
FINAL NOTICE

To: **Capita Financial Administrators Limited**

Of: Capita Financial Services
4th Floor Beaufort House
15 St Botolph Street
London
EC3A 7HH

Date: 16 March 2006

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. ACTION

- 1.1. The FSA gave Capita Financial Administrators Limited ("CFA") a Decision Notice on 15 March 2006 which notified CFA that pursuant to section 206 of the Financial Services and Markets Act 2000 ("FSMA"), the FSA had decided to impose a financial penalty of £300,000 on CFA. The penalty is in respect of breaches of Principle 2 and Principle 3 of the FSA's Principles for Businesses and breaches of Senior Management Arrangements, Systems and Controls SYSC 3.2.6R.
- 1.2. CFA confirmed on 13 March 2006 that it would not be referring the matter to the Financial Services and Markets Tribunal.
- 1.3. Accordingly and for the reasons set out below and having agreed with CFA the facts and matters relied on, the FSA imposes a financial penalty on CFA in the amount of £300,000.

2. REASONS FOR THE ACTION

- 2.1. In the period from April 2003 to December 2004 ("the relevant period"), CFA breached Principles 2 and 3 by failing to conduct its business with due skill, care and diligence in considering the risks posed by financial crime and by failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- 2.2. CFA also breached SYSC 3.2.6R by failing to take reasonable care to establish and maintain effective systems and controls to counter the risk that CFA might be used to further financial crime.
- 2.3. These failures were highlighted by a small number of actual and attempted frauds.
- 2.4. The FSA proposes to take action because of the following failings:
 - (1) CFA did not undertake an adequate assessment of its fraud risk, especially the risk of internal fraud. In doing so the firm did not act with due skill, care and diligence. Operational risk was the key risk being run by CFA and fraud risk was a significant part of this. CFA should have taken a comprehensive approach to identifying fraud risk both prior to and after the discovery of the frauds. It should have assessed the adequacy of its existing controls and considered putting in place additional controls to mitigate any risks that had been identified.
 - (2) CFA did not take adequate steps to ensure that it had effective controls to reduce the risk of fraud, particularly internal fraud. The specific failures were in respect of:
 - (a) controls to ensure that changes to client data and instructions for payments were genuine;
 - (b) controls to ensure that payments were not made to accounts that were not controlled by clients;
 - (c) monitoring by compliance and internal audit to ensure that procedures to mitigate the risk of fraud were being adequately implemented; and

- (d) training to raise awareness of fraud risk and human resources procedures to verify that adequate references had been received.

- 2.5. The weaknesses in systems and controls contributed to a small number of actual and attempted frauds that appear to have been carried out by a small number of colluding CFA staff. The value of the actual frauds was £328,341 and the value of the attempted frauds was £1,552,259. CFA took prompt action to ensure that its clients did not suffer a financial loss as a result. Nevertheless, the control failings were serious. The FSA is particularly concerned that: first, the initial instances of fraud were discovered by clients rather than by CFA. Had these clients not alerted CFA, there remained a material risk that it would not have identified the frauds or taken action to assess and revise its controls, which it has now done; and second, that the cumulative impact of the individual failings represented a significant risk to the FSA objective of reducing the risk of financial crime.
- 2.6. The Capita Group has since put in place an effective remedial programme at CFA. It has taken a positive approach to improving systems and has implemented controls at CFA that are consistent with best practice in the industry. The Capita Group has appointed a new management team and introduced a corporate governance structure that includes support from the Capita Group.
- 2.7. The matters set out in this notice refer to the actions of CFA and not the wider Capita Group.

Relevant Statutory Provisions and Regulatory Rules

- 2.8. Under section 206(1) FSMA, if the FSA considers that an authorised person has contravened a requirement imposed on him by or under FSMA, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate.
- 2.9. Section 2(2) of FSMA includes reduction of financial crime as a regulatory objective for the FSA.
- 2.10. Principles 2 and 3 of the FSA's Principles for Businesses state that

“a firm must conduct its business with due skill, care and diligence”,

and that

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

- 2.11. Rule 3.2.6 of SYSC states that *“a firm must take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system and for countering the risk that the firm might be used to further financial crime”.*

Facts and Matters Relied On

Background

- 2.12. CFA is a third party administrator for collective investment schemes. It is responsible for maintaining clients' records and carrying out client instructions in respect of the purchase and repurchase of investments. As at August 2005, CFA's client base was approximately 126,000 with funds under management in the region of £9.8 billion.

The Frauds

- 2.13. During the period between August 2004 and December 2004, CFA discovered a number of actual and attempted frauds that appear to have been carried out by a small number of colluding CFA staff. The initial instances of fraud were discovered as a result of enquiries from clients. The details of the frauds are:
- (1) In August 2004, CFA discovered that a client's name and address had been changed without instructions from the client and the sale of units was being processed without any instruction from the client. CFA subsequently found that the data held for five other clients had been subject to unauthorised changes and fraudulent requests for payments had been made. The value of the requested payments was £1,134,938. These payments were stopped by CFA before they were made.
 - (2) In September 2004 and December 2004, CFA discovered further actual and attempted frauds. These included fraudulent instructions for £417,321 being processed for 20 clients. Payments were either pending or had been made, in

some instances to bank accounts held outside the UK. The total value of fraudulent payments made was £328,241.

Due Skill, Care and Diligence

Consideration of fraud risk

2.14. The CFA Board did not use appropriate skill, care and diligence when considering the risk of fraud in the business. CFA did not undertake sufficient analysis of the fraud risk that the firm was running. It was too focused on the risk of external fraud. This was based on CFA's fraud experience, which had been largely external frauds. The FSA views this as serious because CFA's business requires it to hold client information on which payments are made. This makes it particularly vulnerable to fraud. Following the acquisition of another fund administrator in April 2003, which significantly expanded the business, CFA management focus was on dealing with IT systems and cultural differences between the businesses within the enlarged business. CFA should have considered fraud risk across the business and assessed the controls in place to ensure that they remained appropriate to withstand fraud risk within an expanded business.

2.15. Managers in business areas produced procedures that were reviewed by the compliance department and signed off by the Board. The focus of the procedures (and the review of the procedures) was to ensure that they complied with specific FSA rules. The procedures contained some controls that were designed to mitigate fraud risk and in some areas these had the intended effect. However, CFA did not give adequate weight to this risk. In view of the nature of CFA's business, the FSA considers that this was a serious omission.

Response to the discovery of fraud

2.16. Following the discovery of the first fraud in August 2004, CFA established a committee to investigate it and examine the controls that had contributed to it. The committee involved suitably senior staff and had clear objectives. However, the scope of its work was predominantly on the specific circumstances of the particular fraud. The discovery of the initial frauds should have prompted CFA to undertake a wider review of its fraud risks.

Systems and Controls

- 2.17. CFA's business requires it to deal with clients who wish to buy or sell units. It is key to its business that CFA has effective systems to verify the identity of the client who gives it instructions. CFA's systems and controls must be robust enough to guard against fraud risk whether external or internal and against the potential misuse of confidential client data. The nature of the business means that the risk of fraud as a result of identity theft is high.
- 2.18. The following are the key controls that CFA had in place to protect against the risk of fraud:
- (1) business unit processes and procedures;
 - (2) compliance monitoring and internal audit; and
 - (3) staff training and human resource procedures.

Business Unit Processes and Procedures

Telephone instructions to sell units

- 2.19. In respect of placing a telephone deal, callers were identified by reference to their account number, name, address and date of birth. This information (apart from the date of birth) was written on the annual statement that is sent to the client in the post.
- 2.20. Rather than using passwords or other client specific information (e.g., first school attended, favourite place) to verify client identity, CFA used publicly available information or information that was easily compromised. This information could be found in electoral roles, from the internet, through theft of annual statements or other correspondence sent to clients by CFA or could easily be accessed by staff. Staff working in the areas processing changes to client data and sale and purchase instructions had unrestricted access to client information.
- 2.21. A fraudster with access to non-secure information could telephone CFA and instruct them to sell a client's unit holding. For telephone instructions, CFA's procedures required it to send sales documentation to the client in the post. The client was

required to sign and return this before any payment was made. CFA did not check the signature on the sales documentation to ensure it was authentic. Within the sales documentation a client could nominate a bank account to receive payment of funds. There was no procedure in place to check that the bank account to be credited was that of the client. Fraudsters could therefore request payment to an account controlled by them rather than the client.

- 2.22. The posting of sales documentation ran a material risk that the documentation could be intercepted internally or through the post system. The FSA accepts that this risk is unavoidable, is not out of step with general industry practice and the telephone request procedures did not contribute to the actual or attempted frauds. However the posting of materials, together with the lack of password controls combined with an absence of checks on the validity of signatures and the ability of clients to request payments to an account of their choice, exposed the firm to unacceptable fraud risk.

Postal instructions to change address and sell units

- 2.23. Where a client requested a change of address they would be required to put their request in writing. On receipt of the letter CFA's internal processes required staff to enter the change onto the IT system. There was no check that the signature on the letter corresponded to the signature held on file by CFA. This was because CFA did not hold signatures for all clients and for those it did the documentation was held off site. The check of the letter was limited to ensuring that it was signed. The checking of signatures is not universal industry practice. In many firms this check may not be required providing there are additional controls in place to verify correspondence is authentic. In this case, the lack of check on signatures was particularly important given the failure set out in paragraph 2.25 below.
- 2.24. A daily report was produced that set out changes made the previous day to client name and address information. Procedures required that each change identified by this report was checked back to the letter from the client. In practice, however, staff counted the number of written requests and matched this with the number of changes to client data. No checks were carried out to ensure that the change on the system corresponded to the instructions in the letter.

- 2.25. After changes to a client's address had been processed, CFA would take the details from the letter and write to the new and old address giving the client the opportunity to act if the change was not genuine. However, a response to these letters was not required. In addition, there was no system in place to identify client accounts where a change of address was quickly followed by a request for the sale of units. This made it particularly important that checks were in place to ensure instructions from clients were genuine.
- 2.26. In the absence of more robust checks on clients' letters of request to sell units or to change address, it was not adequate to send a letter on which a reply from the client was not required.
- 2.27. The effect of the systems identified in paragraphs 2.19 to 2.25 is that a fraudster could have changed a client's address and then instructed CFA to sell units. The fraudster would then have been able to return the confirmation for the sale instruction, request payment to an account controlled by him and the transaction would have been processed.

Compliance and Internal Audit

- 2.28. The weaknesses in the procedures to reduce the risk of fraud and the absence of a review of fraud risk were made more serious by CFA's failure to use its compliance and internal audit functions to monitor anti-fraud controls.
- 2.29. The compliance monitoring programme focused on two areas: fund pricing reviews and rolling monitoring of compliance with FSA conduct of business and collective investment scheme rules. The internal audit programme did not include a review of fraud risk as part of vertical reviews of business areas or as a separate horizontal review across the business.
- 2.30. A system failure that contributed to the frauds was the failure to check changes on the system back to client letters, as identified in paragraph 2.24 above. This failure was not identified by local management, compliance or internal audit.

- 2.31. The failure by management to adequately review the fraud risk, and especially the risk of internal fraud, was made more serious by the lack of focus by compliance and internal audit on fraud risk.

Staff Training and Human Resources Procedures

Fraud training

- 2.32. New joiners were required to attend an induction course during which staff were provided with CFA's compliance manual (which includes CFA's fraud and whistleblower policies). No training, however, was provided either on induction or subsequently in respect of fraud risk and impersonation risk. CFA has now revised its training programme to include a fraud session and a fraud risk workshop.

Human resources review

- 2.33. In October 2004, Group Internal Audit was asked to conduct a review of Human Resources. The purpose of the review was to assess the effectiveness of the Human Resources administration procedures within a number of Capita Group companies, including CFA.
- 2.34. Group Internal Audit's findings identified that although procedures were in place these were not always completed, especially in the following up of references. In 26% of cases looked at, two references had not been provided. This resulted in a material risk that new staff were not competent or lacked integrity.

3. FACTORS RELEVANT TO DETERMINING THE PROPOSED ACTION

Relevant Guidance on Sanction

- 3.1. 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 benefit of compliant behaviour.
- 3.2. In determining whether a financial penalty is appropriate and its level, the FSA is required to consider all the relevant circumstances of the case. ENF 13.3.3 indicates

the factors that may be of particular relevance in determining the level of a financial penalty. The FSA considers the following factors to be relevant.

The Seriousness of the Misconduct or Contravention

3.3. The FSA has had regard to the seriousness of CFA's contraventions, including but not limited to the nature of the requirements breached and the number and duration of the breaches. The level of financial penalty must be proportionate to the nature and seriousness of the contraventions.

3.4. In deciding the level of penalty, the FSA has taken into account the following:

- (1) Throughout the relevant period CFA did not take adequate care to consider the risk of fraud to its business. The FSA acknowledges that it is not always possible for firms to prevent a committed fraudster (particularly if he is in a supervisory role at a firm). However, the FSA's risk based approach requires firms to undertake an assessment of fraud risk and where necessary implement controls to mitigate the risk.
- (2) The initial fraud in each of the groups of attempted and actual frauds were discovered as a result of enquires from clients. If the client enquiries had not occurred, there was a material risk that the breaches would have continued.
- (3) It is the responsibility of regulated firms to ensure that appropriate systems and controls are in place to control their business and ensure compliance with regulatory requirements. CFA instead relied on systems and controls that had been in place prior to the acquisition of another fund administrator in April 2003.
- (4) The reduction of financial crime is one of the FSA's four statutory objectives and the profile of identity theft has increased significantly in recent years. In December 2003 the FSA issued its discussion paper DP26 "Developing our Policy on Fraud and Dishonesty". There have also been numerous high profile articles in the national and trade press, FSA speeches and papers as well as guidance from industry organisations.

Response following Contravention

- 3.5. Management allocated significant resources to investigating the discovery of the attempted frauds in August 2004. CFA's remedial work, however, did not assess wider fraud risk. CFA has now, with support from the Capita Group, carried out a comprehensive review of its anti-fraud systems and put in place an improved control framework and new management team to support this. CFA has implemented a number of controls that are consistent with best practice in the industry.
- 3.6. Throughout the FSA's investigation CFA has co-operated fully and entered into early settlement negotiations.

Previous action taken by FSA

- 3.7. The level of regulatory concern in respect of fraud and identity theft is comparable to that of money laundering. The FSA has, therefore, had regard to previous cases involving breaches of system and control requirements that threaten the FSA's financial crime objective.
- 3.8. The FSA considers that some of the aggravating factors in those cases are present in this case. However, the size of CFA's business is smaller than a number of those fined in the most serious cases.

4. CONCLUSION

- 4.1. Taking into account the seriousness of the contraventions but also having regard to the remedial action that has been taken and the co-operation of CFA and the Capita Group with the FSA, the FSA imposes a financial penalty on CFA of £300,000.

5. DECISION MAKER

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

6. IMPORTANT

- 6.1. This Final Notice is given to CFA in accordance with section 390 of the Act. The following statutory rights are important.

Manner of and time for payment

- 6.2. The financial penalty must be paid in full by CFA to the FSA by no later than 30 March 2006, 14 days from the date of the Final Notice.

If the financial penalty is not paid

- 6.3. If all or any of the financial penalty is outstanding on 31 March 2006, the FSA may recover the outstanding amount as a debt owed by CFA and due to the FSA

Publicity

19. 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.
- 6.4. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate

FSA contacts

For more information concerning this matter generally, you should contact William Amos at the FSA (direct line: 020 7066 1324 fax: 020 7066 1325).

William Amos
Enforcement Division