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**FINAL NOTICE**

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To: J.P.Morgan Securities Ltd  
Of: 125 London Wall. London EC2Y 5AJ  
Ref No: 155240  
Dated: 25 May 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 J.P.Morgan Securities Limited ("JPMSL" or the "Firm") a Decision Notice on 24 May 2010 which notified JPMSL that pursuant to section 206 of the Financial Services and Markets Act 2000 ("**FSMA**" or the "**Act**"), the FSA had decided to impose a financial penalty of £33.32 million on JPMSL in respect of a breach of Principle 10 of the FSA's Principles for Businesses (the "**Principles**") and breaches of the relevant client money rules (set out at paragraphs 3.4 to 3.6 and referred to collectively in this Notice as the "**Client Money Rules**") which occurred between 1 November 2002 and 8 July 2009 (the "**Relevant Period**") within the Futures & Options ("**F&O**") business of JPMSL.
- 1.2 JPMSL has confirmed that it will not be referring the matter to the Upper Tribunal (Tax and Chancery Chamber).
- 1.3 Accordingly, for the reasons set out below and having agreed with JPMSL the facts and matters relied on, the FSA imposes a financial penalty on the Firm in the amount of £33.32 million.
- 1.4 JPMSL agreed to settle at an early stage of the FSA's investigation. JPMSL, therefore, qualified for a Stage 1 discount under the FSA's executive settlement procedures. In this type of case, the FSA considers that the appropriate approach is to calculate the

financial penalty by reference to the amount of client money held. Accordingly, the penalty (before Stage 1 discount) is equivalent to 1 per cent. of the average amount of unsegregated client money held by JPMSL with JPMorgan Chase Bank, N.A. ("JPMCB") over the Relevant Period.

## 2. REASONS FOR THE ACTION

### Summary of conduct in issue

- 2.1 The FSA imposes the financial penalty on JPMSL for a breach of Principle 10 and the Client Money Rules in relation to failings concerning the protection and segregation of client money placed by the F&O business of JPMSL with JPMCB throughout the Relevant Period. In particular, JPMSL failed to place client money in a segregated trust account with JPMCB.
- 2.2 The FSA views this failing as particularly serious because:
- (a) JPMSL is a premier financial institution with significant operations in the United Kingdom and globally. It is one of the largest holders of client money in the UK;
  - (b) The amount of client money which was not segregated throughout the Relevant Period ranged between US \$1.96 billion and US \$23 billion. The average amount of unsegregated client money held by JPMSL at JPMCB during this period was approximately US \$8.55 billion;
  - (c) This failure to segregate and, therefore, adequately protect client money in accordance with the Client Money Rules, lasted for a period of nearly 7 years.
- 2.3 The principal objective of the Client Money Rules is to ensure that client money is adequately protected. A fundamental requirement is that firms must keep client money separate from firm money in segregated client accounts with trust status. This ensures that client money is ring-fenced, to the extent possible, in the event of the insolvency of a firm.
- 2.4 JPMSL's failure to segregate client money held with JPMCB for nearly 7 years posed a significant risk to clients, in the event that JPMSL became insolvent during the Relevant Period. In these circumstances, client money would not have been ring-fenced from JPMSL's money held with JPMCB, but would have been pooled with JPMSL's money. JPMSL's clients would, therefore, have been classed as general unsecured creditors in JPMSL's insolvency process rather than having the right to claim from a pool of protected client money. Consequently, the likelihood of such clients recovering their money in the event of insolvency of JPMSL would have been reduced.
- 2.5 In determining the level of financial penalty, the FSA has taken into account the following mitigating factors:
- (a) The failure to segregate client money held with JPMCB was not deliberate;
  - (b) JPMSL self-reported the segregation error immediately on discovering it and immediately remedied the situation;

- (c) JPMSL worked constructively with the FSA during its investigation;
  - (d) The failure to segregate client money did not result in any incorrect financial reporting by JPMSL for the period 2001-2008 or in any loss to clients of JPMSL; and
  - (e) JPMSL has not previously been the subject of disciplinary action by the FSA.
- 2.6 Although the FSA does not consider this to be an acceptable alternative to the segregation of client money in accordance with the Client Money Rules, the FSA does note that, with effect from 23 March 2007, JPMCB guaranteed the obligations which JPMSL had to its clients. In the event of the failure of JPMSL, this guarantee may have substantially reduced the potential financial impact of JPMSL's failure to segregate the client money.

### 3. **STATUTORY AND REGULATORY PROVISIONS**

- 3.1 The FSA is authorised pursuant to section 206 of the Act, if it considers that an authorised person has contravened a requirement imposed on him by or under the Act, to impose on such person a penalty in respect of the contravention of such amount as it considers appropriate in the circumstances.
- 3.2 Pursuant to section 2(2) and section 3 of the Act, one of the FSA's statutory objectives is maintaining confidence in the financial system.
- 3.3 Principle 10 of the Principles states that:
- "A firm must arrange adequate protection for clients' assets when it is responsible for them."*
- 3.4 Conduct of Business 9.3.37R, in force from 1 November 2002 to 31 March 2004 states that:
- "A firm must, except to the extent permitted by the client money rules, hold client money separate from the firm's money."*
- 3.5 Client Assets Rules 4.3.3R, in force from 1 April 2004 to 31 October 2007 states that:
- "A firm must, except to the extent permitted by the client money rules, hold client money separate from the firm's money."*
- 3.6 Client Money Rule ("CASS") 7.4.11R in force from 1 November 2007 onwards states that:
- "A firm must take the necessary steps to ensure that client money deposited, in accordance with CASS 7.4.1 R, in a central bank, a credit institution, a bank authorised in a third country or a qualifying money market fund is held in an account or accounts identified separately from any accounts used to hold money belonging to the firm."*
- 3.7 The FSA's approach to exercising its enforcement powers to impose a financial penalty on an authorised person is set out in the Enforcement Guide ("EG").

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

##### **Background**

###### ***JPMSL***

- 4.1 JPMSL is a wholly-owned subsidiary of JPMorgan Chase & Co. a global financial institution with its head office in the USA. JPMSL is the main broker/dealer outside the USA for the J.P.Morgan group of companies.
- 4.2 JPMSL is a full service investment firm and is regulated and authorised by the FSA. JPMSL is authorised to carry on investment business including dealing in investments (both as principal and agent), arranging, managing, advising and entering into futures and options contracts on a broad range of investments including equities, bonds and commodities.
- 4.3 As a regulated firm, JPMSL is required to comply with the rules set out in the FSA's Handbook, including the rules governing the protection of client money, namely the CASS rules. In particular, JPMSL is required under the Client Money Rules to hold client money in segregated client accounts, separate and distinct from JPMSL's money, with authorised credit institutions and banks.

###### ***Merger***

- 4.4 JPMorgan Chase & Co was formed on 31 December 2000 from the merger between JPMorgan & Co and The Chase Manhattan Corporation. The merger required significant changes on a succession of key dates during this period, referred to internally as Day 1, Day 2 and Day 3.
- 4.5 Day 1 referred to the merger between JPMorgan & Co and The Chase Manhattan Corporation on 31 December 2000. From 31 December 2000 to 10 November 2001 there were two banks, namely Chase Manhattan Bank and the Morgan Guaranty Trust Bank, which, on 11 November 2001, merged to form JPMorgan Chase Bank (i.e. JPMCB). This was referred to internally as Day 2.
- 4.6 Day 3 occurred on 1 November 2002 and involved two processes:
- (1) The subsidiaries, with JPMSL being the main one were converted into a new infrastructure and JPMSL's ledger was moved to a different system; and
  - (2) Changes were made to treasury processes relating to the funding and transfer pricing systems for JPMSL's F&O business (the "**Funding Changes**").
- 4.7 The Funding Changes were a Treasury led project intended to move F&O business processes to existing systems for other businesses and to reduce operational risk.

###### ***Root cause of the error***

- 4.8 Client money was held within JPMSL's F&O business ("F&O") prior to and during the Relevant Period. Prior to 31 October 2002 and the Funding Changes, F&O client money was transferred at the close of business each day into a segregated overnight money market account with separate underlying currency balances held with JPMCB.

- 4.9 However, the Funding Changes had an unintended consequence for the segregation of F&O client money. Following implementation of the Funding Changes, JPMSL Treasury did not distinguish between F&O client money and JPMSL's own money. The consequence of this failing was that F&O client money was, with effect from 1 November 2002, held overnight in an unsegregated account with JPMCB. F&O staff mistakenly assumed that JPMSL Treasury would continue to place client money into a segregated client bank account with JPMCB.
- 4.10 For the period 1 November 2002 to 8 July 2009, when the error was discovered, F&O client money held by JPMSL with JPMCB was not segregated in accordance with the Client Money Rules in force at that time and, therefore did not benefit from the protections afforded by those rules. From 23 March 2007 JPMCB guaranteed the obligation which JPMSL would have had to repay client money.

#### *Identification of the issue*

- 4.11 The segregation error remained undetected for a period of nearly 7 years. The issue came to light on 8 July 2009, during conversations between senior staff within Compliance and Treasury regarding F&O's contribution to Treasury funding. F&O's view was that most of F&O money would be client money, whereas Treasury explained that it did not know that F&O money was client money. These conversations led to an internal investigation about the status of the money received by Treasury from F&O.
- 4.12 On 9 July 2009, following an internal investigation, it was confirmed that F&O client money held by JPMSL with JPMCB had not been segregated. JPMSL immediately corrected this error by placing the F&O client money in segregated client bank accounts with JPMCB. JPMSL also engaged an independent accountancy firm to conduct a review of this matter.
- 4.13 On 10 July 2009, JPMSL informed the FSA of the error.

#### *Section 166 review*

- 4.14 On 3 August 2009, the FSA issued JPMSL with a Requirement Notice in accordance with section 166 of the Act. The Requirement Notice mandated that JPMSL appoint a Skilled Person, the accountancy firm that JPMSL had previously engaged, to provide the FSA with a report, the purpose of which was to understand the root cause and impact of the failure to segregate client money held by F&O with JPMCB, and to understand the reasons why subsequent reviews and controls did not discover this failure, including the adequacy of the underlying controls, procedures, oversight and governance of client money arrangements.

#### *Skilled Person's Report*

- 4.15 On 20 November 2009, the Skilled Person produced its report (the "**Report**") on client money.
- 4.16 The Report concluded that JPMSL failed to understand the effect of the Funding Changes and failed to carry out a post-implementation review following the Funding Changes, which might have identified the error.

- 4.17 The Report also concluded that the error remained undetected because F&O Operations had not implemented any overarching control processes to confirm that all client money was held in a properly segregated bank account with trust status.
- 4.18 Principle 10 and the Client Money Rules require a firm to arrange adequate protection for client money. The Report confirms that JPMSL failed to segregate client money held by it at JPMCB and therefore failed to protect client money, in accordance with the Client Money Rules, for a period of nearly seven years.
- 4.19 The Report identified that JPMSL lacked a control which required F&O to confirm that the client money placed with Treasury was subsequently placed by Treasury into a segregated account with JPMCB. F&O staff mistakenly assumed that Treasury would continue to place client money into a segregated client bank account with JPMCB and failed to communicate clearly to Treasury that it should continue to segregate funds received from F&O.

### **Conclusion**

- 4.20 For the reasons above, the FSA considers that JPMSL has breached Principle 10 and certain requirements imposed by the Client Money Rules in that the Firm failed to arrange adequate protection of client money held by it with JPMCB when it was responsible for it.

## **5. SANCTION**

- 5.1 The FSA's policy on the imposition of financial penalties and public censures is set out in the FSA's Decision Procedure & Penalties manual ("**DEPP**") and EG. In determining the financial penalty proposed, the FSA has had regard to this guidance. The FSA has also had regard to the provisions of the FSA's Enforcement manual ("**ENF**") which were in force during the Relevant Period.
- 5.2 The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefits of compliant behaviour.
- 5.3 For the reasons set out above, the FSA considers that JPMSL breached Principle 10 and the Client Money Rules. In determining that the financial penalty is appropriate and proportionate in this case, the FSA has considered all the relevant circumstances. The FSA considers the following factors to be particularly important.

### **Deterrence (DEPP 6.5.2G(1))**

- 5.4 The FSA has always viewed compliance with its client money requirements as of significant importance. The FSA considers there to be a need to send a strong and robust message to the industry that firms must handle client money in a way which is compliant with CASS rules and the Principles. In particular, firms must ensure that client money is segregated in accounts with trust status, thereby affording some protection to clients in the event of a firm's insolvency.

- 5.5 JPMSL is a premier global financial institution, with a reputation as an industry leader and a significant brand presence. JPMSL was fully aware of the obligations placed on it by the CASS rules and understood the importance of segregating client money.

**Seriousness and impact of the breach (DEPP 6.5.2(2))**

- 5.6 The FSA has had regard to the seriousness of the breach including the nature of the requirements breached and the duration of the breach. The FSA considers JPMSL's breach of Principle 10 and the Client Money Rules to be particularly serious for the following reasons:
- (a) In the event of the insolvency of JPMSL, the risk to client money held by it at JPMCB was unprecedented in scale. The average amount of unsegregated F&O client money was approximately US \$8.55 billion. At its height (in October 2008), the aggregate unsegregated client money was approximately US \$23 billion;
  - (b) Client money remained unsegregated at JPMCB, and therefore, at risk in the event of JPMSL's insolvency, for nearly 7 years; and
  - (c) The segregation error remained undetected for nearly 7 years.

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

- 5.7 The FSA does not consider that JPMSL committed the breach deliberately or recklessly.

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

- 5.8 In deciding on the level of penalty, the FSA has had regard to the size of the financial resources of JPMSL.
- 5.9 We have no evidence to suggest that JPMSL is unable to pay the financial penalty. JPMSL is part of the JPMorgan Chase & Co group of companies. The group's turnover for 2009 was over US\$100 billion, with profits of US\$11.7 billion.<sup>1</sup>

**The amount of profits accrued or the loss avoided (DEPP 6.5.2(6))**

- 5.10 JPMSL did not profit from the breach.

**Conduct following the breach (DEPP 6.5.2(8))**

- 5.11 Upon discovering the breach, JPMSL immediately remedied the situation, notified the FSA and instructed an independent firm of accountants to investigate the nature and extent of the breach.
- 5.12 On 3 August 2009, the FSA issued JPMSL with a Requirement Notice in accordance with section 166 of the Act mandating JPMSL to appoint a Skilled Person to undertake a review to understand the root cause and impact of the failure to segregate

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<sup>1</sup> JPM Chase 2009 Annual Report.

client money in F&O. The Skilled Person appointed was the same firm of accountants referred to in paragraph 5.11 above.

- 5.13 Having identified and self-reported the issue, throughout the investigation, JPMSL worked constructively with the Skilled Person and the FSA. JPMSL has co-operated fully and worked with the FSA to facilitate an early settlement of this matter.

**Disciplinary record and compliance history (DEPP 6.5.2(9))**

- 5.14 JPMSL has not previously been the subject of FSA enforcement action.

**Other action taken by the FSA (DEPP 6.5.2(10))**

- 5.15 The FSA has had regard to previous cases involving the failure to adequately protect client money. However, given the unprecedented sums of client money involved and the length of time client money remained unsegregated, these previous cases provide little guidance.

**Conclusions**

- 5.16 The FSA considers that the seriousness of JPMSL's breach of Principle 10 and the Client Money Rules merits a very substantial financial penalty. In determining the proposed financial penalty, the FSA has considered the need to send a clear message to the industry of the need to ensure that client money is properly segregated in accordance with the relevant rules and that failure to do so will result in severe consequences.
- 5.17 The FSA considers, taking into account the applicable Stage 1 discount for early settlement, that a financial penalty of £33.32 million is appropriate. This figure has been arrived at by reference to all of the factors above, in particular, the amount of client money held and the failure of JPMSL to segregate client money held by it with JPMCB for nearly 7 years, as well as the mitigating factors, in particular JPMSL's cooperation since discovering the breach. The penalty is equivalent to 1% of the average amount of unsegregated client money held by JPMSL with JPMCB over the Relevant Period.

**6. DECISION MAKERS**

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

**7. IMPORTANT**

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

**Manner of and time for Payment**

- 7.2 The financial penalty must be paid in full by JPMSL to the FSA by no later than 8 June 2010, 14 days from the date of this Final Notice.



**If the financial penalty is not paid**

- 7.3 If all or any of the financial penalty is outstanding on 9 June 2010, the FSA may recover the outstanding amount as a debt owed by JPMSL 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 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 JPMSL or prejudicial to the interests of consumers.

**FSA contacts**

- 7.5 For more information concerning this matter generally, JPMSL should contact Mary O'Connor at the FSA (direct line: 020 7066 7956/020 7066 3032; fax: 020 7066 7957).

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