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## FINAL NOTICE

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To: **Hythe Securities Limited**  
FRN: **124580**  
Of: **337 City Road**  
**London**  
**EC1V 1LJ**  
Date: **14 April 2010**

**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 Hythe Securities Limited ("Hythe") a Decision Notice on 24 February 2010 which notified Hythe that pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to impose a penalty of £200,000 on Hythe for breaches of Principle 3 of the Principles for Businesses ("the Principles") by Hythe that occurred between 1 June 2006 and 21 May 2008 ("the Relevant Period") in relation to the sale of higher risk securities to customers of one of its business units. In particular, Hythe failed to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems in breach of Principle 3.
- 1.2. Hythe has confirmed that it will not be referring the matter to the Financial Services and Markets Tribunal.
- 1.3. Accordingly, for the reasons set out below, the FSA imposes a financial penalty on Hythe in the sum of £200,000.

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

- 2.1. The breaches of Principle 3 arise from a number of serious failings in relation to the sale of higher risk securities to the customers of one of Hythe's business units in the Relevant Period. This business unit dealt primarily with small capitalisation shares ("small cap shares") (including penny shares<sup>1</sup>) on the Alternative Investment Market and PLUS markets, and Contracts for Difference, and was called the "Retail Group".
- 2.2. During the Relevant Period, Hythe failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, in that, in relation to the Retail Group, it failed to:
- (1) implement appropriate management oversight arrangements for its business;
  - (2) implement a structured and formal approach to the monitoring by compliance staff of calls made by sales staff;
  - (3) arrange for adequate records to be kept of its recommendations;
  - (4) take reasonable steps to ensure that its staff were appropriately incentivised;
  - (5) take reasonable steps to ensure that its staff were adequately and appropriately trained;
  - (6) implement a controlled process to ensure that:
    - (a) sufficient and accurate information was obtained from customers when accounts were opened, before recommendations were made;
    - (b) its customers were appropriately classified throughout their relationship with Hythe;
    - (c) sufficient information was obtained from customers to assess whether recommendations were suitable;
    - (d) information about customers was maintained and updated;
    - (e) customers' trading limits were properly documented and adhered to;
    - (f) trades were properly classified;

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<sup>1</sup> A 'penny share' is defined in the FSA Handbook as a readily realisable security in relation to which the bid-offer spread is 10 per cent or more of the offer price, but not (a) a government and public security; or (b) a share in a company quoted on The Financial Times Stock Exchange 100 Index; or (c) a security issued by a company which, at the time that the firm deals or recommends to the client to deal in the investment, has a market capitalisation of £100 million or more (or its equivalent in any other currency at the relevant time).

- (7) implement a documented and formalised process for the selection and research of stocks to ensure that they were appropriate to recommend to Hythe's customers; and
- (8) implement a process for ensuring that customers were provided with sufficient information about the risks of the investment being recommended and any mark-up Hythe received or to ensure that they did not receive unclear or misleading information about Hythe or the investment being recommended.
- (9) implement effective customer identification procedures.

2.3. The FSA has identified instances where Hythe's failures as set out above resulted in:

- (1) failures to treat customers fairly including by failing appropriately to classify customers and inform them of their classification and by employing inappropriate sales practices that included continuing to recommend shares to customers who had stated that they were not interested in purchasing the shares offered and exceeding agreed customer trading limits;
- (2) failures to communicate information to clients in a way which is clear fair and not misleading including by:
  - (a) giving misleading information regarding the research and stock selection processes undertaken by Hythe;
  - (b) failing adequately to disclose all commissions and charges, in particular mark-ups it received;
  - (c) making recommendations without fully setting out the risks of the recommended stock and undermining any risk warnings which were given; and
  - (d) failing to take reasonable care to ensure that it did not provide misleading information on the future performance of shares and misleading information about the past performance of previous recommendations; and
- (3) failures to take reasonable care to ensure the suitability of advice by failing to obtain and maintain sufficient information about its customers' personal and financial circumstances to assess whether its advice was suitable before making recommendations to customers and failing to take into account indications that customers may not be able to afford purchases.

2.4. The following considerations are relevant to the seriousness with which the FSA views Hythe's failings:

- (1) the breaches revealed serious weaknesses in the management systems and internal controls relating to Hythe's business and presented a significant risk to

the FSA's objectives of securing the appropriate degree of protection for consumers and maintaining confidence in the financial system;

- (2) the sale of high risk securities requires the implementation of robust systems and controls in order to mitigate effectively the correspondingly increased risks of customers being treated unfairly;
- (3) the way in which Hythe structured its business, with Retail Group advisers being employed by a separate unregulated company, presented extra challenges to Hythe in ensuring that appropriate systems and controls were implemented and maintained;
- (4) Hythe's customers were exposed to the risk of loss as they relied on the advisers' skills, knowledge and expertise, yet Hythe failed to assess adequately the competence of its advisers, or provide appropriate training for them, despite knowing that customers would rely on their skills, knowledge and expertise; and
- (5) Hythe's customers were entitled to rely on it to take reasonable steps to ensure the suitability of its advice, and to be treated fairly. Its failure to do so created a real and significant risk of customers being recommended shares which were unsuitable for them and not fully understanding the nature of the risks associated with the shares.

- 2.5. In making the decision to impose a financial penalty on Hythe, the FSA has taken into account actions taken by Hythe. It made some improvements to its systems and controls in relation to its sales processes and compliance procedures. The FSA has also been mindful of the fact that the Retail Group is no longer operating at Hythe and that Hythe voluntarily varied its Part IV Permission to reflect this.

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

- 3.1. Section 206 of FSMA 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.”*

- (1) Hythe is an authorised person for the purposes of section 206 of FSMA. A requirement imposed on a firm includes the FSA Principles and Rules made under section 138 of FSMA.
  - (2) The FSA Principles are a general statement of the fundamental obligations of firms under the regulatory system and reflect the FSA's regulatory objectives.
- 3.2. Principle 3 of the FSA's Principles for Businesses states that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

- 3.3. The relevant FSA Rules are set out in Annex 1 to this Notice.
- 3.4. The FSA's Principles and Rules constitute requirements imposed on authorised persons under FSMA; breaching a Principal and/or a Rule makes a firm liable to disciplinary sanctions.
- 3.5. The procedures to be followed in relation to the imposition of a financial penalty are set out in section 207 and 208 of FSMA.

### **Relevant Guidance**

- 3.6. In deciding to take the action set out above, the FSA has had regard to the guidance published in the FSA Handbook in the Decision Procedure and Penalties Manual ("DEPP"), which forms part of the FSA Handbook. In particular, the FSA has taken into account the general criteria for determining whether to take disciplinary action and the factors relevant to determining the appropriate level of financial penalty set out in DEPP 6.2 and 6.5.
- 3.7. The FSA has also had regard to the guidance published in the Enforcement Manual ("ENF"), and in particular Chapters 11 and 13 which set out the relevant guidance in force during the earlier part of the Relevant Period when some of the breaches were committed. In this case, there are no material differences between the guidance and factors to be taken into account when determining whether to taken disciplinary action and the factors relevant to determining the appropriate level of financial penalty that were in force during the Relevant Period and those presently in force.

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

### ***The Firm***

- 4.1. Hythe is a limited company that was incorporated on 7 August 1985 under the name Swift 185 Limited. On 1 November 1985, it changed its name to Spedley PWT Limited and on 3 May 1989 to Hythe Securities Limited.
- 4.2. Hythe has been authorised by the FSA since 1 December 2001, having previously been regulated by the Securities and Futures Authority (from 29 April 1988). Hythe is an authorised person under FSMA with permissions granted for the regulated activities of advising on investments, dealing in investments as principal and agent, arranging deals in investments, managing investments, making arrangements with a view to transactions and arranging safeguarding and administration of assets.
- 4.3. In June 2006 Hythe expanded its business by establishing the Retail Group. Members of the Retail Group were employed by a separate, unregulated company, with this company entering into a service agreement with Hythe specifically for the trading of small cap shares. Under the terms of the service agreement, Hythe shared revenues generated by the Retail Group and Hythe undertook to supervise the members of the Retail Group from a compliance and regulatory perspective. All contracts for business were concluded directly between Hythe and the customer. Hythe provided back office and compliance services to the Retail Group, including the processing of

payments, settlement of trades and compliance monitoring. The service agreement did not expressly give Hythe any control, or right of consultation, over the remuneration of, and payment of commissions to, the Retail Group's sales advisers. These were set and paid by the separate company which employed them.

- 4.4. Advisers in the Retail Group made recommendations primarily through telephone contact with customers. Hythe then sent customers documentation relating to the shares sold and payment details. The first transactions occurred in September 2006.
- 4.5. During the Relevant Period, there were up to 27 individuals in the Retail Group.
- 4.6. During the Relevant Period, Hythe was not exclusively advising on and selling small cap shares but also advised on other investments. The Retail Group was only one part of Hythe's business.
- 4.7. The FSA has reviewed a random sample of 32 recommendations in small cap shares made in 2007 by the Retail Group and has reviewed 32 customer files, most of which were the files of customers covered in the random sample of recommendations.
- 4.8. In the Relevant Period, Hythe completed 1930 small cap transactions for customers of the Retail Group.
- 4.9. During the Relevant Period, the total value of small cap securities transactions conducted by customers of the Retail Group was £10,448,236 generating revenue of £3,891,518.08.

#### ***Managerial oversight***

- 4.10. Senior management at Hythe recognised some of the risks involved in making telephone recommendations to retail customers in higher risk shares.
- 4.11. However, as set out below, Hythe failed to take reasonable steps to establish and maintain an adequate risk management system to monitor and manage the risks of the Retail Group.
- 4.12. Hythe did not take reasonable care to maintain clear and appropriate apportionment of significant responsibilities amongst senior management so that the business and affairs of the Retail Group could be adequately monitored and controlled. The apportionment of responsibilities and duties amongst senior management was unclear and there was no formal, or clearly understood, division of duties. Senior managers were unable to demonstrate a complete understanding of their roles and responsibilities, there were no accepted job descriptions, and employees' registrations with the FSA did not always reflect their position at Hythe. For instance, the CF3 (Chief Executive) function was not held by the director who acted as Chief Executive and senior manager of Hythe during the Relevant Period but by another director of Hythe.
- 4.13. Furthermore there was no formal compliance plan for the Retail Group, nor was there any evidence of compliance monitoring results being reported to, or discussed by,

Hythe's Board of Directors.

***Compliance monitoring procedures***

- 4.14. Hythe failed to implement a structured and formal approach to the monitoring by compliance staff of calls made by sales staff, with remedial action then following.
- 4.15. The compliance resource dedicated to the Retail Group's activities was, in general, insufficient. A compliance consultant was employed in the role of compliance manager in January 2007 in order to establish a more formal compliance monitoring regime. However, the compliance manager typically worked only four half days a week, which was inadequate given the number of customers, transactions and issues relating to the Retail Group's business and a documented compliance monitoring policy was not established until September 2007.
- 4.16. The monitoring of advisers' telephone calls was inadequate in both its extent and its effectiveness. Despite advisers' telephone calls being identified as a risk when the Retail Group joined Hythe, no independent monitoring of the calls took place until January 2007. After that point, some recommendation, administration and promotional calls were monitored. However, this was insufficient, particularly in the period to September 2007. Until September 2007, the only recorded monitoring was carried out by a member of staff who was insufficiently experienced and who was not a dedicated call monitor, also performing other roles within Hythe. In eight months to September 2007 only 35 calls were recorded as having been monitored, with the Retail Group having no records of any call monitoring for two months of 2007. Nine out of these 35 calls had non-compliant elements to them. This level of call monitoring was insufficient given that in the same period the Retail Group recorded 2,383 transactions.
- 4.17. The monitoring process used until September 2007 was also insufficient in its quality, given its failure to identify the issues set out in this Notice. When revised procedures were introduced from September 2007, 72% of calls monitored between September and December 2007 were found to have non-compliant elements.
- 4.18. After September 2007, and during the early part of 2008, new Compliance Assistants were recruited, the compliance monitoring checklist was improved and, from September 2007 to December 2007, the level of compliance monitoring increased, to an average of 19 calls per month. However, this level of monitoring was still inadequate given that the number of trades was on average 270 per month. In addition, although it was Hythe's stated policy that there would be a review of five calls per month for each adviser, in practice no adviser appears to have had five calls a month monitored. Nor was there any increased monitoring of advisers previously identified as non-compliant.
- 4.19. Significant further improvements were not made until February 2008, when more calls were monitored and the monitoring checklist was enhanced.
- 4.20. Furthermore, staff conducting compliance monitoring were not sufficiently experienced and trained, particularly with regard to the requirements of the FSA's

Conduct of Business Rules or other FSA requirements.

- 4.21. There was no record of the actions taken to resolve issues identified in non-compliant calls, nor any formal record of how the results of the monitoring were communicated to senior management.

***Record keeping***

- 4.22. Hythe failed to arrange for adequate records to be kept of advice given to Retail Group customers by telephone. Although Hythe had a call recording system, it was not reliable, as evidenced by Hythe being able to locate only approximately 50% of the calls required by the FSA. In failing to adequately store all telephone calls, Hythe had to rely on contemporaneous notes of advice given to Retail Group customers. However, Retail Group advisers failed to properly record their recommendations to ensure that an adequate record of advice was kept. This was despite Hythe being aware of failings in its call recording system.
- 4.23. Consequently, Hythe failed to maintain an adequate record of advice given to Retail Group customers. This could adversely affect customers if they wished to complain about the advice they received.

***Reward and remuneration systems***

- 4.24. Hythe failed to take reasonable steps to ensure that advisers were appropriately incentivised. The contractual arrangements between Hythe and the unregulated company that employed the advisers gave Hythe no influence over advisers' remuneration.
- 4.25. The Retail Group established a remuneration and reward system which, combined with a pressurised environment, encouraged and incentivised its advisers to sell securities without having proper regard to the suitability of the recommendations and advice given.
- 4.26. The Retail Group set its advisers sales targets. Pressure was applied by the Retail Group on advisers to meet these figures and advisers who were not able to meet targets regularly were disciplined. This pressure risked focussing advisers on meeting targets rather than on recommending what was suitable for their customers. One adviser described how he had no say in how much was traded for each customer and that, on certain occasions, advisers were asked to take their customers "out of their comfort zone".
- 4.27. Retail Group advisers were paid a relatively low base salary, with the majority of their remuneration coming from monthly commissions of between 0.5% and 5% of the value of the shares they had sold. These commissions were set by Retail Group management, and Hythe senior management did not have any input into, and were unable to influence, them. Advisers were therefore incentivised to sell as many shares as possible. However, there were limited formal incentives for advisers to act compliantly. In 2006 and 2007 there were no financial sanctions on advisers who acted non-compliantly.



- 4.28. Internal pressure and incentives to sell led to the risk of unfair treatment of customers by Retail Group advisers. However, there were no sufficient countervailing compliance controls to adequately mitigate this risk. Furthermore, the FSA has identified instances in which customers were unfairly treated by advisers continuing to recommend shares to customers who had stated they were not interested in purchasing the shares offered or recommending more stock than may have been suitable. In nine of the 32 calls reviewed, advisers continued to pressure customers into buying stocks, despite the customer expressing reluctance or uncertainty. In one example, a retired customer said that he had no money and was happy with his current portfolio 15 times in a single telephone call, but the adviser continued to persist with his recommendation to the customer and a sale was eventually made.

#### *Training and competence*

- 4.29. Hythe failed to take reasonable steps to ensure that staff were adequately and appropriately trained in relation to their activities and responsibilities.
- 4.30. The Retail Group did not have a formal induction programme and new advisers were not made aware of, or asked to assess, their individual training needs upon joining the group. The limited training the Retail Group did provide consisted mainly of informal adviser meetings that were unstructured and orientated mainly towards sales techniques. Although a Training and Competence register was kept, there was no formal internal training that sufficiently focused on regulatory and compliance requirements during the Relevant Period. Hythe indicated that it requested references and conducted background checks on advisers who had all passed the relevant examinations. However, there was insufficient evidence to confirm that an appropriate assessment of competence had been undertaken when individuals applied to become an FSA Approved Person, nor were there adequate records to demonstrate that those in customer facing roles maintained their competence.

#### *Obtaining and assessing customer information*

- 4.31. Hythe did not have a controlled process to ensure that it obtained and assessed adequate and accurate information from customers. This meant that there was a risk that recommendations were not suitable for customers.

#### *Account opening*

- 4.32. Deficiencies were found with regard to account opening forms. Until early 2008, when the Retail Group advisers dealt with a new customer they would collect “know your customer” data after any recommendation had been made and after the customer had agreed to buy the shares. Draft account opening forms were then sent to customers to sign and return. Of the 15 account opening calls reviewed by the FSA in which an account opening form had been completed for the customer, 13 of those involved a recommendation being made to the customer prior to the completion of the account opening form and prior to sign off by compliance. Therefore advisers, through having insufficient information about prospective customers, could not ensure that their advice was suitable.

- 4.33. In addition, although initial recommendations were intended to be only “provisional” and were not intended to be finalised until the customer was approved by Compliance, cheques for the initial recommendation were sent to Hythe by the customer before the transactions were finalised. Of the 32 customer files reviewed by the FSA, 22 customers sent funds to the Firm before Compliance had signed off on their account and they had become a customer. One of these customers was not signed off by Compliance until three months after his funds were sent to Hythe.
- 4.34. Furthermore, when information was orally obtained from customers to allow advisers to complete a draft account opening form, leading questions were asked by advisers to elicit answers that would comply with the internal criteria the Retail Group had set for its new customers. One adviser stated that he was instructed to do this. This would undermine the accuracy of the information held about customers. Of the 15 calls reviewed by the FSA in which account opening forms were completed, 11 involved the use of leading questions.

#### *Customer classification*

- 4.35. Hythe initially sought to obtain customers that fell within the “Intermediate” classification (as described, at the relevant time, in the FSA Rules). However, the criteria that Hythe provided to telemarketing companies in order to obtain customer leads was insufficient for this purpose. Furthermore, prior to November 2007, Hythe did not have a clear and consistent procedure with regard to its approach to the classification of Retail Group customers. Until January 2007 customers were automatically classified as Intermediate customers, even though they may more appropriately have been classified as “Private” customers. From January 2007, when a compliance manager was hired, customers continued to be automatically initially classified as Intermediate customers but some were then changed to Private customers upon review by the compliance manager.
- 4.36. There was therefore a risk that customers were not appropriately classified throughout their relationship with Hythe. This is further demonstrated by the fact that instances were noted where customers were classified as Intermediate yet there was evidence that the customer did not have sufficient experience or understanding of small cap shares to warrant such a classification. This included advisers recording that a customer “*doesn’t know a lot on market*” or a customer’s trading was “*infrequent*”, but still retaining the Intermediate customer classification.
- 4.37. The result of failing to assess customers adequately was that many customers were incorrectly informed that they were Intermediate customers, and therefore may have lost the protections associated with being a Private customer. In contrast, there is no evidence that all those who were reclassified as Private customers were informed of this. Therefore, a number of the Retail Group’s customers may have been unaware that they had the protections associated with being a Private customer. Furthermore, Hythe could not properly assess what protections were required and did not, in practice, treat its Private and Intermediate customers differently. As set out in paragraphs 4.53 to 4.57, it failed to provide all its customers, even when they may

have been Private customers, with adequate disclosures about the mark-ups it received and the risks of the investments being recommended.

#### *Recommendations*

- 4.38. Hythe also failed to obtain sufficient information during telephone calls with customers to ensure the suitability of its recommendations which meant that there was a risk that advisers could make unsuitable recommendations to customers. This is demonstrated in particular by the fact that, in the 32 transactions and customer files reviewed by the FSA, the Retail Group failed to obtain adequate personal and financial information when making recommendations. It also failed to consider the customer's attitude to risk prior to making its first recommendations.
- 4.39. Furthermore, in nine out of the 32 recommendations reviewed, advisers continued to give recommendations even though the customers indicated during the calls that they could not afford to make the investment or that they did not understand the risk associated with the investment. In six of the 32 recommendations the adviser recommended the sale of other assets, in some cases blue-chip stocks, without explaining the implications of this, and, in four of the 32 recommendations, offered extended settlement as a way of overcoming possible affordability issues. In another three of the 32 recommendations, the adviser recommended an amount more than the customer stated he could afford. In four calls, Retail Group advisers encouraged customers to purchase larger amounts of the securities than the customer wanted. This was important as it was generally the adviser who recommended that a certain amount of stock be purchased, not the customer stating how much they wanted to buy. Together, these issues suggest that, as a result of Hythe's failures to implement proper processes, some customers may have been encouraged to buy more stock than was appropriate for them.

#### *Maintaining and updating customer information*

- 4.40. Hythe failed to implement a controlled process to ensure that customer information could be reviewed and updated. This meant that there was a risk that Hythe did not have up-to-date, information about a customer to allow it to make suitable recommendations on an ongoing basis.
- 4.41. For instance, Hythe had in place for much of the relevant period a Customer Relationship Management ("CRM") system designed to support the updating of Retail Group customer information on a 'live' basis, in addition to diary notes maintained by the advisers. Procedures were supposedly in place so that all KYC information collected on any call with the customer would be immediately updated in the CRM system. However, in the 32 customer files reviewed by the FSA, there is insufficient evidence of advisers asking for, or recording, updates in customers' circumstances on the CRM system. In only 13 out of 32 customer files reviewed was there any indication that advisers had updated know your customer information. In 14 of the 32 transactions reviewed, the adviser did not appear to have sought any information from the customer that could have updated the know your customer information.

- 4.42. Therefore, despite the CRM system being in place, Hythe failed to implement processes to ensure that the Retail Group held up-to-date information about its customers so as to allow its advisers to make suitable recommendations based on a sufficient understanding of their customers' financial and personal circumstances.

*Customers' agreed trading limits*

- 4.43. The Retail Group had a system whereby customers' agreed maximum trading limits were subsequently approved by compliance based upon the customers' personal circumstances.
- 4.44. However, Hythe failed to implement an adequate system for changes to these limits to be agreed, documented and communicated to clients which meant that there was a risk that customers could trade over their agreed and appropriate trading limits. In 17 of the 32 files reviewed, there had been at least one change to the customer's agreed trading limit. Of these 17, all contained at least one update which had not been dated. The lack of recorded information about when or why updates were made and approved means that it is difficult to determine whether the agreed trading limits were justified or whether they were exceeded before they were updated. Of the updates that were dated, at least two were updates made after or on the day that the agreed trading limit had been exceeded. This indicates that customers were sometimes traded over their agreed trading limits and/or that their limits were updated after the event in order to permit them to be traded over their original limit.
- 4.45. Furthermore, although Hythe sometimes sent letters to customers asking them to confirm that they were happy with increased trading limits, such letters were found on only seven of the 17 customer files which contained updates. In addition, none of those letters was dated, which means that it is difficult to determine what led to the update or whether the change to the trading limit was agreed before or after the customer traded. It was also difficult to determine whether the update had been agreed by the customer on all occasions.
- 4.46. The Firm's failure to ensure that a formal mechanism was implemented to justify any increases in Retail Group customers' trading limits through reference to documented changes in their personal or financial circumstances meant that there was a risk that unsuitable sales above the original limits could occur.

*Classification of trades*

- 4.47. Hythe also failed to implement a controlled process to ensure that trades were properly classified. This is demonstrated by the fact that, although all the 32 transactions reviewed were on an advisory basis, 11 of them were classified as 'execution only' on the contract note provided to customers. The result of this was that there was a risk that these customers were not afforded the protections offered in respect of advisory trades and may therefore have had difficulty in seeking redress for any unsuitable advice.

### ***Selection and research of stocks***

- 4.48. Hythe failed to implement a documented and formalised process for the selection and research of stocks to ensure that they were appropriate to recommend to the Retail Group's customers.
- 4.49. The Retail Group had no dedicated research team, corporate finance division or analysts. Hythe did not have a recorded and formal approach to research for all the sampled stocks being recommended, nor clear records of why the stocks should be recommended to customers.
- 4.50. Although Hythe did produce some factsheets evidencing some research by Hythe in relation to all nine stocks reviewed by the FSA, the dates of the information contained within them meant that, in respect of five of those stocks the version of the factsheet provided to the FSA could not have been used by the adviser at the time of all the recommendations made in that stock.
- 4.51. There was no contemporaneous evidence to suggest that the factsheets had been approved by Hythe's compliance department or senior management.

### ***Information about stocks and services***

- 4.52. Hythe failed to implement a controlled process to ensure that customers were provided with sufficient information or to ensure that they did not receive unclear or misleading information.

### ***Disclosure of commissions and charges***

- 4.53. Hythe failed to implement a process for ensuring that customers were provided with sufficient information about any mark-up Hythe may have been received on the recommended stock.
- 4.54. During the Relevant Period, the Retail Group derived income from a combination of flat fees charged to customers on trades (typically £20 per trade); from inducements paid by third parties to sell the shares (such inducements coming from either the companies whose shares were being sold or from existing shareholders); or, for trades in which Hythe was acting as a principal to the transaction, the difference between the price that it bought the shares and the price which it sold the shares to its customers. For such principal trades, Hythe would typically agree a series of trades with its customers, and send out requests for payment, before collating these agreements and buying the stock from a counterparty. As such it took customer orders and then took principal positions so as to fulfil the customers' orders, with the difference between price charged to the customer and that charged by the counterparty being known as a "mark-up". In doing this, Hythe acquired shares from companies at below the market rate and then sold them to its Retail Group customers at the prevailing market rate.
- 4.55. The existence of the £20 flat fee was disclosed to customers in Hythe's account opening information and was included in the contract notes sent to customers, and the possible existence of fees from third parties and of a margin being earned on the

difference between the buy and sell price on principal trades was mentioned to a limited extent in Hythe's terms of business. However, no specific disclosure was made to Retail Group Private customers by Hythe as to the actual existence or size of any mark-up in the post-trade documentation.

- 4.56. These mark-ups could be substantial. During its review, the FSA noted mark-ups of between 67% and 139%. However, because Hythe obtained shares at a discount to the prevailing market prices, its customers eventually paid a price within the prevailing bid-offer market price range.
- 4.57. In all of the relevant transactions reviewed, Hythe failed to disclose the full amount of its mark-up in the contract note provided to the customer after the trade had been completed and therefore failed promptly to provide essential details of the transaction to the customer.

*Providing recommendations paying due regard to risks*

- 4.58. Hythe also failed to implement a process for ensuring that customers were provided with sufficient information about the risks of the investment that was being recommended.
- 4.59. Although Hythe produced some 'factsheets' for advisers, factsheets were not in place at the time of recommendations for all of the stocks sampled by the FSA. Nor was there a policy to ensure all material risks about the stocks were provided to customers, and, as previously stated, compliance monitoring was insufficient to identify deficiencies in the telephone calls.
- 4.60. As a result, in most of the 32 transactions reviewed, Retail Group advisers provided customers with inadequate and unclear information about the risks of the shares which distorted the balance and content of the recommendation to the extent that the customer may have been misled.
- 4.61. Hythe provided some generic risk warnings about the risks of investing in small cap shares through its terms of business and through its contract notes. It also provided the generic risk warning applicable to all small cap shares in 29 out of the 32 telephone call recommendations reviewed by the FSA. However, in 23 of these 29 recommendations, the risk warning was given only *after* the customer had agreed to the recommendation. In 18 of the 29 recommendations, the risk warning was then undermined by the adviser seeking to rush or diminish the risk warning in some way, for example by stating part way through the risk warning, "*you pretty much know this stuff don't you?*" or "*it can result in a loss of money, I don't expect that to happen, obviously*". Statements such as this detract from the risk warning and might lead the customer to disregard, fail to assess, or not pay proper heed to, the risks attached to a particular trade.
- 4.62. Furthermore, in 31 out of 32 recommendations no, or insufficient, warnings were given about the risks inherent in a specific stock, such as illiquidity, business performance or financial structure, and in some cases inaccurate statements were made about such risks. For most of the Relevant Period there was no formal process

to communicate these risks to the advisers, or to their underlying customers. Only some of the factsheets Hythe produced for the recommended stocks (used by advisers in making telephone recommendations but not sent to customers) gave details of the specific risks of the relevant stock.

- 4.63. Consequently, most calls only contained information about the benefits of the shares, potentially providing a misleading impression of the risks of the securities.
- 4.64. The Firm did not make any improvements in the balance of the Retail Group's recommendations until February 2008, when some additional points were added to the generic risk warning and brokers were required to mention at least three company specific risk factors.

*Providing information about stock performance*

- 4.65. Hythe also failed to implement a process to ensure that Retail Group advisers did not provide unclear or misleading information to customers about Hythe's services or the stocks being recommended. Retail Group advisers provided customers with selective information about the previous performance of earlier recommendations by Hythe, as well as providing unsubstantiated forecasts about the growth potential of the stocks they were recommending.
- 4.66. Hythe's failure to implement adequate processes for ensuring that customers were provided with sufficient information about the investment being recommended to them meant that there was a risk that customers were provided with misleading information about stock performance.
- 4.67. For instance, in nine of the 32 recommendations reviewed, the adviser made misleading claims about the general performance of particular previous Hythe recommendations, by only referring to stocks which had increased in value without making reference to those Hythe recommendations that had decreased in value.
- 4.68. In ten of 32 recommendations to customers, Retail Group advisers also provided customers with misleading information about the general performance of Hythe's previous recommendations. For example, one adviser stating that between May and October 2007, Hythe had returned between 34% and 52% to its customers.
- 4.69. This performance data was misleading as it did not relate to the performance of Hythe's small cap recommendations, but across other areas of Hythe's business. It also included hypothetical examples of the returns on leveraged portfolios. This was not made clear to customers. When the FSA calculated the performance of the 12 main stocks recommended by the Retail Group in 2007, it found that, in total, Retail Group customers' investments increased by approximately 1% in the first 6 months of 2007 by following Hythe's recommendations. This is significantly different to the performance data given by the advisers.
- 4.70. In addition to historic performance data, customers were given forecasts of how the recommended stocks might perform. These forecasts were produced by senior management who then informally communicated these to the advisers. No formal

record of the basis of these forecasts was maintained.

- 4.71. In 18 out of 32 Retail Group recommendations reviewed, advisers gave unsubstantiated indications of how they expected the recommended stock to perform, for example:

*“we are expecting them to go up between 25 and 30% over the next pursuant weeks and thereafter.”*

- 4.72. In several of the transactions reviewed, inconsistent performance predictions were also provided to customers with different returns being predicted in different recommendations of the same security, with for example, on the same day one customer being told *“our target price is 20p roughly”* whilst another was told *“these guys in my personal opinion are quite easily a 25-30p stock”*.
- 4.73. As a result of this, customers could have been provided with unsupported or unrealistic expectations about the potential performance of the recommended shares which they might, as a result of the representations, reasonably have believed were achievable.

#### *Providing information about services*

- 4.74. Hythe failed to implement a process to ensure that Retail Group advisers did not provide misleading information to customers about the extent of the research that was conducted. In contrast with the position described at paragraphs 4.48 to 4.51 above Hythe provided information to its Retail Group customers that suggested that it conducted extensive due diligence and research on the stocks that it promoted. It sent its customers brochures on the AIM market referring to Hythe’s *“dedicated research team [which] allows customers to take advantage of an information network that would otherwise only be available to the institutional and expert investors. This approach, based on research and analysis, has proved to be extremely effective in filtering through the vast number of companies on the AIM and identifying companies with share prices that do not reflect their true potential, resulting in our investors enjoying the lofty returns these companies can offer”* and its terms of business brochure referred to its *“in house research team and our brokers also have access to a wealth of third party research material”*. In addition, in nine of the 32 recommendations reviewed, the Retail Group advisers make reference to the use of “analysts” employed by Hythe in the stock selection process.

#### *Incorrect statements about trading by other customers*

- 4.75. In nine of the 32 recommendations, Retail Group advisers made incorrect statements in relation to trading by other customers. Examples included incorrectly suggesting that all of an adviser’s customers were moving into a particular stock or suggesting that an adviser’s large investment banking customers (of which he had none) were investing in the stock.

#### *Customer identification and anti-money laundering procedures*



- 4.76. Hythe failed to implement effective customer identification procedures. New Retail Group customers were required to provide proof of identification for the purpose of anti-money laundering controls. Hythe's policy was that original documents had to be provided or that, if copies were provided, they should be certified by a professional. However, no procedures were put in place to ensure that this policy was adhered to. Notwithstanding this policy, in seven of the 32 files reviewed, advisers had requested photocopies of documents, without specifying that they needed to be certified, and in four of these files the advisers had then themselves certified the copies as true copies of the originals, even though it appears that they had never seen the original documents or met the customer in person. This indicates that, when Retail Group customers sent uncertified copies of their identification documents to Hythe, the Retail Group advisers would themselves certify them to be a true likeness of the original and that, given that the advisers had not always seen the original documents and had not always met the customer in person, their certifications may have been false or incorrect.
- 4.77. By relying on photocopied and uncorroborated photographic documents, and by certifying copies as originals when the originals had not been seen and the adviser had not met the customer face to face, Hythe exposed itself to the risk of the firm being used as a vehicle for financial crime by third parties. Such practices could have exposed the firm to the risk of being utilised for money laundering, for example.

## **5. ANALYSIS OF BREACHES**

- 5.1. By reason of the facts and matters set out in paragraphs 4.10 to 4.77 above, Hythe did not take reasonable care to organise and control the affairs of the Retail Group responsibly and effectively, in breach of Principle 3.
- 5.2. The FSA considers that, in addition to Hythe's breaches of Principle 3, Hythe has also failed to comply with certain provisions of the Conduct of Business Rules ("COB"), Senior Management Arrangements, Systems and Controls Rules ("SYSC") and Training and Competence Rules ("TC") set out in Annex 1 to this Notice.
- 5.3. The deficiencies which were revealed by the FSA's review of a random sample of 32 transactions and client files which are described in detail above, indicate that there have been instances of Hythe:
- (1) failing to treat customers fairly;
  - (2) failing to communicate information to customers in a way which is clear, fair and not misleading; and
  - (3) failing to take reasonable care to ensure the suitability of its advice.

## **6. ANALYSIS OF SANCTION**

- 6.1. As set out in section 3 above, in considering whether to impose a financial penalty and the amount of the penalty to impose, the FSA had regard to the provisions of DEPP

and ENF which set out a non-exhaustive list of factors that may be taken into consideration. Having regard to all the circumstances and having taken into account Hythe's representations, the FSA considered that the following factors were particularly relevant in this case.

### **Deterrence**

- 6.2. The FSA has had regard to the fact that the principal purpose of imposing a sanction 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. The FSA considers that the imposition of a significant financial penalty on Hythe is required, given the need to deter others from committing similar breaches and to encourage compliant behaviour in relation to the sale of high risk securities.

### **The nature, seriousness and impact of the breach**

- 6.3. In determining the appropriate sanction, the FSA has had regard to the seriousness of the contraventions, including the nature of the breaches, the number and duration of the breaches, and the number of customers who were exposed to risk of loss. For reasons set out at paragraph 2.4 above the FSA considers that the breaches identified in this case are of a serious nature.
- 6.4. The FSA accepted that Hythe did take some steps to improve its processes and that there is no proven loss to customers. However, the FSA considered that Hythe did not take sufficient steps to control the Retail Group or mitigate the risks inherent in its business which were exacerbated by the way in which the business was structured. The FSA was also mindful of the risk of loss to customers occasioned by Hythe's conduct given that, in the Relevant Period, Hythe completed 1930 small cap transactions for customers of the Retail Group and the total value of transactions undertaken by customers of the Retail Group was £10,488,235.83. The FSA also considers that Hythe's failings in relation to customer identification led to a risk that Hythe might be used as a vehicle for financial crime.

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

- 6.5. The FSA considered the extent to which Hythe's actions were reckless or deliberate. The FSA has not determined that Hythe deliberately contravened regulatory requirements and has had regard to the improvements which Hythe has sought to make to its systems and controls. However, the FSA considered that in some respects Hythe was reckless because no consideration appears to have been given to the consequences of the behaviour and the extent of the risks to customers, particularly with regard to:
- (1) the failures to implement adequate compliance monitoring and reporting procedures, notwithstanding that some improvements were made during the Relevant Period;

- (2) the failures to implement a controlled process to ensure that sufficient and accurate information was obtained from customers before recommendations were made and that customers were appropriately classified; and
- (3) the failures to implement a documented and formalised process for the selection and research of stocks to ensure that they were appropriate to recommend to Hythe's customers and that customers were provided with sufficient information about the risks of the investment being recommended.

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

- 6.6. In determining the level of penalty, the FSA were mindful of the size and overall financial position of Hythe, including its regulatory capital position. Hythe submitted that it would be unfair to impose a penalty which might affect other areas of its business which were unconnected with the Retail Group. During the Relevant Period, total revenue earned by the Retail Group in relation to small cap shares was £3,891,518. Hythe Group profit in relation to the small cap share activities of the Retail Group was £586,659.82 and Hythe made a total profit after tax of £225,000. Although Hythe made operating losses of £249,468 for the 12 months to June 2009, its net assets on 30 June 2009 were £967,042.

**Conduct following the breach**

- 6.7. After Hythe was informed by the FSA of its concerns, Hythe co-operated fully with the FSA and indicated its willingness to take all reasonable steps to satisfy the FSA that it will seek to comply with its regulatory requirements on an ongoing basis. Further, there is now no longer a Retail Group operating at Hythe and Hythe has varied its Part IV permission to reflect this.

**Disciplinary record and compliance history**

- 6.8. Hythe has not previously been the subject of any disciplinary action by the FSA.

**Other action taken by the FSA**

- 6.9. In determining whether to impose a financial penalty, the FSA has taken into account penalties imposed by the FSA on other authorised persons for similar behaviour. Hythe highlighted some factors which it submitted distinguished it from previous firms including that failings took place over a relatively short period: the Retail Group started trading in September 2008, investigators were appointed in May 2008 and Mr Mehta closed the Retail Group in Summer 2008. Furthermore, Hythe submitted that it was compliant by December 2007.

**7. CONCLUSIONS**

- 7.1. In light of the matters set out above, the FSA has concluded that between 1 June 2006 and 21 May 2008 Hythe breached the FSA's Principle for Business 3 in relation to advising on and arranging the sale of higher risk securities to customers of its Retail

Group and that this resulted in the examples of customers not being treated fairly set out in this notice. Taking into account all the relevant circumstances, including the factors set out above, the FSA has decided that it is appropriate to impose a penalty of £200,000 on Hythe.

## **8. DECISION MAKER**

- 8.1. The decision which gave rise to the obligation to give this Final Notice was made by the Regulatory Decisions Committee.

## **9. IMPORTANT**

- 9.1. This Final Notice is given to the Firm under section 206 of FSMA and in accordance with section 390 of the Act.

### **Method and time of Payment of the Fine**

- 9.2. Hythe must pay £50,000 by 12 May 2010, 28 days from the date of the Final Notice. The remaining balance of the financial penalty must be paid in two equal instalments of £75,000 on 14 April 2011 and 16 April 2012.

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

- 9.3. If all or any of the financial penalty is outstanding after the agreed dates of payment, the FSA may recover the outstanding amount as a debt owed by the Firm and due to the FSA.

### **Publicity**

- 9.4. 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.
- 9.5. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

### **FSA contacts**

- 9.6. For more information concerning this matter generally, you should contact Stephen Robinson (direct line: 020 7066 1338) of the Enforcement and Financial Crime Division of the FSA.

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**Georgina Philippou**

**FSA Enforcement and Financial Crime Division**

## **Annex 1: Relevant FSA Rules**

### *Senior Management Arrangements, Systems and Controls (“SYSC”) Rules*

**SYSC 3.1.6R** – A firm which is not a common platform firm must employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.

**SYSC 3.2.6R** - 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.

**SYSC 3.2.20R** - (1) A firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system.

### *Conduct of Business (“COB”) Rules in force up to 1 November 2007*

**COB 3.8.22R** - A firm must take reasonable steps to ensure that an individual who makes a real time financial promotion on the firm's behalf:

- (1) does so in a way which is clear, fair and not misleading;
- (2) does not make any untrue claims; ...

### **COB 4.1.4R** –

- (1) Before conducting designated investment business with or for any client, a firm must take reasonable steps to establish whether that client is a private customer, intermediate customer or market counterparty...

**COB 5.2.5R** - Before a firm gives a personal recommendation concerning a designated investment to a private customer, or acts as an investment manager for 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.

### **COB 5.3.5R** -

- (1) A firm must take reasonable steps to ensure that, if in the course of designated investment business:

- (a) it makes any personal recommendation to a private customer to:

- (i) buy, sell, subscribe for or underwrite a designated investment (or to exercise any right conferred by such an investment to do so);...

the advice on investments or transaction is suitable for the client....

- (3) In making the recommendation or effecting the transaction in (1), the firm must have regard to:

- (a) the facts disclosed by the client; and
    - (b) other relevant facts about the client of which the firm is, or reasonably should be, aware.

**COB 5.4.3R** - A firm must not:

- (1) make a personal recommendation of a transaction;...

with, to or for a private customer unless it has taken reasonable steps to ensure that the private customer understands the nature of the risks involved.

**COB 8.1.3R** –

- (1) A firm must, subject to COB 8.1.6 R, despatch to the customer a written confirmation recording the essential details of the transaction, and must do so promptly...

**COB 8.1.15E (11)** – Provides that the written confirmation of a transaction must include details of the remuneration of the firm in connection with the transaction, distinguishing the amount of any commission charged, the basis on which the commission has been determined (unless all commission has already been disclosed to the customer or the basis has already been disclosed to him elsewhere) and, if the firm acted as principal in executing the transaction, and the firm owes a duty of best execution to its customer, the amount of any mark-up or mark-down imposed by the firm.

*Training and Competence (“TC”) Rules*

**TC 2.3.1R** – If a firm’s employees engage in or oversee an activity with or for private customers, the firm must:

- (1) at intervals appropriate to the circumstances, determine the training needs of those employees and organise appropriate training to address these needs; and
- (2) ensure that training is timely, planned, appropriately structured and evaluated.

**TC 2.4.5R** –

- (1) A firm must not assess an employee as competent to engage in or oversee an activity unless the employee:
  - (a) has been assessed as competent to apply the knowledge and skills necessary to engage in or oversee the activity without supervision; and
  - (b) has passed each module of an appropriate examination.

**TC 2.6.1R** – A firm must have appropriate arrangements in place to ensure that an employee who has been assessed as competent to engage in or oversee an activity maintains competence.

**TC 2.7.5AR** – A firm must have arrangements in place to ensure that an employee who is engaging in an activity with or for private customers and who has been assessed as competent is appropriately monitored.

**TC 2.8.1R** –

- (1) A firm must make appropriate records to demonstrate compliance with the rules in this chapter.
- (2) The records in (1) must be retained by the firm for at least three years after an employee ceases to engage in or oversee an activity, except for the records of pension transfer specialists, which must be retained indefinitely.