore suitable for those clients. There was no evidence that Mortgage House had verified any of the information it had received from clients in circumstances where there was an inconsistency between separate sources of information. There was also no evidence that market research had been carried out before mortgage contracts were recommended, meaning that there was a risk that such contracts were recommended without Mortgage House having reasonable grounds for concluding that they were the most suitable from those available.

As a result of the above failings, Mortgage House was found to have failed to organise and control its affairs responsibly and effectively and failed to mitigate the risk that customers were not being treated fairly in every case.

5.1.2 **Setting the penalty**

The FSA considered Mortgage House's failings to be serious, for the following reasons:

- All clients were exposed to the risk of having been given unsuitable advice regarding mortgage contracts.
- Mortgage House may have given inaccurate information regarding clients' financial positions to lenders, which would have meant that the lenders' MCOB 11 "responsible lending" assessments were affected.
- The extensive lack of record-keeping would hinder an independent party's ability to investigate customer complaints.
- The failure to ensure that Mortgage House understood the FSA's regulatory requirements or to implement adequate systems to ensure compliance created a risk that clients were not treated fairly and received unsuitable advice.

The FSA considered the following factors as mitigating the seriousness of the breaches:

- Mortgage House cooperated with the FSA's investigations.
- Mortgage House agreed to meet the cost of a skilled person undertaking a past business review in order to identify unsuitable recommendations to clients.

5.1.3 **Key points**

- The importance of record-keeping cannot be overemphasised. It is not enough for a firm to believe that it is compliant – a firm must be able to *demonstrate* to the FSA that it has been compliant. Mortgage firms are required to ensure that the products on which they advise are suitable for their customers: compliance with that requirement must be evidenced by records showing that the firm has completed a comprehensive fact-find of a client's needs, preferences and circumstances together with its financial position. In addition, the firm must evidence the fact that it has conducted research into the relevant market so that it can show how the product it advised upon was the most suitable of the range available.
- Controls such as assessments of the quality of advice being given, regular reviews of business activities and training programmes are particularly important where advisers are operating in different offices.



5.2 Mr Mohammad Rana (registered as Countrywide Management Consultancy and trading as Property Compass) (Final Notice: 21 May 2008)

5.2.1 Summary

Mr Mohammad Rana was registered as Countrywide Management Consultancy (“Countrywide”), a sole trader retail mortgage broker trading as “Property Compass”. Mr Rana was the senior manager and principal of Countrywide. His role included managing Countrywide’s system and controls and supervising Countrywide’s sole mortgage adviser. Mr Rana did not give mortgage advice himself. Countrywide advises principally on regulated mortgage business, although it also arranges buy-to-let mortgages (which are not regulated by the FSA).

Countrywide was one of 89 mortgage brokers visited by the FSA’s Small Firms Division in 2007 as part of its “self certification and affordability of mortgage contracts” project. Concerns about Countrywide’s systems and controls were identified during a visit on 12 September 2007 and were similar to concerns that had been raised during an FSA visit in 2006. As a result, Countrywide was one of seven firms the project referred to the FSA’s Enforcement Division.

The investigation reviewed a sample of Countrywide’s mortgage sale files from the period 16 February 2006 to 12 September 2007 and reviewed the management systems that the firm had in place to control its business. The investigation found evidence of breaches of Principles 3 (Management and control) and 9 (Customers: relationships of trust) of the FSA’s Principles for Businesses and the rules in Chapter 4 of the FSA’s “Mortgages and Home Finance: Conduct of Business Sourcebook” (“MCOB”). Following its investigation, the FSA fined Countrywide £14,700 (taking into account a 30 per cent discount from £21,000 for agreeing to settle at an early stage).

Details of the breaches include:

- *Poor organisation and management systems.* In all the files reviewed, Countrywide made incorrect and misleading references to the previous mortgage regulator, the Mortgage Code Compliance Board. There were inadequate systems and controls in place for ensuring that Countrywide met regulatory requirements. Mr Rana did not make and keep appropriate records to show how Countrywide carried out training, supervision and monitoring of its one adviser and did not ensure that appropriate management and control arrangements were in place as instructed to do so by the FSA in a letter containing remedial instructions dated 30 October 2006.
- *Suitability of recommended contracts.* Regulatory rules require a firm to take reasonable steps to ensure that its recommendations are suitable for customers. Countrywide demonstrated systematic weaknesses in a number of key areas. Its information-gathering process did not demonstrate that the mortgages it recommended to customers suited their particular needs, preferences or circumstances or were affordable for those customers. In addition, Countrywide had failed to set out and record on the customer files the facts and matters supporting the assessments made regarding suitability and reasons for recommendations: in particular, there was no evidence of market research having been carried out so that Countrywide could not demonstrate that a particular recommended product was the most suitable of those available.

5.2.2 Setting the penalty

The FSA noted that there was no evidence that Countrywide’s conduct was deliberate, but found that the lack of records supporting the suitability of the contracts meant that there was a risk that every customer had been given unsuitable advice.

The FSA felt the conduct was serious because:

- Countrywide had failed to act on previous remedial instructions given by the FSA following a supervision visit;

- the failings in the recording of personal and financial information of customers meant that Countrywide could not demonstrate that the advice it had given was suitable and clients were therefore exposed to the risk of purchasing an unaffordable or unsuitable product;
- because of the widespread record-keeping failures, any investigations into customer complaints would be hindered.

The following were deemed to be mitigating factors:

- Countrywide had cooperated with the FSA in relation to its investigation and had reassured the FSA that it would take reasonable steps to satisfy the FSA that it would meet regulatory requirements going forward.
- Countrywide had not previously been subject to disciplinary action.

5.2.3 Key points

- Comprehensive records must be kept – see the “Key points” in relation to the Mortgage House case above.
- Thematic visits by the FSA should be treated seriously by firms – as this case shows, shortcomings identified during thematic visits may be referred to the Enforcement Division and can result in disciplinary action.
- It is obviously important to respond to pre-enforcement letters from the FSA calling for remedial measures to be implemented. Enforcement action may be averted where a firm has shown that it has heeded the warnings and has sought to remedy its shortcomings.
- Firms should ensure that all their documentation is up-to-date, does not include incorrect and misleading references (for instance to the MCCB as the previous mortgage regulator) and accurately recites FSA statements and risk warnings where required.

5.3 Stephen Charles Jones (Final Notice: 22 September 2008)

5.3.1 Summary

Stephen Jones was a senior partner of Jones & Poole independent Mortgage Specialists (“Jones & Poole”), where he performed the controlled functions of CF4 (Partner) and CF8 (Apportionment and Oversight).

The FSA prohibited Mr Jones from carrying out any function in relation to any regulated activity carried on by an authorised person and imposed a fine of £100,000 for failing to comply with Principles 1 (Approved person to act with integrity), 4 (Approved person to deal with FSA and regulators in open and cooperative way) and 7 (Approved person performing significant influence functions to ensure firm’s compliance with its regulatory requirements) of the Statements of Principle for Approved Persons. The junior partner, Mr Poole, was also fined £10,000 (less a 30 per cent early settlement discount) for failing to record whether he had assessed clients’ ability to afford mortgages and to implement changes recommended by a compliance consultant.

Details of the FSA’s findings include the following:

- *Retrospectively created fact-find documents.* The FSA found that Mr Jones asked customers to retrospectively sign and date 12 fact-find documents so as to make it appear that he had created contemporaneous sales documents.
- *False information on own mortgage application.* The FSA found that Mr Jones knowingly gave an inaccurate statement of his income and failed to declare income from other sources in an on-line mortgage application in April 2006. He failed to reply to the FSA’s requests for information about his income. This failure to cooperate was deemed to be material as it hindered the FSA’s investigation.



- *Compliance failings and poor information-gathering.* The FSA also found that Mr Jones failed to implement systems within Jones & Poole to ensure that it complied with regulatory compliance requirements – this failure continued following a report from an external consultant containing specific recommendations about how to ensure compliance. In particular, the two partners did not discuss compliance arrangements or monitor each other's mortgage sales. Mr Jones failed in a number of areas relating to information-gathering and record-keeping about the suitability of mortgage recommendations for clients. As a result, he had exposed approximately 1,500 customers to the risk of receiving unsuitable advice.

5.3.2 **Setting the penalty**

Mr Jones' lack of integrity in making the fraudulent mortgage application and failure to cooperate with the FSA were below the standard of behaviour to be expected of an approved person and contributed to the high personal fine. In addition, the FSA found that his failure to manage the partnership so as to ensure that it complied with its regulatory requirements and treated its customers fairly meant that a Prohibition Order was necessary.

5.3.3 **Key points**

- In line with the FSA's move towards more principles-based enforcement, the action against Mr Jones was founded entirely on the basis of breaches of the Statements of Principle for Approved Persons.
- The case also evidences the FSA's determination to pursue *individuals*, where appropriate.
- The FSA felt that Mr Jones' behaviour in submitting a fraudulent mortgage application, fabricating documents and failing to cooperate with the FSA's investigation was particularly egregious, stating that he posed a "serious risk to customers and to confidence in the financial system".

5.4 **Darren Millington and Michael Worthington (Final Notices: 19 September 2008)**

5.4.1 **Summary**

Mr Worthington was the chief executive and Mr Millington a director of Lifestyle Finance Limited ("Lifestyle", now in administration), a mortgage broker specialising in the sub-prime market. Both individuals were approved persons, with Mr Worthington overseeing compliance and Mr Millington being the MLRO.

Both were found to have breached Principles 6 (Approved persons performing significant influence functions to manage the business exercising due skill, care and diligence) and 7 (Approved persons performing significant influence functions to ensure compliance with regulatory requirements) of the Statements of Principle for Approved Persons. In addition, Mr Worthington was found to have breached Principle 5 (Approved persons performing significant influence functions to organise the business effectively).

In their capacities as approved persons with significant influence functions:

- both men were found to have failed to take reasonable steps to ensure that the business of the firm complied with the relevant requirements and standards of the regulatory system – in particular, they failed to oversee the establishment and maintenance of appropriate systems and controls relating to compliance and sales practices and did not monitor compliance with the relevant requirements;
- Mr Worthington, in having the apportionment and oversight function, was found to have failed to take reasonable steps to ensure that the business of the firm was organised so that it could be controlled effectively – in particular he failed to take reasonable steps to monitor and supervise the firm's compliance function or to review the competence, knowledge, skills and performance of the firm's staff in order to assess their suitability to fulfil their duties;

- Mr Millington, as the MLRO, was found to have failed to take reasonable steps to oversee the establishment and maintenance of appropriate AML systems and controls and to monitor compliance with AML requirements;
- both men were found to have failed to ensure that a Past Business Review was completed on time; at the same time they both failed to ensure that the compliance department was appropriately resourced and they both allowed funds to be diverted away from the Past Business Review and the compliance department despite being aware that both areas were under-resourced.

5.4.2 **Setting the penalty**

Both Mr Worthington and Mr Millington agreed not to apply to hold any controlled functions involving significant management influence in the future.

The FSA saw the conduct of the men as serious because:

- the failings for which they were each responsible were widespread;
- the failure of the firm to complete the Past Business Review meant that any customers who had been mis-sold mortgages remained unidentified and without redress;
- the failings happened over a prolonged period.

While the FSA did not consider that Mr Millington had deliberately contravened the requirements imposed upon him, it felt that Mr Worthington was “personally culpable” and that “his conduct fell below the standard required under the regulatory system”.

Had it not been for the fact that both men were bankrupt, the FSA would have fined each of them £150,000.

5.4.3 **Key points**

- As in the *Stephen Charles Jones* case, the actions against both Mr Worthington and Mr Millington were founded entirely on the basis of breaches of the Statements of Principle for Approved Persons in APER.
- The case also evidences the FSA’s determination to pursue *individuals*, where appropriate and to limit their ability to work in the financial services industry in the future.

6 **Mortgage fraud**

The FSA is currently engaged in a wide-reaching programme designed to tackle mortgage fraud. The programme includes visits to 200 mortgage intermediaries to assess their systems and controls, streamlining reporting processes in order to increase intelligence from lenders (which helps the FSA target the fraudsters) and strengthening the FSA’s partnership with regulators such as the National Fraud Strategic Authority. This tough approach reflects the FSA’s stated belief that mortgage fraud causes social harm and is linked to criminal activities such as money laundering. The increase in mortgage fraud during years of easy credit conditions is being matched by the FSA’s numerous bans on those involved in such activities. The case referred to below is representative of the FSA’s determination to take action against people involved in mortgage fraud. In terms of enforcement action, the FSA has banned 17 individuals for being involved in mortgage fraud activities, including Sadia Nasir who was fined £129,000 (see below). Margaret Cole has warned that “Perpetrators of fraud will increasingly find themselves facing bans and significant fines, as well as action by the police or other agencies aimed at confiscation of assets.”



6.1 Sadia Nasir (Final Notice: 4 July 2008)

6.1.1 Summary

Sadia Nasir was a director of “Sucasa (London) Limited”, formerly “London Mortgages and Financial Services Limited” and trading as “House of Finance”, a mortgage broker. House of Finance was authorised by the FSA between 31 October 2004 and 25 May 2007. During that time, Ms Nasir performed the controlled function of CF1 (Director), and was the only mortgage adviser at the firm.

The FSA reviewed seven mortgage applications that Ms Nasir submitted to seven different lenders over a five-year period, four of which were submitted through House of Finance and three via third-party mortgage intermediaries. The FSA found that the seven applications contained false information about Ms Nasir’s employment and earnings.

Ms Nasir was fined £129,000 and prohibited, pursuant to Section 56 FSMA 2000, from performing any function in relation to any regulated activity carried on by any authorised person. The penalty represented £29,000 for disgorgement of profit and an additional £100,000 penalty.

Details of the breaches by Ms Nasir included:

- *Ms Nasir’s own mortgage applications: submission of false information.* The FSA found that Ms Nasir knowingly and intentionally submitted seven mortgage applications to different lenders over five years that contained false information relating to her employment. Financial statements submitted with two applications were not consistent with information stored at Companies House. Ms Nasir confirmed that it was her signature on the documents and, therefore, that she knew the contents of the misleading statements. Ms Nasir knowingly and intentionally submitted three mortgage applications on a residential basis for properties being bought as buy-to-let, which meant that the interest rates obtained were lower than if the applications had been made correctly. Ms Nasir did not disclose the full extent of her property portfolio on four of the applications.
- *Client mortgage applications: using a third-party’s identity.* The FSA found that on applications made on behalf of four of her clients, the direct debit forms contained banking details for an account held in Ms Nasir’s name. One application in a client’s name was accompanied by a copy of Ms Nasir’s bank statement, which was used to verify the address. The FSA traced the client (who was the only one of the four clients they could find) and was told that she had not submitted a mortgage application through Ms Nasir. The FSA concluded that it was highly likely that Ms Nasir had attempted to buy properties for her own gain using the identity of a third-party.
- *Failure to cooperate with the FSA.* The FSA found that Ms Nasir did not disclose information relating to a county court judgment filed against her in September 2005 and although she maintained that she was unaware of the judgment until April 2007, she did not notify the FSA at this later date. Ms Nasir did not disclose all her assets in an authorisation application to the FSA to operate as a sole trader. She intentionally withheld a key section of a copy of a mortgage application by altering the version she sent to the FSA when it was requested.

6.1.2 Setting the penalty

The FSA referred to the following factors when considering the seriousness of Ms Nasir’s conduct in relation to the question of whether she had the necessary honesty, integrity and reputation to be a fit and proper person to carry out a regulated activity:

- Ms Nasir demonstrated a lack of honesty and integrity by knowingly being involved in the submission of false mortgage applications;
- it was highly likely that she attempted to purchase properties for personal gain by using the identity of a third-party;
- she deliberately withheld information from the FSA;

- she was knowingly involved in the submission of three false mortgage applications, using a third-party intermediary.

6.1.3 Key points

The penalty is large and clearly designed to have a deterrent effect – the FSA is not afraid to impose large, six-figure fines on individuals and to prevent them from working in the financial services industry again.

7 Selling practices – high-risk shares

In June 2006, the FSA started looking at the selling practices used by small firms that recommend higher risk shares, in order to ensure that customers are being treated fairly. As the cases below highlight, the FSA's review of these firms has led to large fines being imposed for behaviour which the FSA considers contrary to the fair treatment of customers. Firms, and individuals within those firms, face steep penalties for behaviour such as failing to disclose risks to customers, or creating high-pressure sales environments which reward volume of sales over customer care and inadequate compliance monitoring systems.

7.1 Square Mile Securities Limited (Final Notice: 10 January 2008)

7.1.1 Summary

Square Mile Securities Limited ("Square Mile") is an agency stockbroking firm based in London, with customers from around the UK. The firm specialised in derivative products and also advising and dealing in securities that have been, or will be, admitted to trading on the AIM and PLUS Markets.

The FSA visited Square Mile in June 2006. The visit revealed concerns with Square Mile's practices in respect of selling small cap securities, the information which it provided to customers, and its systems and controls. As a result, the matter was referred to the FSA's Enforcement Division. The FSA found a number of breaches of its Principles for Businesses during the period March to May 2006, including breaches of Principles 1 (Integrity), 3 (Management and control), 6 (Customers' interests), 7 (Communication with clients) and 9 (Customers: relationships of trust) and of its Conduct of Business rules. The breaches related to Square Mile advising on and arranging the purchase of higher risk securities issued by five new or emerging smaller capitalised companies.

Square Mile was fined £250,000, although it would have been £1.5 million (less the 30 per cent discount) had it not been for Square Mile's financial circumstances and the fact that Square Mile had agreed to pay for independent approval of its transactions and new account openings, the appointment of a skilled person and any appropriate redress.

Details of the breaches include:

- *Inadequate systems and protections relating to high-risk businesses.* The FSA found that despite having a business involving recommending higher risk securities, Square Mile recklessly failed to conduct its own research into the small cap securities it recommended and failed to obtain and communicate sufficient information about the business, likely performance and risks to customers. Senior management at Square Mile were aware that reasonable steps had not been taken to understand the regulatory requirements, to organise the firm's affairs and to set controls for risk management. In particular, there were no controls for the management of non-public information and training was inadequate.
- *Poor sales practices.* Square Mile did not give its advisers adequate information about the securities meaning that advisers tried to supplement the information themselves. Square Mile created a high-pressure sales environment in which volume of sales was rewarded at the expense of ensuring regulatory compliance. Square Mile knew its advisers were using high-pressure and inappropriate sales techniques and even encouraged advisers



not to provide customers with risk information and/or the negative aspects of investing in the high-risk securities. Square Mile had ignored the concerns of its Compliance Department in relation to the elaborate and inaccurate sales pitches being used. Square Mile was dishonest in that, in some of the transactions reviewed, a purchase of the securities was recorded in a customer's name without any consent or instructions from that customer. Senior management apparently cooperated with the writing up of trade tickets without customer instructions.

- *Failing to treat customers fairly.* The FSA found that Square Mile's highly pressurised selling environment, combined with a remuneration system that rewarded volume selling as well as the selling of riskier securities, led to the probability that advisers were tempted to meet the sales targets without having regard to the fair treatment of customers and their interests. Advisers in all of the reviewed cases applied undue pressure on customers.
- *Failings relating to alerting clients to risk.* The FSA found that Square Mile did not provide risk warnings, as required by regulations, of the possibly restricted market for the securities and/or the extra risk associated with the securities. Square Mile did not pay due regard to the information needs of its customers and its advisers gave exaggerated and unsupported information about the future performance of the securities, often based on little more than their own unsubstantiated predictions. Advisers also made unfair and misleading references to the performance of securities the firm had recommended in the past which had no connection to the securities in question and, in some cases, were completely untrue. Advisers also gave misleading information about their skills and experience and in a number of cases, ascribed their recommendations to the work of a research analyst, when no analyst was engaged by the firm.
- *Failings relating to collecting information.* The FSA found that Square Mile failed to obtain sufficient personal and financial information about customers before making recommendations, and in fact only completed detailed "Know Your Client" enquiries after a customer had provisionally agreed to the purchase. Square Mile failed to keep information it held about customers under regular review and to update it in line with new information provided by customers. Square Mile failed to ensure that its recommendations were affordable and/or within the customer's attitude to risk or agreed risk capital level.
- *Poor delineation of roles.* The FSA found that Square Mile failed to take reasonable steps to maintain clear and appropriate division of significant responsibilities between senior management. It lacked delineated reporting systems, formal compliance procedures and a clearly delineated role for the Compliance Department. Square Mile did not take reasonable steps to ensure it complied with regulatory requirements.

7.1.2 **Setting the penalty**

The FSA believed the breaches were of a serious nature because:

- there were widespread and serious weaknesses in Square Mile's systems and controls;
- Square Mile failed to implement arrangements in relation to important areas such as training, fair treatment of customers and sale processes;
- during the reviewed period, Square Mile sold a significant volume of securities and did not promptly remedy problems when they were identified;
- the breaches may have serious financial consequences for those customers who bought the high risk securities – all of the securities which were sold were higher risk and/or illiquid and all had decreased in value since they were purchased;
- Square Mile acted recklessly as it undertook a high-risk business and failed to implement systems to protect customers and ensure compliance with regulations. Furthermore, it knew there were reasons to doubt certain sales practices and control of its affairs, but did not address the risks.

The penalty was mitigated to some extent by the fact that Square Mile engaged an independent consultant to review its business and gave undertakings in relation to, amongst other things, changes in senior management and writing to customers to advise them of the FSA's findings.

7.1.3 Key points

- The FSA has repeatedly warned the industry that high-pressure selling environments created by a firm's sale practices and remuneration structures can result in customers being treated unfairly. For example, commission-driven reward systems can lead to advisers placing undue pressure on clients to buy securities which they could not afford or are reluctant to purchase.
- There is a risk that if advisers are not given adequate information about the financial products they are selling, they will supplement information with inaccurate statements.
- The Compliance Department had issued warnings about misleading and often false statements being made in sales calls – but these were ignored.
- Firms undertaking high-risk business will be deemed to have acted recklessly if they fail to implement systems to protect customers, ensure compliance with regulations and to address concerns about sales practices that put customers at risk.
- The FSA found that it was probable that Square Mile could not show that it understood the characteristics, including the higher risks, of the securities and, in not considering the risks when selecting the securities or communicating the risks to customers, it put customers at risk of being treated unfairly as a result of unsuitable recommendations and inadequate information.
- In investigating a firm, the FSA will also follow up concerns that arise about individuals within the firm (see *Somal* below). An individual may be penalised for behaviour which arose, in part, from the firm's culture.

7.2 Baljit Somal (Final Notice: 8 July 2008)

7.2.1 Summary

Baljit Somal was an employee of Square Mile (see above). Somal joined Square Mile in October 2002, and was approved to perform the CF21 Investment Adviser controlled function (as it then was). His job included recommending investments in higher-risk shares.

As part of its investigation into the activities of Square Mile, the FSA identified evidence suggesting misconduct by Somal, and carried out a detailed review of 11 transactions by Somal. The FSA found that he failed to act with integrity in breach of Statement of Principle 1 and failed to act with due skill, care and diligence when making recommendations to clients, in breach of Statement of Principle 2. The FSA banned Somal and fined him £16,000, representing a 20 per cent (stage 2) discount from £20,000.

Somal was held to have knowingly recorded, on four occasions, a purchase of securities by a customer of Square Mile without having their consent. He would have received commission on these transactions. Somal claimed that this was only done in order to relieve the "immense pressure" on him to meet his daily sales targets. The FSA found his conduct to be dishonest and deliberately misleading. He failed to give customers appropriate risk warnings and to take steps to ensure they understood the risks associated with higher-risk securities. He also made misleading and factually inaccurate statements to customers and made recommendations without having obtained adequate information about their personal and financial needs. He failed to give a balanced recommendation to customers and supplemented information given with his own (unsubstantiated) opinion. He used tactics that put undue pressure on customers, continuing to make recommendations even when customers showed clear reluctance to invest.



7.2.2 Setting the penalty

The FSA held the following factors to be relevant to the seriousness of Somal's behaviour:

- Square Mile's customers were entitled to rely on Somal to take reasonable steps to ensure the suitability of the advice given and to be treated fairly without being subject to inappropriate sales practices;
- Somal's behaviour may have had serious financial consequences for Square Mile's customers (many of whom were elderly) as they relied on his recommendation to buy securities that were higher risk and/or illiquid and have decreased in value since purchase;
- the (deliberate) breaches occurred over a period of six months.

The following factors were deemed to be mitigating:

- Somal accepted his conduct was improper and expressed regret;
- Square Mile created the high pressure sales environment in which he worked;
- Somal has not been subject to any other findings of misconduct by the FSA or any other regulatory body.

7.2.3 Key points

An individual whose conduct is identified as suspect during an FSA investigation into a firm can face his own heavy penalties, even where his behaviour was found to be endemic within the firm and in part owing to the culture the firm had fostered.

7.3 Mansion House Securities Limited (Final Notice: 31 March 2008)

7.3.1 Summary

Mansion House Securities Limited ("Mansion House") was a small retail stockbroking firm specialising in advising and dealing in shares that have not yet been admitted to trading on any market. Its business almost exclusively involved UK private clients purchasing high-risk shares. The FSA conducted a review of Mansion House's systems and controls and a random sample of 30 recommendations made by it to 30 private customers of higher risk shares. The transactions reviewed involved 15 different brokers and related to shares issued by five companies.

Mansion House was found to be in breach of Principles 3 (Management and control), 6 (Customers' interests), 7 (Communications with clients) and 9 (Customers: relationships of trust) of the FSA's Principles for Businesses and its Conduct of Business rules. The FSA fined Mansion House £122,500, representing a 30 per cent discount from £175,000 for early settlement.

Details of the breaches included:

- *Poor communications with customers and misleading information.* Mansion House's conduct was deemed to be in breach of the FSA's regulatory principles as a result of a number of practices, including representations about Mansion House's work in its mailshots which were misleading and may have led customers to believe it had greater expertise than it in fact did. Mansion House did not always reveal the commission it received from the companies whose shares it promoted.
- *Failings in assessing and recording suitability of investments.* Mansion House had poor systems for reviewing the suitability of investments for its customers.
- *Poor sales practices.* Customers were not given adequate risk warnings before recommendations were made to them and where some form of risk warning was given, it was undermined by the broker's other comments. Recommendations were made to customers

even when they said they could not afford the investments or did not want to invest. Furthermore, 25 of the 30 recommendations contained exaggerated or misleading claims, in particular relating to the future performance of the shares. Customers were often pressurised into making quick decisions about investments and were also phoned even when they had shown obvious reluctance to invest. Compliance systems, including monitoring brokers' phone calls, were inadequate and the firm's formal compliance monitoring programme was not implemented adequately until October 2006. Compliance training was also inadequate.

7.3.2 *Setting the penalty*

The following factors were considered to make this a serious case:

- customers were pressurised into making immediate investment decisions and subject to unacceptable sales practices, which involved using misleading and inaccurate information;
- customers relying on their broker's advice were exposed to the risk of loss because Mansion House had not adequately trained or assessed their brokers;
- there were serious weaknesses in the sales process and overall systems in the firm, meaning that there was a significant risk that customers were not protected and also that confidence in the financial system would be damaged.

The FSA took into account the following mitigating factors:

- Mansion House engaged an independent compliance consultant and, where necessary, changed its procedures after learning of the FSA's concerns; and
- Mansion House was open and cooperative with the FSA.

7.3.3 *Key points*

- Provision of clear and accurate information about potential investments is key, especially where the investments are high risk.
- Adequate risk warnings should be made to customers and should not then be undermined by the adviser's comments.
- Obtaining and recording information about customers concerning their suitability for investments is key.
- Mansion House failed to mitigate the risks of conflict arising from the fact that the party doing its due diligence investigations into the investment companies had a direct interest in the success of those companies.
- Advisers should not use high-pressure tactics, including those that suggest to customers that there are reasons of great urgency for them to make the investment quickly.

8 **Payment Protection Insurance**

The past few years have seen a significant number of documents and speeches from the FSA in relation to sales of payment protection insurance ("PPI"), including a thematic review and a follow-up review. In September 2007 the FSA signalled its intention to impose higher levels of fine for breaches of its rules and principles in this area in order to increase the level of deterrent. The period covered by this article has seen published enforcement actions against HFC Bank Limited, Land of Leather Limited and Liverpool Victoria Banking Services Limited. Some of the failings identified in these cases are matters which had been addressed by the FSA in its publications. This will have weighed heavily against the firms.



While some of the cases refer to specific FSA rules, as with other areas there is an emphasis on breach of the Principles. The Principles addressed by the more recent Final Notices are some or all of Principle 3 (systems and controls); 6 (customers' interests); 7 (information needs and communications with clients); and 9 (suitability of advice).

HFC was fined £1,085,000, Land of Leather £210,000 and Liverpool Victoria £840,000, in each case after a 30 per cent reduction for settling the case at an early stage.

Examples of some of the issues identified included:

- sales staff not collating and considering sufficient information about customers' circumstances and objectives, creating an unacceptable risk that advisers might make unsuitable sales;
- failing to provide customers with an adequate explanation of why they were recommended a particular policy and an indication of which of the customers' demands and needs were and were not being met. In one case, the statement of demands and needs was generic and not tailored to each customer. Since the statement was the only record of the advice given, the records of PPI sales were insufficient to demonstrate their suitability;
- in one case, the cost of PPI was automatically added to the cost of a loan being sold by the firm without being requested by the customer and staff were encouraged to use "objection handling" techniques if this was queried by the customer;
- the provision of insufficient information to customers concerning the PPI;
- record-keeping was inadequate;
- staff training, competency testing and monitoring procedures were inadequate;
- staff were awarded financial incentives for PPI sales, which created a conflict of interest which was not adequately managed or monitored; and
- insufficient management information and issues which were highlighted to senior management not being acted upon.

In determining the levels of the penalties, factors noted by the FSA as relevant included:

- the number of policies sold by the firm;
- the firm's income from PPI;
- whether customers were treated fairly;
- the impact of the failings on customers – in some instances the additional financial cost to the customer would have been considerable;
- the fact that a significant number of the failings identified had been the subject of warnings from the FSA in its publications relating to PPI;
- the desire to offer a credible deterrent to others;
- whether the breaches were identified by the firm itself or whether the problems had continued unidentified until discovered by the FSA during the course of a visit;
- if the firm had identified the issues, whether it had addressed them promptly; and
- the firm's response to the FSA once the issues were identified and in particular, any steps taken to offer redress.

On 6 October 2008, Alliance & Leicester was fined £7,000,000. As with the cases falling within the period of our review, Alliance & Leicester received a 30 per cent discount for early settlement – meaning that, were it not for the discount, Alliance & Leicester would have been fined £10,000,000.

9 Treating Customers Fairly

The FSA's Treating Customers Fairly ("TCF") initiative, which derives from Principle 6, has been high on its agenda for some time. The emphasis has been on firms with retail clients, but by 31 December 2008 the FSA expects *all* regulated firms, not just those with retail clients, to be able to demonstrate that they are consistently treating their customers fairly.

While there is only one case described in this section, TCF is an overarching issue which often arises in connection with customer-facing breaches. Other enforcement cases covered in this issue therefore also have regard to the fair treatment of customers – see, for example, the cases relating to the sale of regulated mortgages and payment protection insurance.

9.1 Hastings Insurance Services Limited (Final Notice: 24 July 2008)

9.1.1 Summary

Hastings Insurance Services Limited ("Hastings") is an insurance intermediary specialising in retail motor and household insurances. In the space of four months, Hastings cancelled approximately 4,550 incorrectly priced customer motor insurance policies. The decision to cancel the affected policies arose from system errors which led to Hastings providing certain customers with inaccurate insurance quotations. The quotation errors meant that customers paid much lower insurance premiums than they should have.

A large number of policies were cancelled mid-term. This forced many customers to take out new insurance at short notice and this occurred before they received the refund on their cancelled insurance. Moreover, despite the cancellation being through no fault of their own, some customers had to pay increased premiums on their new insurance; some did not accrue the full year's no claims discount to which they would otherwise have been entitled; and customers would have been disadvantaged by being forced to declare to future insurers that they had had a policy cancelled.

The FSA fined Hastings £735,000 for failing to pay due regard to the interests of its customers and treat them fairly (in breach of Principle 6). In particular, the FSA held that:

- by cancelling affected policies, Hastings did not properly consider the interests of its customers by giving insufficient consideration to investigating other possible solutions;
- the cancellation clause in the policies which Hastings relied upon was not generally intended to be used to deal with such a situation and, by cancelling the policies, Hastings failed properly to consider its customers' interests; and
- there were serious failings in the way that Hastings dealt with customers after the cancellations, including in its complaints handling.

9.1.2 Setting the penalty

The FSA considered this to be a serious case for the following key reasons:

- despite the emphasis that the FSA had placed on TCF at the time, Hastings still decided to cancel the affected policies without following a proper and objective process that took account of the potential implications for its customers and considered all available options;
- given the large customer base, the decision had a significant impact on customers, which made it all the more important for Hastings to ensure that it was meeting its TCF obligations;



- all affected customers suffered inconvenience from the decision to cancel the insurance policies and there might be a continuing detrimental effect on the affected customers as they are now obliged to declare, when seeking new insurance, that they have previously had insurance cancelled; and
- Hastings failed to advise the FSA of the problems it experienced with its quotation system, or of the implications of these problems for its customers, until after it had taken the decision to cancel the affected policies.

The FSA took account of the following factors in mitigation:

- Hastings has expressed regret about the effect of its actions on its customers;
- Hastings has taken a number of steps to remedy the potential ongoing detriment to its customers, including writing to all affected customers to clarify that the cancellation was through no fault of the customer but arose out of Hastings' systems errors, and to invite customers who had not previously been compensated to contact Hastings to claim compensation for any financial detriment and/or inconvenience suffered; and
- Hastings has subsequently taken substantial remedial action in relation to its systems and controls on the pricing of policies and has changed its senior management and board of directors.

9.1.3 Key points

- This case demonstrates that where firms, particularly those with retail clients, have failed to sufficiently implement a Treating Customers Fairly ("TCF") policy, the FSA will use its enforcement powers to ensure that such firms deliver the six TCF consumer outcomes.
- The case shows that the FSA will punish firms which prioritise their financial interests over their customers' interests, particularly where they fail to demonstrate that they have properly and proactively considered the full implications of their decisions on their customers.
- The fine was mitigated by settlement and substantial remedial action.

10 Financial Promotion

During the period under review, the FSA took public enforcement action against two firms for inadequate financial promotions in relation to mortgages, fining Select Mortgage Services £10,500 in September 2007 and publicly censuring PB Roberts in December 2007. The fact that there were relatively few public enforcement actions in relation to financial promotion does not mean that the topic has become a lower priority issue for FSA supervision and enforcement. The standard of financial promotions continues to be a high priority for the FSA, particularly as part of its retail market strategy where the FSA sees its work as being part of the wider TCF initiative. The FSA continues to maintain a dedicated financial promotion team whose role is to monitor financial promotions made through a variety of media – television, direct marketing, press and websites. In the first half of 2008 the FSA monitored just under 13,000 promotions.

In addition to the two enforcement actions referred to above, a notable financial promotion matter was referred to the Financial Services and Markets Tribunal ("FSMT"). The *Fox Hayes* case summarised below provided a comparatively rare example of FSA interpretations of rules being tested by the FSMT. Some aspects of the case are subject to appeal.

10.1 Financial Services and Markets Tribunal decision: Fox Hayes v The Financial Services Authority (FIN/2006/0015, 5 October 2007 and FIN/2006/0015, 29 February 2008)

10.1.1 Summary

During 2003 and 2004, Fox Hayes, a Leeds-based firm of solicitors, approved a number of financial promotions for its clients, some of which were unauthorised overseas companies. The financial promotions consisted of letters approved by Fox Hayes which were subsequently sent by the companies to private investors in the UK. Each of these letters offered a free research report in relation to a company in which the private investor already held shares. Fox Hayes also approved the research reports, which were later sent by the companies to the investors who requested them. Investors were aware that, unless they requested otherwise (which they had the opportunity to do), by asking for a research report, the same company would also contact them about opportunities to invest in other companies, including companies overseas.

In September 2006, the FSA issued a decision notice in which it imposed a penalty on Fox Hayes of £150,000 for breach of the FSA's rules relating to the approval of financial promotions on the grounds that Fox Hayes (i) had not taken reasonable steps to ensure that the financial promotions were clear, fair and not misleading and (ii) had reason to doubt that the overseas companies would deal with customers in the UK in an honest and reliable way.

Fox Hayes appealed against the FSA's decision notice by referring the matter to the FSMT. Fox Hayes disputed all of the FSA's findings and also argued that the amount of the penalty was excessive.

The FSA was permitted to put two additional issues before the FSMT, namely that:

- Fox Hayes did not arrange for approval of the financial promotions to be carried out by a person with appropriate expertise; and
- Fox Hayes did not conduct its business with due skill, care and diligence.

Contrary to the FSA's decision notice and its further allegations at the hearing, the FSMT agreed with Fox Hayes on all but one of the FSA's grounds for issuing the decision notice. The FSMT held that Fox Hayes:

- did take reasonable steps to ensure that the promotions were clear, fair and not misleading;
- did arrange for approval of the financial promotions to be carried out by a person with appropriate expertise;
- did conduct its business with due skill, care and diligence; and
- initially did not have reason to doubt that the overseas companies would deal with customers in the UK in an honest and reliable way (the "no reason to doubt rule"). However, by mid-November 2003, Fox Hayes did have such reason to doubt and, in the FSMT's view, should then have ceased to act until the doubts had been removed.

On the issue of whether the penalty imposed by the FSA was excessive, the FSMT stated that it would, in principle, reduce it to £70,000 to reflect its findings. However, at a very late stage of the FSMT hearing, it transpired that one of Fox Hayes' partners had received commissions from some of the overseas companies. In light of this information, the FSMT deferred its final decision about the penalty until a hearing in February 2008 during which the FSMT unanimously decided to reduce the penalty amount from £150,000 to £146,000.

The FSA has been given leave to appeal to the Court of Appeal in relation to certain limited matters of law. These are:

- the meaning of "clear, fair and not misleading";



- the interpretation, on the facts, of the rule which requires that a person approving a financial promotion for an overseas person must have no reason to doubt that UK investors will be dealt with in an honest and reliable way; and
- whether the finding that Fox Hayes acted with due skill, care and diligence was supported by the evidence.

The outcome of the appeal is awaited.

10.1.2 Setting the penalty

The penalty on Fox Hayes recommended by the FSMT principally reflected:

- the net profit that Fox Hayes had made from the work carried out for the overseas companies;
- the commissions received by Fox Hayes' senior partner; and
- a punitive or deterrent factor.

When setting the penalty, the FSMT also stated that there should be no incentive for an authorised person to seek to reduce a penalty by making arrangements not to receive money that was otherwise due to it (referring to the fact that Fox Hayes had indicated that it did not intend to take action to recover from its former senior partner commissions received by him).

In setting the penalty, the FSMT took account of the following factors in mitigation:

- three out of the four matters in the FSMT's first decision were in favour of Fox Hayes and the FSMT had been partly in favour of Fox Hayes on the fourth matter;
- Fox Hayes did not receive the advice and help that could have been given by the FSA; and
- when concerns arose, Fox Hayes took legal advice, arranged a meeting with the overseas companies to discuss its concerns and proposed a new code of compliance, including arrangements for the monitoring of telephone calls made by the overseas companies to investors.

10.1.3 Key points

- The case is useful in identifying the FSMT's views on what actions taken by firms amount to taking reasonable steps to ensure that financial promotions are clear, fair and not misleading and what amounts to financial promotion approvals being carried out by someone with appropriate expertise.
- The case also helps to illustrate what actions the FSMT perceives to amount to conducting a business with due skill, care and diligence and sets out its views on interpreting the "no reason to doubt rule". There was no obligation on Fox Hayes to make enquiries about the overseas companies – in particular, the rule did not say a firm "*must ensure* that the overseas company will deal with customers in the UK in an honest and reliable way". The FSA had issued no guidance as to the level of enquiry it expected authorised firms to make which would indicate a more onerous requirement.
- In setting the penalty, the FSMT took into account that Fox Hayes did not receive the advice and help which it sought from, and could have been given by, the FSA. In particular, the FSMT concluded that the FSA could have provided Fox Hayes with more guidance on which unauthorised overseas companies it had concerns with.
- The FSMT emphasises that the financial promotion rules regulate the approval of the financial promotion only and not behaviour which may follow the promotion. Fox Hayes was required to ensure that the research reports were clear, fair and not misleading, but was not obliged to ensure that they were of high quality.

- The case illustrates the willingness of the FSA – and the reluctance of the FSMT – to try to stretch the scope of existing rules to capture areas with which it has policy concern but which are not obviously within the scope of the rules.

11 Disclosure Rules and Listing Principles

The action against Woolworths Group plc for breach of the Disclosure Rules (now known as the Disclosure and Transparency Rules) and Listing Principles was a high-profile case reflecting the FSA's determination to protect the order and efficiency of the market. It was the sixth penalty imposed on a public company in five years for similar breaches of the Listing Rules. The FSA has stated that the Disclosure Rules and Listing Principles are key for ensuring that shareholders are protected and that all users of the markets receive full disclosure of information at the same time.

11.1 Woolworths Group plc (Final Notice: 11 June 2008)

11.1.1 Summary

Entertainment UK ("EUK"), a subsidiary of Woolworths Group plc ("Woolworths"), entered into a contract with Tesco Stores Limited, a subsidiary of Tesco Plc, for the wholesale supply of entertainment products. This agreement was varied by a deed dated 20 December 2005. The effect of the variation was to reduce Woolworths' anticipated profits by £8 million.

The key issue was whether this variation amounted to "inside information". The FSA looked to Section 118C FSMA 2000 to determine this and disagreed with Woolworths' claim that Section 118C provides only a set of factors to be taken into account. The FSA held that "likely to have a significant effect on price" must be assessed in relation to the Section 118C(6) test only – i.e. "information would be likely to have a significant effect on price if and only if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions" – and analysis of *actual* price movements is relevant only to the question of penalty. An analysis of actual price movements would be an unworkable test, given the fact that there are cases where the relevant piece of information is not ever disclosed. The FSA rejected Woolworths' claim that a share price fall of 10 per cent or more in relation to a piece of information is needed for there to be a "significant effect on price". The FSA referred to guidance in the Disclosure Rules stating that there is no set figure or percentage to determine whether there is a "significant effect on price".

The FSA therefore concluded that the variation of the contract was inside information and should therefore have been disclosed to the market as soon as possible and no later than when the variation to the agreement was signed. In breach of the Disclosure Rules and Listing Principle 4, the variation was not announced to the market until 18 January 2006, effectively leading to a false market in the company's shares for 29 days.

The FSA fined Woolworths £350,000 for having failed to disclose information to the market in a timely manner.

11.1.2 Setting the penalty

The FSA took into account the following aggravating factors:

- Woolworths' shares were in the FTSE 250 and the breaches impacted on the orderliness of capital markets and public confidence in them;
- the long (29-day) delay in announcing the information from the date the obligation arose;
- Woolworths failed adequately to take professional advice regarding its disclosure obligations;



- Woolworths' internal processes did not cause it to identify promptly the need to consider itself whether there was inside information, even though its Board was made aware of the possible impact shortly before signing the variation to the agreement.

The FSA saw the following as mitigating factors:

- the breach was not deliberate;
- Woolworths cooperated with the FSA and had not been subject to previous disciplinary action.

11.1.3 Key points

- Woolworths chose not to settle the action, but instead made written and oral representations.
- The FSA was unimpressed that Woolworths failed adequately to take professional advice regarding its disclosure obligations and that its internal processes did not lead it to identify promptly the need to consider whether there was a disclosure obligation.
- The FSA held that analysis of actual price movements is relevant only to the question of penalty and is the test for determining whether the information has a "significant effect on price".

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