
FINAL NOTICE

To: Derrick Hales Financial Planning ("DHFP"/ "the Firm")

Of: 20 Keighley Road, Halifax, West Yorkshire HX 8AL

Date: 9 October 2008

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

1 THE PENALTY

- 1.1 The FSA gave DHFP a Decision Notice on 9 October 2008 which notified DHFP that for the reasons set out below, and pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), and on the basis that DHFP has agreed to certain remedial action detailed at paragraph 1.4 below, the FSA has decided to impose a financial penalty of £10,500 (reduced from £15,000, after a 30% discount for early settlement) on DHFP in respect of breaches of the FSA's Principles for Businesses ("Principles") and certain related FSA Rules between August 2004 and November 2005 ("the relevant period").
- 1.2 DHFP confirmed on 2 September 2008 that it will not be referring the matter to the Financial Services and Markets Tribunal.
- 1.3 Accordingly, for reasons set out below and having agreed with DHFP the facts and matters relied on, the FSA imposes a financial penalty in the amount of £10,500.
- 1.4 DHFP has breached:
 - (1) Principle 3 (management and control);
 - (2) Principle 7 (communications with clients); and
 - (3) Principle 9 (customers: relationships of trust),

in relation to failings in DHFP's advice and sales processes in respect of Geared Traded Endowment Policies ("GTEPs") during the relevant period.

- 1.5 DHFP has also breached the following FSA Rules ("Rules"), in particular Rules, 5.2.5R and 5.4.3R in the part of the Handbook in force during the relevant period entitled Conduct of Business ("COB").
- 1.6 DHFP has agreed to the following remedial action:
 - (1) a phased Past Business Review ("PBR"), the first phase of which will relate to advised sales of capital at risk non-deposit taking investment products sold by the Firm in order to identify the extent to which other clients may have been given unsuitable advice and, where applicable, assess and make good any losses suffered as a result; and
 - (2) the variation of its permission to exclude advising on or arranging sales of GTEPs.
- 1.7 DHFP agreed to settle at an early stage of the FSA's investigation. It therefore qualified for a 30% (stage 1) discount under the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a financial penalty of £15,000 on DHFP.

2 REASONS FOR THE PENALTY

- 2.1 The FSA has decided to impose a financial penalty on DHFP for breaches of the FSA Principles and Rules identified in Section 1 above that occurred during the relevant period. These breaches relate to failings in DHFP's advice and sales processes which resulted in customers being advised to purchase GTEPs in default of evidence that such sales were suitable.
- 2.2 In summary, the FSA has made the following findings:
 - (1) DHFP failed to demonstrate that customers' attitude to risk was commensurate with the recommended product's risk profile, in breach of Principle 9;
 - (2) DHFP failed to gather or record adequate Know Your Customer ("KYC") information to support its assessment of suitability, or update that information, in breach of Principle 9 and COB 5.2.5R;
 - (3) DHFP failed to communicate: (i) why it had concluded that GTEPs were suitable or (ii) the characteristics of and risks associated with GTEPs to customers in a clear and fair way, in breach of Principle 7 and COB 5.4.3 R;
 - (4) DHFP failed to undertake adequate or independent product research and, as a consequence, failed to ensure that its adviser fully understood GTEPs and their inherent risks prior to recommending them, in breach of Principle 3;
 - (5) DHFP failed to take appropriate steps to monitor and review client files and the suitability of advice, in breach of Principle 3; and
 - (6) DHFP failed to organise and control its affairs responsibly and effectively and to allocate responsibility for compliance matters to a partner of the Firm, in breach of Principle 3.
- 2.3 These failings are set out in more detail in paragraphs 4.6 to 4.26 below.

3 RELEVANT STATUTORY AND REGULATORY PROVISIONS

- 3.1 The FSA's statutory regulatory objectives set out in Section 2(2) of the Act include the protection of consumers.
- 3.2 Section 138 of the Act provides that the FSA may make such rules applying to authorised persons as appear to it to be necessary or expedient for the purpose of protecting the interests of consumers.
- 3.3 Section 206 of the Act provides:

"If the Authority considers that an authorised person 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 an amount as it considers appropriate."

Principles for Businesses

- 3.4 Under the FSA's rule-making powers, the FSA has published in the Handbook the Principles which apply either in whole, or in part, to all authorised persons.
- 3.5 The Principles are a general statement of the fundamental obligations of firms under the regulatory system and reflect the FSA's regulatory objectives.
- 3.6 A firm may be liable to disciplinary sanction where it is in breach of the Principles.
- 3.7 Principles, which are relevant to this matter, are set out below.
- 3.8 **Principle 3** (Management and control) provides that:

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

- 3.9 **Principle 7** (Communications with clients) provides that:
- A firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.*
- 3.10 **Principle 9** (Customers: relationships of trust) provides that:
- A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.*

- 3.11 The relevant provisions of the module of the FSA's Handbook entitled Conduct of Business ("COB") (which was in force during the relevant period) are as follows:

COB 5.2.5R requires that before a firm gives a personal recommendation concerning a designated investment to a private customer, it must take reasonable steps to ensure that it is in possession of sufficient personal and financial information about that customer relevant to the services that the firm has agreed to provide; and

COB 5.4.3R provides that a firm must not, amongst other things, make a personal recommendation of a transaction to a private customer unless it has taken reasonable steps to ensure that the private customer understands the nature of the risks involved.

4 FACTS AND MATTERS RELIED ON

GTEP Products

- 4.1 Traded endowment policies ("TEPs") are with-profits endowment policies (a long term, regular premium savings plan with a life policy attached, which may be associated with an interest-only mortgage) which are no longer required by their original holder and have been sold on the secondary market. The purchaser of such policies agrees to pay the remaining premiums on the policy and in return receives the value of the policy at maturity or when the original owner dies, depending on which occurs first. This payout will include both bonuses declared at the time of the sale and subsequent bonuses, though such bonuses are not guaranteed.
- 4.2 Investment in GTEPs involves an added element of gearing, as part of a two stage investment process. At the first stage, a portfolio of TEPs is purchased using cash savings, funds raised through a mortgage on the investor's home or a charge on a bond already owned by the investor. At the second stage, the newly-acquired TEPs are then secured against a loan, which is used to invest in more TEPs. These varying levels of gearing are effectively using the strategy of borrowing to invest, which can be a high risk strategy. The product has to outperform the interest rate payable on the loan (and the mortgage, if applicable) in order for the investor to make a profit. In addition, gearing introduces an interest rate risk, increases exposure to the usual risks of the investment (such as fluctuations in performance and secondary market demand), and if the initial cash injection was raised through a mortgage, there is a risk that the investor could lose their home. There is no generic level of risk which a firm could apply to all clients of GTEPs as each portfolio of TEPs is constructed individually.
- 4.3 In respect of the GTEPs sold by DHFP, customers, on the basis of an illustration, are required to state whether they wish to proceed. A portfolio of TEPs is then constructed for them. The construction process is lengthy, taking up to 18 months, and there is no 'cooling off' period meaning that customers who decide not to proceed may incur a penalty fee.

The Firm

- 4.4 DHFP is a partnership comprising of Mr Derrick Hales ("Mr Hales") and his wife, Mrs Kathleen Hales ("Mrs Hales"). The Firm has been trading since 1997 and has longstanding relationships with many of its clients, many of whom are retired, or who are approaching retirement. Mr Hales has been a financial adviser for over 37 years and is the sole financial adviser at the Firm. The Firm has held permissions to advise and arrange designated investment business since December 2001.
- 4.5 During the relevant period, DHFP made 24 recommendations for GTEP products of which only 9 proceeded to completion, earning DHFP commission in the region of £49,000, in addition to an ongoing trail commission. Of those cases that did not proceed to completion, 2 were rejected by the lender because of insufficient assets and income, while the remaining clients decided not to proceed. Of those 9 cases where clients proceeded with the recommendation to invest, 5 raised the initial capital by means of a mortgage, 2 through charging a bond and 2 by means of cash.
- 4.6 As a result of its investigation, the FSA found evidence of the breaches set out below.

Breaches of Principles and Rules

Systems and Controls

4.7 A number of failings in relation to DHFP's systems and controls were identified, as set out below.

4.8 Prior to promoting GTEPs, DHFP failed to:

- (1) ensure, through independent due diligence or otherwise, that its adviser fully understood GTEPs and their inherent risks; or
- (2) apprise itself of the lenders' criteria for the loan product recommended to fund the purchase of GTEPs.

4.9 DHFP exercised inadequate control over its sales process by failing to gather and record sufficient customer information. In particular, the following breaches were noted:

- (1) fact finds were not routinely completed, with relevant sections left blank, including details of customers' income, expenditure, attitude to risk and investment objectives. In some cases, even though clients stated they were interested in lump sum investments, the section on the fact find in which more specific details concerning lump sum investments should have been recorded was not completed;
- (2) fact finds were not routinely updated, meaning that much of the customer information was out of date; and
- (3) attitude to risk was not routinely recorded, and where it was, the risk categories were not adequately defined.

4.10 DHFP did not ensure that responsibility for compliance matters was allocated effectively, in that, despite holding controlled function CF10 (Compliance Oversight), Mr Hales did not involve himself in day-to-day compliance issues or actively oversee compliance matters. He stated in interview that he did not '*get involved in the client files*' and had not done so since the 1970s. In response to issues raised by external compliance consultants, remedial action was delegated to an administrative assistant. As a result, there was no adequate oversight of compliance issues.

4.11 In connection with the above, DHFP failed to take appropriate steps to monitor and review client files and the suitability of advice as there were no internal systems in place to monitor compliance matters. Consequently, Mr Hales was unable to tell the FSA what the Firm's systems and controls were or provide explanations of why those systems had failed.

4.12 DHFP did not have any formal complaints management systems in place. In interview, when Mr Hales was questioned about a specific incident where customers had expressed concerns about their investment, he did not consider this to be a formal complaint.

4.13 By failing to ensure that systems were in place to ensure its adviser was adequately informed regarding the characteristics of the product or the lenders' criteria; to control its sales process; to monitor and review its client files regarding the suitability of its advice; or to monitor compliance matters effectively, thereby rendering any review of customer files and the systems and controls in place by third parties such as the FSA

difficult, DHFP failed to take reasonable steps to organise and control its affairs responsibly and effectively, in breach of Principle 3.

Communications with clients

- 4.14 A number of failings were identified in respect of documentation provided to DHFP's customers, as set out below.
- 4.15 Documents sent to clients were often long and complicated and lacked sufficiently clear information for a client to make an informed decision as to whether to take the advice or not.
- 4.16 DHFP provided the clients with information supplied by the product provider which appeared to be from a third party and gave a favourable view of GTEPs, without detailing who the firm was and what their experience was.
- 4.17 In respect of DHFP's suitability letters, the following issues were identified:
 - (1) DHFP's standard suitability letter contained a generic explanation of GTEPs, their advantages and potential disadvantages, failing to explain in particular why DHFP had concluded that GTEPs were a suitable investment for the particular client, on the basis of the personal and financial circumstances disclosed to it;
 - (2) The risk warnings were inadequate. Again, they were generic rather than tailored to the clients' situation and placed at the end of the recommendation letter, which served to dilute their message; and
 - (3) DHFP's standard suitability letter states that the Firm '*looked at a number of alternative arrangements*' despite the fact that there was no evidence that alternative product research was conducted, meaning that DHFP did not communicate with its customers fairly..
- 4.18 By failing to ensure documentation provided to customers was sufficiently clear and balanced, in particular by failing to ensure that its suitability letters explained the characteristics of and risks associated with GTEPS and why DHFP had concluded that GTEPs were suitable, DHFP failed to pay due regard to the information needs of its clients, or communicate with them in a way which was clear, fair and not misleading, in breach of Principle 7. By failing to ensure that customers understood the nature of the risks involved, DHFP has breached COB 5.4.3R.

Suitability of advice

- 4.19 On the basis of the file reviews and interview, a number of failings demonstrating that the advisory process was unclear were identified in respect of the Firm's advice and sales processes, regarding recommendations to invest in GTEPs, as set out below.
- 4.20 DHFP could not demonstrate that it had considered the needs and circumstances of each client prior to raising the possibility of an investment in GTEPs, instead discussing the product with a large number of the clients approaching the firm for financial advice during the relevant period. Mr Hales has explained in interview that this is because clients wanted the Firm to '*think outside the box and come up with innovative products, something a bit different, otherwise they'd go to another IFA and*

just do a pension or a bond and that would be it'. Mr Hales went on to explain that GTEPs were suitable for customers interested in generating income from equity in their homes or using an existing holding in bonds. One result of this failure to consider suitability was that customers advised to apply for a loan to invest in GTEPs were rejected by the lender on grounds such as age, health and low levels of income and assets.

4.21 As noted at paragraph 4.9 above, information recorded on files was incomplete, for example in some cases relevant sections of the fact find had not been filled in and/or a customer's attitude to risk was not identified. Where a customer's attitude to risk was recorded, there was no evidence of how this matched the risk rating of the product provided, or an explanation provided when the two did not match.

The following examples demonstrate that the recommendation made by DHFP does not appear to have regard to the facts disclosed by the relevant customer:

(1) In one case, a customer disclosed to DHFP a high level of existing debt and a relatively low level of income during the course of the fact find process. There is no evidence on the face of the fact find or suitability letter that the increased risks entailed in taking on further substantial debt were highlighted. The same client's application was subsequently rejected by the lender, as the client's financial position did not meet its lending criteria amongst other things.

4.22 As noted at paragraph 4.18 above, there is no evidence on the client files that alternatives to GTEPs were considered with the customer or researched. The 'alternative products considered' section of the suitability letter which purported to consider alternative products, adopted one of two pro-forma options which appear to be based on precedents supplied by the product provider, further suggesting that DHFP did not consider individual customers' needs and circumstances when recommending GTEPs.

4.23 There is no evidence, on the basis of the suitability letters considered at paragraph 4.18 and 4.24 above that DHFP explained why it had concluded that GTEPs were a suitable investment for the particular client, on the basis of personal and financial circumstances disclosed to it.

4.26 By failing to gather and record sufficient personal and financial information about customers, or explain why it had concluded that GTEPs were suitable for each customer, DHFP was not able to demonstrate that the sale of such products was suitable. Taking these deficiencies together, DHFP failed to take reasonable care to ensure the suitability of its advice in breach of Principle 9 and COB 5.2.5.

5 ANALYSIS OF PROPOSED SANCTION

5.1 The FSA's policy on the imposition of financial penalties as at the date of this notice is set out in Chapter 6 of the Decision Procedures and Penalties Manual ("DEPP"), which forms part of the FSA Handbook. In addition, the FSA has had regard to the corresponding provisions of Chapter 13 of the Enforcement Manual ("ENF") in force during the relevant period. The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have committed breaches from committing further breaches, and helping to deter other firms from committing

similar breaches, as well as demonstrating generally the benefits of compliant business.

- 5.2 In determining whether a financial penalty is appropriate, and if so, its level, the FSA is required to consider all the relevant circumstances of a case. DEPP 6.5.2¹ sets out a non-exhaustive list of factors that may be of relevance in determining the level of a financial penalty.
- 5.3 The FSA considers that the following factors are particularly relevant in this case.

DEPP 6.5.2(1): Deterrence

- 5.4 When determining the appropriate level of penalty, the FSA will have regard to the principal purpose for which it imposes sanctions, namely to promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches and helping to deter other persons from committing similar breaches, as well as demonstrating generally the benefits of compliant business. In this case, a financial penalty is necessary because of the importance of firms obtaining sufficient KYC information, matching a customer's attitude to risk to the risk profile of a product, and explaining risk warnings to a customer properly to ensure the suitability of advice. In addition, a financial penalty demonstrates the importance of compliance and record keeping.

DEPP 6.5.2(2)²: The nature, seriousness and impact of the breach in question

- 5.5 In determining the appropriate sanction, the FSA has had regard to the seriousness of the breaches, including the nature of the requirements breached, the duration and frequency of the breaches, whether the breaches revealed serious failings in the firm's systems and controls and the number of customers who were affected and/or placed at risk of loss. For the reasons set out below the FSA considers that the breaches in this case are of a serious nature.
- 5.6 DHFP's failings are viewed as being particularly serious because:
 - (1) inadequate collection of KYC information, assessment of risk and a failure to warn customers of risks meant that DHFP was not able to demonstrate that customers were sold a product which was suitable for their risk profile and personal circumstances;
 - (2) the Firm did not demonstrate that it exercised discretion concerning the type of individual for whom GTEPs were suitable and instead discussed the possibility of investing in GTEPs with a large number of its customers; and
 - (3) the majority of DHFP's clients are retired with no source of income other than a pension. Certain of them had no significant assets other than their home which was remortgaged to fund the purchase of GTEPs, putting them at risk of losing their home;

¹ ENF 13.3

² ENF 13.3.3 G (1)

5.7 The FSA has also taken into account the following steps taken by DHFP which have served to mitigate the seriousness of its failings:

- (1) DHFP has accepted that there were issues with its systems and controls and has taken steps to rectify these short-comings;
- (2) as yet, there is no evidence of financial losses suffered by any clients of the Firm who purchased a GTEP although the term of the product (10-15 years) means that losses may still be incurred;
- (3) the Firm voluntarily undertook to cease recommending GTEP products to new customers;
- (4) the Firm has agreed to procure an increased level of ongoing support from external compliance consultants and to implement a training programme for the Firm's sole adviser in order to ensure that the Firm complies with its regulatory obligations; and
- (5) the Firm has agreed to the remedial action set out at paragraph 1.4 above.

DEPP 6.5.2(3)³: The extent to which the breach was deliberate or reckless

5.8 The FSA has found no evidence to show that DHFP acted in a deliberate manner. However, the Firm did not demonstrate that it exercised discretion concerning the type of individual for whom GTEP products were suitable, and instead discussed

them with a large number of its customers. Furthermore, the firm appeared to view its role as one of providing customers with the opportunity to attempt to take out a GTEP

policy. The FSA considers this approach, viewed in conjunction with the failings in the Firm's sales and advice processes outlined above, to be reckless.

DEPP 6.5.2(5)⁴: The size, financial resources and other circumstances of the firm

5.9 In determining the level of penalty, the FSA has been mindful of the need to ensure that the interests of customers are protected. The FSA has also considered the following issues:

- (1) DHFP's latest financial statements;
- (2) the cost of the skilled persons report incurred by the Firm prior to the Enforcement investigation;
- (3) the cost of the proposed PBR and other remedial action; and
- (4) the need for the Firm to be able to afford the cost of paying financial redress to those customers who choose to seek it within the three year timescale permitted by the Financial Ombudsman Service.

³ ENF 13.3.3 G (2)

⁴ ENF 13.3.3 G (3)

Having considered the above issues, the FSA considers that a financial penalty of £15,000 (subsequently discounted by 30% to £10,500 for early settlement) is appropriate.

DEPP 6.5.2(6)⁵: The amount of benefit gained or loss avoided

5.10 The FSA notes that DHFP made £48,531.59 in commission from the sale of GTEPs during the relevant period and continues to earn trail commission.

DEPP 6.5.2(8)⁶: Conduct following the breach

5.11 DHFP has voluntarily undertaken to cease recommending GTEPs and has agreed to the remedial action set out at paragraph 1.4 above.

DEPP 6.5.2(9)⁷: Disciplinary record and compliance history

5.12 DHFP has not been the subject of previous disciplinary action. The selling practices of the Firm came to the FSA's attention in November 2001. Further to a supervision visit, certain failings in respect of DHFP's fact finding and suitability letters were identified; however, these were not deemed to be systemic and no further substantive action was taken. At the time of the FSA's visit, DHFP's business was described as 85% investment business (for example, bonds of various types, ISA and unit trust investments) and the remainder was pension related.

DEPP 6.5.2(10)⁸: Other action taken by the FSA

5.13 In determining the level of financial penalty, the FSA has taken into account penalties imposed by the FSA on other authorised persons for similar behaviour.

5.14 The FSA is also mindful of the ancillary action that it is imposing on both Mr and Mrs Hales.

6. DECISION MAKERS

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

7. IMPORTANT

7.1 This Final Notice is given to DHFP in accordance with section 390 of the Act.

Manner of and time for Payment

⁵ ENF 13.3.3 G (4)

⁶ ENF 13.3.3 G (5)

⁷ ENF 13.3.3 G (6)

⁸ ENF 13.3.3 G (7)

7.2 The financial penalty of £10,500 must be paid by DHFP in 12 equal monthly instalments of £875 per month. Each monthly instalment must be paid on or before the 25th of the month with the first payment to be received by the FSA on 25 October 2008 and the final payment to be received by the FSA on 25 September 2009.

If the financial penalty is not paid

7.3 If any of the financial penalty instalments are outstanding on the day after the due date for payment the FSA may recover any outstanding amount as a debt owed by DHFP and due to the FSA.

Publicity

7.4 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this Final Notice relates. Under those provisions, the FSA must publish such information about the matter to which this final notice relates 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 DHFP or prejudicial to consumers.

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

FSA contacts

7.6 For more information concerning this matter generally please contact Andrea Bowe (direct line: 020 7066 5886 fax: 020 7066 5887) of the Enforcement Division of the FSA.

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Jonathan Phelan

Head of Department
FSA Enforcement Division