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## FINAL NOTICE

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**To:** W Deb MVL PLC (formerly known as Williams de Broe Plc)

**Of:** 29-30 Cornhill  
London  
EC3V 3NF

**Date:** 15 January 2007

**TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice about a requirement to pay a financial penalty.**

### 1. THE PENALTY

- 1.1 The FSA gave W Deb MVL PLC, formerly known as Williams de Broe Plc ("the Firm") a Decision Notice on 12 January 2007 which notified the Firm that pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act") the FSA had decided to impose a financial penalty of £560,000 on the Firm in respect of breaches of Principles 2, 3, 10 and 11 of the FSA Principles for Businesses ("Principles") and the FSA rules ("FSA Rules") referred to below during the period from 1 December 2001 to 3 May 2005 ("the relevant period").
- 1.2 The Firm confirmed on 11 January 2007 that it will not be referring the matter to the Financial Services and Markets Tribunal.
- 1.3 Accordingly, for the reasons set out below and having agreed with the Firm the facts and matters relied on, the FSA imposes a financial penalty on the Firm in the amount of £560,000.
- 1.4 The Firm agreed to settle this matter at an early stage of the proceedings. It therefore received a 30% (Stage 1) reduction in penalty pursuant to the FSA's executive

settlement procedures.<sup>1</sup> Were it not for this discount the FSA would have sought to impose a financial penalty of £800,000 on the Firm.

## **2. REASONS FOR THE ACTION**

2.1 The FSA has decided to impose a financial penalty on the Firm for failures in its senior management arrangements, systems and controls and its failure to adhere to the regulatory requirements relating to accounting procedures and records, the Firm's own stock positions, client money and compliance. As a result of these failures, the Firm has acted in contravention of Principles 2, 3, 10 and 11 and where referred to, applicable FSA Rules.

### **Accounting Systems and Controls**

2.2 The Firm breached Principle 3 in that during the relevant period it failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. Specifically:

- (1) It failed to take reasonable care to establish and maintain accurate records of matters and dealings (including accounting records) for the purposes of preparing and submitting statutory and regulatory accounts for the year ending 31 December 2004. In particular, the Firm failed to make and retain adequate accounting records to substantiate a proportion of its assets. This led to the Firm making a provision of £49,416,734 in its accounts for the year ended 31 December 2004 and a provision of £16,905,729 in its accounts for the year ended 31 December 2005 against amounts viewed as irrecoverable. This raised issues relating to the Firm's potential insolvency leading to the former parent company of the Firm being required to waive various loans to the sum of £58 million to ensure that the Firm was adequately capitalised.
- (2) It failed to take reasonable care to establish and maintain adequate systems and controls and/or records in relation to its use of a £100 million inter-group credit facility.
- (3) It failed to take reasonable care to establish and maintain adequate systems and controls and/or records in relation to its accounts, cash balances and stock positions. In particular, the Firm:
  - i. did not investigate and correct in a timely manner differences between the Firm's cash balances and stock positions as recorded by the Firm and the corresponding positions recorded by the Firm's counterparties, including banks, custodians and other third parties; and
  - ii. lacked adequate documented procedures for its accounting processes and reconciliations.
- (4) It failed to properly manage preparation and implementation of the Second Cut-Over (as defined below).

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<sup>1</sup> Chapter 13.7 of the Enforcement Manual ("ENF") contains guidance on discounts for early settlement.

- 2.3 As a result of the above, the Firm's ability to monitor its own financial position and comply with applicable financial reporting requirements was undermined.
- 2.4 The Firm also breached Principle 3 because during the relevant period it failed to take reasonable care to establish and maintain adequate arrangements to oversee compliance with regulatory requirements. In particular, the Firm failed to properly apportion responsibility for accounting and compliance areas within the Firm and ensure that all key employees understood what areas within the Firm they were responsible for.

### **Skill, Care and Diligence**

- 2.5 The Firm breached Principle 2 in that during the relevant period it failed to conduct its business with due skill, care and diligence. Specifically, the Firm failed to take appropriate steps to act upon the warning signals referred to in section 4 below and remedy the failings identified by, amongst other things, the Firm's internal audit function and the Firm's external auditor in its reports to the FSA.

### **Client Assets**

- 2.6 The Firm breached Principles 10 and 3 in that it failed to establish and maintain effective client money procedures and controls and undertake appropriate reviews of its client money procedures and controls to ensure that it was complying with the FSA's Client Asset Rules ("CASS Rules") during the relevant period.
- 2.7 The Firm breached Principle 10 and CASS 4.3.66R in that it failed to perform the calculation and segregation of client money during the period 1 November 2004 to 31 March 2005.
- 2.8 In addition, the Firm breached Principle 10 and CASS 4.3.48R in that it failed to put in place trust letters during the period from 1 November 2004 to 31 March 2005.

### **Relations with Regulators**

- 2.9 The Firm breached Principle 11 and CASS 4.3.87R by failing to notify the FSA of its failure to perform the daily client money calculation during the period from 1 November 2004 to 31 March 2005.

### **Seriousness of the Findings**

- 2.10 The Firm's failings are viewed by the FSA as serious in that:
- (1) There were systemic weaknesses in establishing, operating and maintaining adequate management systems and internal controls in relation to accounting procedures and records, the Firm's own stock positions, client money and compliance.
  - (2) The failure to apportion responsibility properly for accounting and compliance areas within the Firm and implement, operate and maintain appropriate compliance arrangements meant that there was a lack of key

safeguards in place to ensure adherence to the Principles and the FSA Rules and to ensure the protection of consumers.

- (3) The combined adjustment of £66.3 million to the Firm's accounts in 2004 and 2005 was off-set by a write-off against various inter-company loans in the sum of £58 million. This arose following concerns of the Firm and its former parent company that as a consequence of the adjustment the Firm was potentially insolvent and unable to maintain its FSA authorisation.
- (4) The failings occurred over a prolonged period and despite a number of warning signals provided by, amongst other things, the Programme of Improvement of November 1998, the Securities and Futures Authority ("SFA", a predecessor of the FSA) Direction of November 1999, and internal and external audit reports produced during the relevant period.
- (5) The failings, in particular the Firm's failure to take reasonable care to establish, operate and maintain effective systems and controls in respect of its holding of client money as a result of its inadequate client money procedures, exposed the Firm's client base to potential losses.
- (6) The Firm did not perform the client money calculation for a 5 month period from 1 November 2004 to 31 March 2005 and it did not notify the FSA of this failure during that period.
- (7) The Firm has previously been disciplined by the SFA regarding its client assets and its failure to calculate its financial resources properly leading to an overstatement of the same.

2.11 In deciding the level of the financial penalty, the FSA has taken account of the following:

- (1) The Firm identified potential regulatory issues at the Firm in 2005 and reported these to the FSA at the instigation of the Firm's former parent.
- (2) The FSA does not consider that the Firm deliberately contravened the Principles and/or the FSA Rules.
- (3) The Firm was open and co-operative with the FSA during the course of its investigation. It instructed its solicitors and accountants to undertake an independent review of the matters surrounding the potential regulatory issues identified by it and provided the FSA with a copy of the resulting reports. The Firm also undertook remedial action to improve its systems and controls and to implement appropriate procedures.
- (4) When the Firm's former parent became aware of the situation due to concerns regarding the solvency of the Firm it waived loans to ensure that the Firm was adequately capitalised and subsequently contributed funds to the Firm's pension fund to bring it in line with FRS 17 standards, as at its last annual valuation date.
- (5) There is no evidence that any clients have suffered any actual loss as a result of the Firm's failings.

- (6) Significant changes were made to the Senior Management of the Firm commencing from May 2005.
- (7) In February 2006 the Firm was placed for sale by its former parent. The purchaser and the former parent, in consultation with the FSA, structured the sale process in such a way to achieve the successful migration of the Firm's regulated activities. Following this, the Firm will not carry on any regulated business and is being closed down in an orderly manner including the future cancellation of the Firm's permissions, and it will be placed in members voluntary liquidation in the near future.

### **3. RELEVANT STATUTORY PROVISIONS**

3.1 Section 206 of the Act provides that:

*If the Authority considers that an authorised firm has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate.*

3.2 The Firm is an authorised firm within the meaning of section 206 of the Act. The relevant requirement imposed on the Firm by or under the Act includes the Principles and FSA Rules made under section 138 of the Act. The relevant Principles and FSA Rules are as follows:

#### **The Principles**

- Principle 2

*A firm must conduct its business with due skill, care and diligence.*

- Principle 3

*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.*

- Principle 10

*A firm must arrange adequate protection for clients' assets when it is responsible for them.*

- Principle 11

*A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.*

## **FSA Rules**

The relevant FSA Rules relating to client assets are set out in Appendix 1 to this Notice.

## **4. FACTS AND MATTERS RELIED ON**

### **The Firm**

- 4.1 The Firm has been authorised by the FSA since 1 December 2001. During the relevant period its principal areas of business included the dealing in and provision of investment services for institutional and private investors. The Firm was previously regulated by The Securities Association and then the SFA from 29 April 1988. During the relevant period the Firm had approximately 4400 private client accounts.
- 4.2 During the relevant period, the Firm was a public company limited by shares. In June 2006 the Firm changed ownership and subsequently changed its name to W Deb MVL PLC.

## **WARNING SIGNALS ABOUT THE FIRM'S SYSTEMS AND CONTROLS BEFORE 1 DECEMBER 2001**

### *Previous regulatory history*

- 4.3 On 10 November 1998 the FSA (acting on behalf of the SFA) sent a letter to the Firm outlining matters that the FSA considered to be of a serious nature and attaching a Programme of Improvement to target the key concerns (the "Programme of Improvement"). The matters of a serious nature related to, inter alia, client money calculations and reconciliations. The Programme of Improvement included a requirement for the Firm to design, test and install a new computer system to replace SYSTEM A. SYSTEM A was the Firm's primary transaction settlement system used between 1992 and 15 October 1999 to record all client and proprietary transactions, balances and holdings. The Firm was also required to design and implement a system to monitor client money and to alert senior management and SFA immediately when daily calculations could not be completed.
- 4.4 On 10 November 1999, following an SFA visit to the Firm, which highlighted a number of SFA rules breaches, the Firm was issued with a Direction to reconcile its safe custody investments, ensure reconciliations were completed in accordance with SFA rule 4-112 and ensure that the annual circularisation for customers complied with SFA Rules 4-113(d) and 4-114(2).
- 4.5 On 30 March 2000, the SFA issued the Firm with a Warning for overstating its financial resources and thereby breaching the relevant SFA Rule.

### ***Qualified Financial Statements for the year ending 31 December 1998***

- 4.6 In 1998 the Firm experienced a number of interface problems between SYSTEM A and CREST. CREST is the UK automated stock exchange settlement system for the sales and purchases of UK registered securities.
- 4.7 SYSTEM A had a weakness in closing down trades and the manual procedures put in place to overcome these problems were insufficient given the increasing volume of trades being processed through SYSTEM A. The internal control to check the CREST system to SYSTEM A was the performance of a reconciliation of the CREST cash control account. However this internal control was not effective given the interface problems of SYSTEM A and led to unreconciled substantial amounts on the CREST cash control account.
- 4.8 In 1998 these unreconciled amounts totalled a net receivable of £3,994,669 and a net payable of £2,517,666. Provisions in excess of £1.5 million were made in the Firm's financial statements for the year ended 31 December 1998 in order to address the risk that all or part of the net debtor balances may not have been recoverable. As the Firm's external auditor was unable to determine whether such provisions were either required or sufficient, as there were no other satisfactory audit procedures that it could adopt to substantiate these balances, it qualified its audit opinion for the Firm's financial statements for the year ended 31 December 1998.

### ***The First Cut-Over***

- 4.9 In October 1999, as a result of on-going functionality problems with SYSTEM A and the concern that it was not Y2K compliant, the Firm implemented a new system, SYSTEM B ("the First Cut-Over"). SYSTEM B was a transaction processing system for settlement and accounting for securities trades (equities, bonds and other securities).
- 4.10 In its management letters for 1998 and 1999, the Firm's external auditor set out its concerns about the First Cut-Over including significant processing delays at the year-end. The external auditor's management letter for the year ending 31 December 1999 highlighted the difficulties which included, amongst other things:
- (1) An incomplete number of opening balances transferred from SYSTEM A.
  - (2) Configuration errors in the automatic postings between key accounts.
  - (3) Errors in the standing data, particularly with regard to client settlement details.
  - (4) Difficulties with trade input, particularly in the distinction between principal and agency trades.

### ***Qualified Financial Statements for the year ending 31 December 1999***

- 4.11 As it had in the previous year, the Firm's external auditor stated in relation to the Firm's financial statements for the year ended 31 December 1999 that the Firm had difficulties reconciling balances with CREST as a result of problems with the systems and processing of CREST settlement, combined with high volumes. The

external auditor found that there remained a net unreconciled balance on a CREST related control account of £48,000, reduced from the net unreconciled balance of £1,477,000 receivable as at 31 December 1998. The previous year's £1.5 million provision was brought forward but was then seen as being unlikely to be required. As there were no other satisfactory audit procedures that the external auditor could adopt to substantiate these balances, the external auditor qualified its audit opinion for the Firm's financial statements for the year ended 31 December 1999.

***On going issues with CREST cash reconciliation post the First Cut-Over***

- 4.12 As the reconciliation problems were not resolved prior to the First Cut-Over and due to functionality problems arising from SYSTEM B, the problems with the CREST cash reconciliation account continued in 2000.
- 4.13 The Firm's financial statements for the year ending 31 December 2000 were not qualified by the external auditor. However, the external auditor noted in its management letter for the year ending 31 December 2000 that the reconciliation for the key CREST Cash Control account was not performed on a timely basis during the year and the reconciliation of the year-end position took approximately three months to complete.
- 4.14 The external auditor believed that the existing reconciliation process required further enhancement and observed with regard to the existing reconciliation process that:
- (1) The current procedure was a complex manual process, requiring formatting and visual investigation of spreadsheets, which increased the risk of human error, especially in the event of the absence of the reconciliation clerk.
  - (2) There was no formal evidence of independent management review of the work undertaken.
  - (3) Exceptions identified as sourced from CREST were investigated and a manual settlement adjustment made to SYSTEM B. The manual adjustment was entered on to SYSTEM B as a backdated entry – therefore the audit trail of original bargain entry and subsequent adjustment was lost.

***Issues concerning the stock and depot reconciliations***

- 4.15 In its management letter for 1998, the external auditor noted the Firm's failure to perform stock reconciliations between custodians and SYSTEM A.
- 4.16 Likewise, in the management letter for 1999, the external auditor noted the Firm's failure to perform stock reconciliations.
- 4.17 In its management letter for 2000, the external auditor noted that the reconciliations for stock depot accounts were not performed on a timely basis during the year. As a result there remained a large number of reconciling items across various SYSTEM B account balances at the year-end. Furthermore, differences between the Firm's stock records and those of the corresponding depots were not investigated and resolved on a timely basis.

### ***Issues concerning cash (or Nostro) reconciliations***

- 4.18 In its management letter for 1999, the external auditor noted the Firm's failure to perform cash (or Nostro) reconciliations.
- 4.19 In its management letter for 2000, the external auditor noted that the reconciliations for key Nostro accounts were not performed on a timely basis throughout the year. This required a qualification in the external auditor's report to the SFA as client money accounts had not been adequately reconciled during the year. Although balances per bank statements for delivery versus payment accounts had been used for the statutory accounts, it was still necessary for the Firm to perform regular reconciliations not only identifying the reconciling differences, but also resolving them and posting the correcting journals. The external auditor further noted that there was little supporting documentation for the resolution of the differences.

### ***Issues concerning private client assets***

- 4.20 In its management letter for 1998, the external auditor noted the Firm's failure to perform formal stock reconciliations between SYSTEM P and SYSTEM A. Also during the financial year from April 1997 to April 1998 dividends received on SYSTEM P were not reconciled to SYSTEM A. (SYSTEM P was a portfolio management system used for discretionary clients. It provided the individual client position of each of the Firm's clients i.e. it tracked money held on their account and monies paid out on their account.)
- 4.21 In its management letter for 1999, the external auditor noted the Firm's failure to perform reconciliations of private client stock holdings between SYSTEM P and SYSTEM A/SYSTEM B on a regular basis.
- 4.22 In its management letter for 2000, the external auditor noted that reconciliations of private client stock holdings between SYSTEM P and SYSTEM B had not been performed on a regular basis. The auditor also noted that with respect to the SYSTEM P and SYSTEM B reconciliation, the reconciliation was only performed at the year-end and a number of differences identified on the reconciliation had not been fully resolved three months after the year-end.

### ***The importance of client money reconciliations***

- 4.23 During the relevant period the Firm was required to perform the client money calculation on a daily basis in order to check that the amount of client funds actually held on behalf of its clients was at least equal to the amount of funds it owed to its clients and was therefore required to segregate and hold in trust for its clients.
- 4.24 The purpose of the client money calculation was to act as a check that the amount of client money that was segregated at banks and third parties was sufficient to meet the Firm's obligations to its clients on a daily basis. The objective of each client money calculation was to identify the amount of money the Firm was required to transfer to or from its house accounts to segregated client accounts in order to ensure the correct amount of money was held in each segregated client account.

### ***Issues with client money reconciliations***

- 4.25 The external auditor's reports to the SFA for 1998, 1999 and 2000 all identified a number of issues in respect of the Firm's client money reconciliation. They included:
- (1) The calculation of the "client money requirement" was not performed for several days in September 1998 due to system problems and on these days the SFA was not informed that the calculation of the previous day had been used.
  - (2) The Firm did not complete the reconciliation of customer investments held by CREST every 25 days throughout the year ended 31 December 1998.
  - (3) On certain occasions in 1999 and 2000, cheques received from customers requiring segregation were not paid into a segregated bank account in accordance with the relevant SFA rule.
  - (4) In 2000 client money accounts were not reconciled throughout the year as required by the relevant SFA rule.
- 4.26 On certain occasions in 1999 and 2000, cheques received from customers requiring segregation were not paid into a segregated bank account within one business day of receipt.
- 4.27 In 2000, although they were reconciled as at the year-end, client money accounts were not reconciled during the year. (The Firm relied on a daily reconciliation of amounts recorded by banks to amounts determined as requiring segregation).

### ***General Control Environment before 1 December 2001***

- 4.28 In its management letter for 2000, the external auditor noted the following weaknesses in the Firm's general control environment:
- (1) Procedures Manuals: the Firm was lacking detailed procedures manuals regarding roles, responsibilities and reporting lines.
  - (2) Segregation of Duties: a lack of segregation of duties concerning access to the IT systems. Certain staff had been granted user 'amend' access to the front office, back office and accounting systems. There were instances where the same individual could both input and amend trade and settlement details without requiring independent review and approval of his or her actions.
  - (3) Absence of an Audit Committee: to monitor the controls in place in the business and identify perceived gaps in the control environment.
  - (4) Insufficient training on SYSTEM B: key personnel in several areas of the back office expressed concern that they had not received sufficient training on SYSTEM B to be able to take full advantage of its capabilities.

- 4.29 It is the FSA's view that the weaknesses in the Firm's systems and controls identified prior to 1 December 2001 continued from that date and were manifested in the Firm's failure to adhere to the regulatory requirements relating to compliance, accounting procedures and records and client money as described below.

#### **POST 1 DECEMBER 2001: ACCOUNTING SYSTEMS AND CONTROLS**

- 4.30 The Firm never fully resolved functionality problems from the First Cut-Over arising from the implementation of SYSTEM B in 1999. Subsequently in December 2003, the Firm decided to move from SYSTEM B to SYSTEM C. SYSTEM C, like SYSTEM B, was a transaction processing system for settlement and accounting for securities trades (equities, bonds and other securities). At the cutover which took place in October 2004 (the "Second Cut-Over"), there were in the region of 1,800 unreconciled items, of which 1,600 were more than two years old, with many having their origin in SYSTEM A.
- 4.31 This led to ongoing reconciliation problems with a number of key interfaces post 1 December 2001, namely the CREST cash control account, the SYSTEM P to SYSTEM B (and later SYSTEM C) reconciliations and stock reconciliations. The Firm failed to rectify fully the problems year-on-year and therefore failed to maintain adequate accounting systems as set out in further detail below.
- 4.32 The FSA considers that the facts as set out below illustrate the Firm's failure to take reasonable care to implement senior management arrangements, systems and controls which were adequate for the nature, scale and complexity of its business in breach of Principle 3.

#### ***The clearance of unreconciled items***

- 4.33 The Firm had inadequate written procedures for cash reconciliations during the relevant period. In addition there was inadequate management reporting of the number or age of unreconciled cash items during the relevant period. The Firm also had inadequate written procedures in place for performing stock reconciliations. The Firm's staff created informal procedures which had evolved slowly over time. Any new staff members were trained 'on the job'.
- 4.34 The Firm failed to keep a comprehensive record of the value of the unreconciled items. For example, the reconciliations matrix which was reviewed at weekly meetings simply recorded the number of unreconciled items and aged them between 0 and 90 days without recording the corresponding value of any of the unreconciled items.
- 4.35 In May 2002, the Firm's internal audit function prepared a report on SYSTEM P administration. However this report was not finalised by the Firm until January 2003 and it was then provided to the FSA in February 2003. The main findings outlined in the executive summary included:
- (1) There was no clearly defined management structure for the SYSTEM P Administration team and roles and responsibilities were not clearly defined.

- (2) A number of key reconciliations were not performed, or were performed inadequately. These included stock reconciliations, cash reconciliations and dividend reconciliations. Reconciling items were not cleared on a timely basis and errors remained uncorrected.
- (3) There were no policies or procedures governing work of the SYSTEM P Administration team. There was a lack of consistency in the way that various tasks were performed.
- (4) There was poor segregation of duties with cashiering duties and reconciliations being performed by the same person.

4.36 The Firm's response to the internal audit was that it agreed that:

- (1) Dividend reconciliations were not performed adequately between SYSTEM P and SYSTEM B (identified as a 'Medium' risk in the report, which was defined as meaning that these risks were important and management should quickly develop action plans that would ensure timely and permanent resolution of the weaknesses noted).
- (2) There was no stock reconciliation performed between SYSTEM P and SYSTEM B on a regular basis. (The risk attached by internal audit to the absence of this stock reconciliation was 'High' i.e. the risk was so significant to the entity that it required immediate attention of Senior Management and priority to finding a solution.)

4.37 The FSA understands that the Firm undertook a manual "daily tick-out" to match transactions. However, the practice of "daily tick-outs" was not guaranteed to identify all instances where SYSTEM P and SYSTEM B did not agree. Further, formal monthly reconciliations which could have identified any such differences were not undertaken.

4.38 It is the FSA's view that these failures demonstrate that reconciliations between two systems both designed to record the same client transactions were not done appropriately and/or recorded adequately.

4.39 The external auditor's report to the FSA for the year ending 31 December 2002 stated:

*"Progress reported last year in that balances and positions with custodians, banks and intermediate brokers were now being reconciled had been continued. During the year they were reconciled within the required timeframe, although a number of old reconciling items have still not been cleared as required by FSA Rules 10-11(1-3)*

*...whilst reconciled at the year end, a number of control and wash accounts were not reconciled regularly during the year, as required by FSA Rules 10-11(1-3). In addition, while efforts were made to reconcile the [SYSTEM P] Private Clients systems to the main settlement system on a monthly basis, not all the reconciling differences were explained or cleared on a timely manner. We note that the reconciliation process was strengthened during the year and the number of such*

*unexplained differences has significantly reduced. However, there are still a number of old outstanding items that have yet to be explained and cleared, as required by FSA Rules 10-11(1-3)."*

4.40 The external auditor's report to the FSA for the year ending December 2003 stated:

*"Balances in two non-trading bank accounts were not reconciled during the year within the required timeframe as set out in FSA Rule 10-11(3);*

*Other than the accounts noted in (1), during the year balances and positions with custodians, banks and intermediate brokers were reconciled within the required timeframe, although a number of old reconciling items have still not been cleared as required by FSA Rules 10-11(1-3);*

*As noted last year, whilst reconciled at the year end, a number of control and wash accounts were not reconciled regularly during the year, as required by FSA Rules 10-11(1-3). In addition, while the monthly process of reconciling the [SYSTEM P] Private Clients system to the main settlement system has been strengthened, we note that not all the reconciling differences were explained or cleared in a timely manner. Although the number of such unexplained differences have significantly reduced, there are still a number of old outstanding items that have yet to be explained and cleared, as required by FSA Rules 10-11(1-3)."*

4.41 Accordingly, whilst the relevant accounts were to a limited extent being reconciled to each other, journals were not then being posted to clear the items which had been reconciled. The FSA therefore considers that the systems and controls adopted by the Firm in respect of the SYSTEM P and SYSTEM B interface to reconcile the records maintained on the two systems including identifying and clearing outstanding reconciling items were neither appropriate nor effective.

4.42 At the Second Cut-Over in October 2004 the Firm switched to using the bank balance rather than the cash book balance for the client money reconciliation and for the financial statements in breach of CASS 4.3.92R. This demonstrates that the Firm felt unable to rely on its own internal accounting records.

#### ***Ongoing reconciliation problems post 1 December 2001***

##### CREST cash control account reconciliations

4.43 Post 1 December 2001 the weaknesses in the CREST cash control account reconciliations continued. The external auditor's draft management letter for 2003 noted that whilst this reconciliation was now being performed, the procedure still had weaknesses in the operation of the spreadsheet. Furthermore there was no formal evidence of independent management review of the performance of this control account and no formal testing of the spreadsheet had been performed.

##### Firm's own stock position reconciliations

4.44 The external auditor's draft management letter for 2003 noted that the Firm's own stock positions were not reconciled to custodian statements or CREST on a regular

basis. The Firm's adjustment of its accounts as at 30 September 2004 included an adjustment in the sum of £1.7 million in relation to the Firm's own stock.

#### Bank reconciliation process

- 4.45 The external auditor's draft management letter for 2002 noted that the Firm did not appear to have effective controls to ensure that all new bank accounts were reconciled. The external auditor observed that this led to a risk of poor control of these accounts, potentially leading to a situation such as had arisen with some other accounts where old items remained on "recs" for long periods.
- 4.46 The external auditor's draft management letter for 2003 noted that a number of bank account reconciliations were not performed and that there were a substantial number of old reconciling items on reconciliations for long periods.

#### Control accounts

- 4.47 The external auditor's draft management letter for 2003 set out its observations in respect of the structure of SYSTEM B. SYSTEM B required the creation of a number of control and suspense accounts in order to process the particular types of transactions entered into by the Firm. As aspects of the SYSTEM B configuration were incorrect this caused large balances to be posted to the control accounts and there was no formal process for the identification, control and timely resolution of these control and suspense accounts on a regular basis. As a result, the balances on the control account were not resolved and this internal control was ineffective.

#### *General control failures*

##### Change controls for SYSTEM B static data

- 4.48 The external auditor's draft management letters for 2002 and 2003 both noted a weakness in respect of the controls on SYSTEM B in that the static data held on SYSTEM B could be changed by staff in the middle and back offices. The external auditor observed that this exposed the Firm to an increased risk of fraud as staff could change bank account details and errors in the straight-through processing of trading data, resulting in an increasing number of exceptions which had to be resolved.

##### Corporate Governance: Apportionment of responsibility and segregation of duties

- 4.49 The external auditor's draft management letters for 2002 and 2003 both observed as a weakness in respect of corporate governance that there were no formalised procedures governing responsibilities, segregation of duties and roles of individuals. Therefore, there existed little formal documentation identifying what exact tasks individuals should be performing and to whom they reported. Subsequently there was little review and sign-off by heads of department.
- 4.50 The external auditor's draft management letter for 2003 also noted unlimited or extensive access to various systems in the front, back office and support areas.

- 4.51 The external auditor's draft management letter for 2003 also notes that the Firm's internal audit function was under-resourced and had no clear remit.
- 4.52 It is the FSA's view that the Firm did not adequately apportion key responsibilities for accounting and compliance areas within the Firm and this led to internal confusion surrounding the roles of some key members of staff. Written job descriptions were inadequate and the roles and responsibilities of key members of staff were not documented through organisational charts and diagrams. Some key members of staff were unable to demonstrate a complete understanding of their roles and responsibilities.
- 4.53 In addition to the above, it appears to the FSA that the Firm failed to take appropriate steps to act upon and remedy the findings of the internal audit function.

#### Treasury management

- 4.54 In April 2003, the Firm's internal audit function produced a draft report of Treasury Management with an audit rating of "unsatisfactory". (This audit rating was defined as the operations being audited were 'assessed to have an inadequate system of internal controls and procedures in many areas, or be inadequate in at least one area of fundamental importance' and that the impact of weaknesses identified in the control environment exposed the business or function to an unacceptable level of risk).
- 4.55 In June 2003, the Firm's internal audit function issued the final report on Treasury Management. The main findings of the report are stated as:

*"The audit opinion regarding the adequacy of internal control related to [the Firm's] treasury management is **weak**. This results from [the Firm's] inability to properly justify one main component of the daily borrowing i.e. the "stock on water" component, and from the lack of procedures, transparency and monitoring of the treasury management activity.*

...

*Our main audit concerns are ...(no clear-cut traceable justification for the "stock on water" calculation) and ...(no daily monitoring of funding)."*

- 4.56 It is the FSA's understanding that "stock on the water" refers to stock in transit between stock depots.
- 4.57 The audit rating assigned to the final report was "weak" (the definition of which was that *"the operations are assessed to have an inadequate system of internal controls and procedures in certain areas, or be inadequate in at least one area of significant importance' with the impact of the weakness(es) identified in those areas of the control environment exposing the business to a serious level of risk"*). The Firm has provided the FSA with no satisfactory explanation as to the reason for upgrading the audit rating from unsatisfactory to weak.
- 4.58 In February 2004, the Firm's internal audit function issued a follow up report on Treasury Management. The audit concluded that:

*"Despite [the Firm's] main achievements regarding funding monitoring, the audit opinion regarding the adequacy of internal control related to treasury management can't be yet regarded as satisfactory and therefore remains **weak**.*

*CAS appreciates the involvement of the firm's management in the funding monitoring and all the operational and organisational efforts made since the first assignment, which have allowed to discover related funding issues such as missing stock, undue [stamp duty] payments, FX timing difference, ... "*

4.59 In summary these issues related to:

- (1) An estimated £14.5 million stamp duty paid by mistake to the Inland Revenue since 1998.
- (2) £2.3 million of missing firm stock with another £2.5 million of potentially missing firm stock.
- (3) A residual inability to trace all of the borrowings uses, especially those not assessed in the daily analysis of the borrowings.
- (4) A continued inability to account for any more than 70-90% of the daily borrowings on a daily basis with the simultaneous criticism that the process used to account even for these levels was not documented.

4.60 There was also the restated concern that as borrowing remained at the £100 million level, this demonstrated that funding monitoring was not effective which in turn bore the risk that the firm could hit its borrowing limit.

#### Stamp duty overpayment

4.61 Following the February 2004 Treasury Management internal audit report which identified the overpayment of stamp duty since 1998, the Firm's internal audit function produced the Overpayment of Stamp Duty report dated June 2004. By the time this report was produced the Firm had already received repayment from the Inland Revenue of the £14.5 million overpaid stamp duty.

#### *The Second Cut-Over*

4.62 It is the FSA's view that the Firm failed to prepare adequately for and implement the Second Cut-Over in October 2004 from SYSTEM B to SYSTEM C. In particular, the Firm failed to give adequate consideration to, and appreciate the significance of, the change from SYSTEM B and SYSTEM C. As a result, the Firm failed to:

- (1) Ensure that adequate project management procedures were in place.
- (2) Conduct appropriate full user acceptance testing.
- (3) Ensure that there were adequate resources available to the IT and accounts departments to enable them to carry out the necessary testing.
- (4) Provide adequate training to staff on SYSTEM C.

- (5) Ensure the appropriate involvement of the Compliance Department in the Second Cut-Over.

4.63 By virtue of the above failings, the Firm experienced significant difficulties in producing reliable management and accounting information. For example:

- (1) Daily cash reconciliations and stock reconciliations were not being performed.
- (2) A number of the Firm's compliance monitoring systems were disrupted upon the Second Cut-Over which resulted in some of its monitoring reports not being produced, for example the confirm suppression report which was used to monitor fraudulent behaviour in the back office, and the late trades report and the short sales report which were both used to monitor trades.

***Lack of proper audit trail***

4.64 The process of extracting a trial balance for audit purposes at the Firm was not an automatic process. Due to functionality issues with the IT systems within the Firm, a number of manual adjustments needed to be made to arrive at an accurate trial balance. The process was problematic due to:

- (1) The large number of manual journals posted.
- (2) The complexity of audit trail of the manual journals produced through spreadsheets.
- (3) The complexity of the audit of opening balances in the trial balance (as a result of the large number of back postings that were made to the trade details).

4.65 In December 2003, the Firm's internal audit function prepared a draft audit report on Finance-Accounting – Reconciliations, however this report was never finalised despite the inclusion of management comments. In the FSA's view this failure to progress the report beyond draft form is in itself further evidence of the Firm's poor systems and controls and, in particular, the Firm's failure to implement the internal audit function as a robust control.

4.66 The audit rating on this draft report was "Unsatisfactory" (the definition of which is set out above at paragraph 4.54).

4.67 The main findings of the report contained within the Executive Summary are as follows:

"Due to remaining uncertainties and issues surrounding some key balances of the entity, CAS is presently not in a position to confirm the existence of a proper audit trail and consequently, to assess the level of possible financial exposure linked to those items".

4.68 The FSA considers that this draft report identified a significant failure on the part of the Firm to provide a sufficient audit trail in support of a number of key balances.

### *Adjustment to the balance sheet as at 30 September 2004*

- 4.69 Due to the ongoing problems with the Firm's accounting systems, by 2004 the Firm's former parent company was of the view that the Firm was unable to produce annual financial statements with an adequate audit trail within the time-frame stipulated for group reporting purposes. It was decided at group level to subject the Firm's financial statements as at 30 September 2004 to an audit for group reporting purposes, with the intention to use the resulting audit opinion for the group financial statements as at 31 December 2004.
- 4.70 However, requests by the Firm's former parent company and the external auditors to the Firm for the provision of an adequate audit trail for a number of key areas (including the CREST/SYSTEM B reconciliations) were not fulfilled to the satisfaction of the Firm's former parent company or the external auditors.
- 4.71 The former parent company therefore decided to take a different approach to the preparation of the financial statements, and the resulting accounts prepared as at 30 September 2004 made full provision against any amounts that could not be supported by adequate documentation. These accounts were audited by the Firm's internal audit function and the balance sheet was the subject of a specific scope review by the external auditors dated 15 August 2005 ("the Review").
- 4.72 The provision made in the accounts subject to the Review amounted to £51.7 million comprising, inter alia, a net provision against unverified trade debtors and creditors of £39.7 million and a provision against bank reconciling items outstanding over 30 days of £4.6 million. Subsequently the Firm confirmed to the FSA that an adjustment of £58 million was made to the Firm's accounts as at 30 September 2004. The difference of £6.4 million is attributable to a number of miscellaneous provisions.
- 4.73 The adjustment of £58 million to the Firm's balance sheet as at 30 September 2004 was offset by the write-off of an equivalent amount against an inter-company loan owed to the former parent company by the Firm. This was achieved by means of a recapitalisation agreement. This agreement was reached following the concerns of the Firm and its former parent that as a consequence of the adjustment, the Firm was potentially insolvent and unable to maintain its FSA authorisation.
- 4.74 The Firm's financial accounts for the year ending 31 December 2004 were completed in August 2006 and the Firm's financial accounts for the year ending 31 December 2005 were completed in November 2006. These accounts reveal that the Firm made a provision for net reconciled receivable balances of £49,416,734 in its accounts for the year ended 31 December 2004 and a provision for net reconciled receivable balances of £16,905,729 in its accounts for the year ended 31 December 2005.

## *Summary of Accounting Systems and Controls*

### **Principle 3 breach**

- 4.75 The FSA considers that the facts set out in paragraphs 4.33 – 4.74 above illustrate that during the relevant period the Firm has breached Principle 3 in that it failed to:
- (1) Take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems.
  - (2) Take reasonable care to establish and maintain adequate arrangements to oversee compliance with regulatory systems and in particular it failed to apportion responsibility in accounting and compliance areas of the Firm's business.

### **Principle 2 breach**

- 4.76 The FSA considers that during the relevant period the Firm has breached Principle 2 in that, the Firm failed to take appropriate steps to act upon the warning signals set out above and remedy the failings identified by, amongst other things, the Firm's internal audit function and the Firm's external auditor in its reports to the FSA.

## **CLIENT ASSETS**

### *The absence of monitoring client money procedures*

- 4.77 The Firm did not implement adequate procedures or undertake appropriate reviews of its client money systems and controls to ensure that it was complying with the FSA's CASS Rules, notwithstanding the importance of the proper protection of client money and the Firm's regulatory obligations as an authorised person.
- 4.78 In particular, the Firm did not have in place sufficiently robust systems and controls to:
- (1) Ensure that its client money calculation was performed and adequately reviewed and signed-off during the relevant period.
  - (2) Identify and manage the limitations imposed by the functionality issues concerning SYSTEM P and SYSTEM B (and later SYSTEM C).
- 4.79 At no stage between 1 December 2001 to 1 April 2005 did the Firm carry out any formal review of client money and client asset procedures or the related account systems, save for a review of the client banks and trust status of accounts in which client assets are held.
- 4.80 The Firm failed to give sufficient consideration to CASS Rules and, in particular, whether the daily client money calculation was being performed in accordance with those Rules.
- 4.81 From April 2004 the Firm changed its procedures so that rather than requiring daily confirmation that the client money calculation had been done, it only required

notification to be given if the calculation had not been performed by 1:30pm each day. Therefore, the Firm did not have in place effective systems and controls to monitor whether the client money calculation was being performed on a daily basis as there was no way of distinguishing between (a) no notification being received as the calculation had been done and therefore notification was not required, or (b) no notification being received because despite the calculation not being carried out, the relevant party had omitted to send the required notification.

4.82 The Firm failed to perform the reconciliation of client money balances properly and in particular, investigate and correct in a timely manner the differences between the client money balances recorded by the Firm and corresponding positions recorded by third parties during the relevant period. This constitutes a breach of CASS 4.3.92R.

4.83 Accordingly, as a result of the above, it is the FSA's view that during the relevant period the Firm failed to:

- (1) Arrange for adequate protection for clients' assets when it was responsible for them in breach of Principle 10; and
- (2) Take reasonable care to organise and control its affairs responsibly and adequately in breach of Principle 3.

***Failure to carry out the client money calculation***

4.84 As stated above at paragraph 4.23 during the relevant period, the Firm was required to perform the client money calculation on a daily basis. However, the Firm has acknowledged that from 1 November 2004 to 31 March 2005:

- (1) No substantive client money calculations or reconciliations were performed.
- (2) Given the absence of formal calculation throughout this period, it is unclear as to how the client money was calculated.

4.85 This amounts to a breach of CASS 4.3.66R.

4.86 The Firm has also acknowledged that during April 2005 despite having performed the client money calculation, the amount in the bank accounts was not being topped up/reduced, ostensibly due to mistrust of the calculation, so incorrect amounts were being segregated. This constitutes a breach of CASS 4.3.66R.

4.87 The breaches described in paragraphs 4.84 to 4.86 above illustrate a failure on the Firm's part to arrange for adequate protection for clients' assets when it was responsible for them in breach of Principle 10.

***Absence of trust letters in place***

4.88 The Firm has acknowledged that from 1 November 2004 to 31 March 2005 client bank accounts were being opened without the knowledge of the Compliance Department and with no trust letters in place. This was a breach of Principle 10 and CASS 4.3.48R.

## **RELATIONS WITH REGULATORS**

### ***Failure to inform the FSA about the failure to perform the daily client money calculation***

4.89 The Firm has acknowledged that from 1 November 2004 to 31 March 2005 it failed to notify the FSA that it had not performed the daily calculation of client money. This failure to notify the FSA constitutes a breach of Principle 11 and CASS 4.3.87R.

## **5. RELEVANT GUIDANCE**

5.1 When exercising its powers, the FSA seeks to act in a way which it considers most appropriate for the purpose of meeting its regulatory objectives as set out in section 2(2) of the Act. The FSA considers that imposing a financial penalty of £800,000 on the Firm meets the regulatory objectives of market confidence, that is maintaining confidence in the financial system, and protection of consumers.

5.2 In deciding to take the action proposed, the FSA has had regard to guidance published in the FSA Handbook, in particular as set out in Sections 1.3, 11.4 and 13 of the FSA's Enforcement Manual ("ENF").

5.3 In particular, ENF 1.3.1(2)G states that the FSA will seek to exercise its enforcement powers in a manner that is transparent, proportionate and consistent with its publicly stated policies. The criteria for determining whether to take disciplinary action are set out in ENF 11.4.1G. ENF 11.4.1G states that the FSA will consider the full circumstances of each case and that the criteria listed are not exhaustive: not all of them may be relevant and there may be other factors that are relevant.

5.4 As set out in ENF 13.1.2G, the principal purpose of the imposition of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions, and demonstrating generally to firms the benefits of compliant behaviour.

5.5 Having regard to the matters summarised above, to the guidance set out in ENF and to the FSA's statutory objectives of the protection of consumers and market confidence, the FSA considers it proportionate and appropriate in all the circumstances to take disciplinary action against the Firm for its failings in respect of its senior management arrangements, systems and controls, accounting records, client money, assets and compliance.

5.6 For the avoidance of doubt, this analysis of the level of penalty was undertaken before applying the 30% stage one discount (ENF 13.7.3).

## **Factors the FSA considers to be particularly relevant to this case**

### ***The seriousness of the misconduct or contravention***

- 5.7 The FSA has had regard to the seriousness of the contraventions, including the nature of the requirements breached and the number and duration of the breaches. For the reasons set out below the FSA considers that the breaches are of a serious nature.
- 5.8 The failings resulted from systemic weaknesses in the Firm's systems and controls and its senior management arrangements. It failed to maintain a clear and appropriate apportionment of significant influence responsibilities which resulted in internal confusion surrounding the roles of some key staff. The absence of clear senior management responsibilities and appropriate compliance arrangements meant that there was a lack of key safeguards in place to ensure adherence to the Principles and the FSA Rules and to ensure the protection of consumers.
- 5.9 The failure to establish and maintain accurate records of matters and dealings (including accounting records) resulted in the Firm having to make a substantial adjustment of £49.4 million to its accounts as at 31 December 2004 and a further adjustment of £16.9 million to its accounts as at 31 December 2005. A consequence of these provisions was that but for the waiver of the loans in the sum of £58 million by its former parent company and the subsequent contribution of funds into the Firm's pension fund, the Firm was potentially insolvent and unable to maintain its FSA authorisation.
- 5.10 These failings, in particular the Firm's failure to take reasonable care to establish and maintain effective systems and controls in respect of its holding of client assets and client money as a result of its inadequate client money procedures, exposed the Firm's clients to potentially serious losses particularly in circumstances where the Firm had approximately £1 billion assets under management.
- 5.11 The breaches occurred following a number of warning signals to the Firm that there were problems surrounding its senior management arrangements, systems and controls relating to compliance, accounting records, client money and client assets.

### ***The duration and frequency of the misconduct***

- 5.12 The breaches occurred over a prolonged period from 2002 to 2005.

### ***The extent to which the misconduct was deliberate or reckless***

- 5.13 The FSA considers that the contraventions were not deliberate or reckless.

### ***The size, financial resources and other circumstances of the firm***

- 5.14 Although the Firm no longer carries on business, there is no reason to believe that the Firm will not be able to pay the financial penalty.

### *Conduct following the contravention*

- 5.15 The Firm identified potential regulatory issues at the Firm in 2005 at the instigation of its former parent company and reported these to the FSA. The Firm was open and co-operative with the FSA during the course of its investigation. It instructed its solicitors and accountants to undertake an independent review of the matters and provided the FSA with a copy of the resulting reports. The Firm also undertook remedial action to improve its systems and controls and to implement appropriate procedures. Finally the Firm was sold in an agreed manner that would allow for the orderly migration of the business and formal close down of the Firm.

### *The disciplinary record and compliance history of the firm*

- 5.16 The Firm has not previously been the subject of disciplinary action by the FSA. The Firm was disciplined by the SFA prior to 1 December 2001.

### *The previous action taken by the FSA in relation to similar findings*

- 5.17 The FSA seeks to ensure consistency when it determines the appropriate level of penalty. The FSA has in the past taken action against firms for similar failings and these have been taken into consideration in setting the level of penalty against the Firm.

## **6. CONCLUSION**

- 6.1 Taking into account the seriousness of the breaches and the risk they posed to the FSA's statutory objectives, the FSA has decided to impose a financial penalty of £560,000 on the Firm.

## **7. DECISION MAKERS**

7. The decision which gave rise to the obligation to give this Final Notice was made by the Executive Settlement Decision Makers on behalf of the FSA.

## **8. IMPORTANT**

- 8.1 This Final Notice is given to the Firm in accordance with section 390 of the Act.

### **Manner of and time for Payment**

- 8.2 The financial penalty must be paid in full by the Firm to the FSA by no later than 29 January 2007, 14 days from the date of the Final Notice.

### **If the financial penalty is not paid**

- 8.3 If all or any of the financial penalty is outstanding on 30 January 2007, the FSA may recover the outstanding amount as a debt owed by the Firm and due to the FSA.

## **Publicity**

- 8.4 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.
- 8.5 The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

## **FSA contacts**

- 8.6 For more information concerning this matter generally, you should contact Liz Ludlow (direct line: 020 7066 1474 /fax: 020 7066 1475) of the Enforcement Division of the FSA.

**Georgina Philippou**  
**FSA Enforcement Division**

## **Appendix One: THE RELEVANT CASS RULES**

CASS 4.3.48R states:

*When a firm opens a client bank account, the firm must give or have given written notice to the bank requesting the bank to acknowledge to it in writing:*

- (1) that all money standing to the credit of the account is held by the firm as trustee (or if relevant, as agent) and that the bank is not entitled to combine the account with any other account or to exercise right of set-off or counterclaim against money in that account in respect of any sum owed to it on any other account of the firm; and*
- (2) that the title of the account sufficiently distinguishes that account from any account containing money that belongs to the firm, and is in the form requested by the firm.*

CASS 4.3.66R states:

*Each business day, a firm that adopts the normal approach in accordance with CASS 4.3.8R must:*

- (1) check whether its client money resource, being the aggregate balance on the firm's client bank accounts, as at the close of business on the previous business day, was at least equal to the client money requirement, as defined in CASS 4.3.71R, as at the close of business on that day; and*
- (2) ensure that:*
  - (a) any shortfall is paid into a client bank account by the close of business on the day the calculation is performed; or*
  - (b) any excess is withdrawn within the same time period unless CASS 4.3.5R or CASS 4.3.6R applies.*

CASS 4.3.87R states:

*A firm must notify the FSA immediately if it is unable to, or does not, perform the daily calculation required by CASS 4.3.66R or CASS 4.3.67R*

CASS 4.3.92R states:

*A firm must compare:*

- (1) the balance on each client bank account as recorded by the firm with the balance on that account as set out on the statement or other form of confirmation issued by the bank with which those accounts are held; and*
- (2) the balance, currency by currency, on each client transaction account as recorded by the firm, with the balance on that account as set out in the statement or other form of confirmation issued by the person with whom the account is held;*

*and identify any discrepancies between them.*