
FINAL NOTICE

To: **The Kyte Group Limited**

Of: Business Design Centre
52 Upper Street
London
N1 0QH

Date: 21 August 2006

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

1 PENALTY

- 1.1 The FSA gave you, The Kyte Group Limited (“Kyte”), a Decision Notice on 3 August 2006 which notified Kyte that, having taken into account written and oral representations received in relation to the Warning Notice given to Kyte on 4 May 2006, the FSA had decided pursuant to section 206 of the Financial Services and Markets Act 2000 (“FSMA”) to impose a financial penalty on Kyte of £250,000.
- 1.2 Accordingly and for the reasons set out below, the FSA imposes a financial penalty of £250,000 on Kyte in respect of breaches of Principle 3 and Principle 10 of the FSA's Principles for Businesses ("the FSA Principles"), Rules 3.1.1, 3.2.6 and 3.2.20(1) of the FSA's Senior management arrangements, Systems and Controls sourcebook ("SYSC") and Rules 9.3.37, 9.3.100, 9.3.105, 9.3.121, 9.3.123, 9.3.126 and 9.3.131 of the FSA's Conduct of Business sourcebook ("COB").

2 REASONS FOR THE PENALTY

2.1 The FSA has decided to impose a financial penalty on Kyte for breaches of the FSA Rules and Principles because it considers that Kyte failed:

2.1.1 from 1 December 2001 to September 2003 to:

- perform properly the reconciliations of client money balances;
- transfer appropriate funds as required, to or from its segregated client accounts, to ensure the correct amount of client money was segregated on behalf of its clients;
- take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which resulted in the misstatement of Kyte's balance sheet by approximately £7.2 million for the year ended 30 April 2003 and/or take reasonable care to establish and maintain effective systems and controls in respect of its accounting function.

2.1.2 from 1 December 2001 to 17 October 2003 to:

- take reasonable care to establish and maintain effective systems and controls in respect of its holding of client money and client assets by having inadequate client money procedures;
- undertake adequate compliance reviews of its client money procedures to ensure that it was complying with the applicable FSA client money and client asset Rules;
- consistently perform properly or accurately the daily client money calculation;
- notify the FSA of those instances when it had failed to perform either the client money calculation or client money balances reconciliation;
- hold client money separate from Kyte's money.

2.2 The FSA considers that the above failures amount to a failure by Kyte to take reasonable care to organise and control its affairs responsibly and effectively contrary to Principle 3 of the FSA Principles and a failure to arrange adequate protection for clients' assets for which it was responsible, contrary to Principle 10 of the FSA Principles.

2.3 The FSA recognises that although Kyte's failings occurred over a prolonged period of time, Kyte's conduct was not deliberate. Kyte has cooperated with the Enforcement investigation and taken remedial action to improve its systems and controls and to implement appropriate procedures to ensure that it is now compliant with the standards required under the regulatory system. Kyte has corrected the misstatement of its balance sheet for the year ended 30 April 2003 by making a prior year adjustment in its financial statements for the year ended 30 April 2004, which restated its comparative financial results for the previous year. The FSA also recognises that no customers have suffered actual loss as a result of Kyte's failings.

- 2.4 In all the circumstances, and taking into account action taken in similar cases by previous financial services regulators and by the FSA, the FSA considers it appropriate and proportionate to impose a financial penalty on Kyte of £250,000.
- 2.5 The facts and matters relied on in the Warning Notice dated 4 May 2006 are set out in paragraphs 5.1–5.129 below. This Final Notice summarises the key representations made in response to the matters raised in the Warning Notice and the FSA's conclusions in the light of the representations.

3 RELEVANT STATUTORY PROVISIONS AND REGULATORY RULES

- 3.1 Section 206 of FSMA states:

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 amount as it considers appropriate.

- 3.2 Kyte is an Authorised Person within the meaning of FSMA.

FSA Principles

- 3.3 Principle 3 states:

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

- 3.4 Principle 10 states:

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

Systems and Controls Rules

- 3.5 SYSC 3.1.1R states:

A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business.

- 3.6 SYSC 3.2.6R states:

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.

- 3.7 SYSC 3.2.20R states:

(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 Rules

- 3.8 The rules in Chapter 9 of COB apply because the contraventions occurred before 1 January 2004 when the part of the Handbook entitled Client Assets, which now contains the relevant rules, took effect.
- 3.9 The relevant COB Rules are set out in Annex 1 to this Notice.

Transitionals

- 3.10 Under the transitional provisions made by the FSA under section 156(2) of FSMA, former Securities and Futures Authority ("SFA") regulated firms are deemed not to have contravened specified Rules in COB Chapter 9 in the period from 1 December 2001 (N2) to 30 June 2002, provided the firm in question is able to demonstrate that in that period, it has complied with substantially similar rules of SFA.¹
- 3.11 SFA did have rules that were substantially similar to the applicable FSA Rules in COB Chapter 9. However, the FSA is of the view that Kyte is unable to rely on any defence provided by the transitional provisions as and where applicable, as Kyte cannot demonstrate that, in that period, it was complying with those substantially similar SFA rules.

4 RELEVANT GUIDANCE

- 4.1 When exercising its powers, the FSA seeks to act in a way it considers most appropriate for the purpose of meeting its regulatory objectives, which are set out in section 2(2) of FSMA. The FSA considers that imposing a financial penalty of £250,000 on Kyte meets the regulatory objectives of the protection of consumers, that is, securing the appropriate degree of protection for consumers, and of market confidence, that is maintaining confidence in the financial system. Consumers include persons using Kyte's services.²
- 4.2 In deciding to take this action, the FSA has had regard to the guidance set out in Sections 1.3 and 11.4 of the FSA's Enforcement manual ("ENF"), which is part of the FSA's Handbook.
- 4.3 In particular, ENF 1.3.1(2)G states that the FSA will seek to exercise its enforcement powers in a manner that is transparent, proportionate and consistent with its publicly stated policies. The criteria for determining whether to take disciplinary action are set out in ENF 11.4.1G. ENF 11.4.1G states that the FSA will consider the full circumstances of each case and that the criteria listed are not exhaustive: not all of them may be relevant and there may be other factors that are relevant.
- 4.4 Having regard to the matters summarised in paragraph 2.1 above, to the guidance set out in ENF and to the FSA's statutory objectives of the protection of consumers and market confidence, the FSA considers it proportionate and appropriate in all the circumstances to take disciplinary action against Kyte for its failings in respect of its systems and controls.

¹ COB TR 1 Transitional Rules for pre-N2 and ex-Section 43 firms

² See section 5 and section 138 FSMA

5 FACTS AND MATTERS RELIED ON

Background to Kyte

- 5.1 Kyte is a company incorporated in England and Wales which provides independent trading facilities, including broking and clearing, to predominantly professional clients ranging from private investors to multinational institutions to trade futures and options either on their own accounts, as customers of Kyte or as proprietary sub-accounts of Kyte.
- 5.2 Kyte was previously regulated by SFA from 29 April 1988. It has been authorised by the FSA since 1 December 2001 ("N2") .
- 5.3 At all material times, Kyte was a member of the London International Financial Futures Exchange ("LIFFE"), Euronext Liffe, Euronext Paris and the London Stock Exchange and was and is authorised to hold client money.

Warning signals about Kyte's systems and controls (pre-N2)

- 5.4 Kyte's external auditors qualified their report to the FSA with respect to Kyte's holding of client money and assets for the year ended 30 April 2000.
- 5.5 Kyte's auditors also pointed out to Kyte's senior management in April 2000, March 2001 and July 2001 a number of weaknesses in Kyte's accounting systems and controls. In particular, the management information provided to Kyte's board was limited, including an absence of key control statistics such as value and age of reconciling items and instances of client money exceptions. Also, Kyte's auditors identified problems with Kyte's resourcing and commented that Kyte was overly reliant on a few key employees, in particular the then Finance Director (and Chief Financial Officer), and the Back Office Manager, and that staff within Kyte's finance and compliance functions were not sufficiently experienced.
- 5.6 In February 2001 following an inspection visit in December 2000, FSA (acting on behalf of SFA) recognised that Kyte had addressed a number of concerns from a previous SFA visit but identified a number of issues in respect of Kyte's internal controls and organisation, particularly in respect of its holding and calculating of client money and the allocation of resources to the accounting and regulatory reporting functions. FSA concluded that Kyte's client money systems and controls did not meet the standards expected of a regulated firm and therefore required Kyte to undertake a full review of its client money and reconciliation procedures to ensure that it was compliant with SFA's Rules.
- 5.7 Kyte subsequently responded in March 2001 outlining the measures it had taken to address the issues raised following the December 2000 visit and provided FSA with a set of its revised client money procedures, which it implemented with immediate effect.
- 5.8 Following its qualified auditors' report for the year ended 30 April 2001 (which again included a number of exceptions in respect of Kyte's holding of client money and assets), the FSA (acting on behalf of SFA) wrote to Kyte in October 2001 asking whether it had addressed each of the exceptions identified by the auditors. Kyte

responded in November 2001 that, following the revision of its procedures in March 2001, it was confident that it had improved its client money procedures to a level which would comply with FSA requirements but pointed out that individual error would still occur on an infrequent basis because a large amount of manual input was required.

- 5.9 In addition to the qualifications and concerns relating to Kyte's holding of client money, its management information and its resourcing as described above, Kyte's auditors identified a number of other issues in respect of Kyte's systems and controls as described below:
- 5.9.1 In March 2001, its auditors informed Kyte that it had no formal operating procedures. There were also a number of errors in Kyte's financial return to the FSA (regarding its financial position) and a number of procedural and administrative weaknesses including bank reconciling items not being posted on a timely basis and an insufficient audit trail to support the numbers presented in the statutory accounts;
- 5.9.2 In July 2001, Kyte's auditors informed it that neither Kyte nor any of its subsidiaries maintained a detailed fixed asset register which made it difficult to identify any misappropriated assets;
- 5.9.3 In July 2001, (and again in July 2002), Kyte was informed that its lack of systems automation necessitated a considerable degree of manual intervention which was not only a drain on staff resources but greatly increased the potential for human error to occur which could give rise to accounting errors;
- 5.9.4 In July 2001, there was no evidence to demonstrate that the reconciliations between broker statements and Kyte's back office system, a useful management control in ensuring that all trades were completely and accurately captured by the system and then entered into Kyte's accounting system, were reviewed by senior management on a regular and timely basis.
- 5.10 The FSA recognises that Kyte did take some steps in the period up to N2 to address the concerns raised by its auditors and the FSA regarding its systems and controls. For instance, following the concerns raised in March and July 2001 Kyte completed a detailed fixed asset register, began senior management sign-off of broker reconciliations and improved its resourcing and succession planning, particularly with the appointment of a Junior Compliance Officer in August 2001. However, the FSA considers that the steps taken by Kyte in response to the warning signals were insufficient to address the weaknesses in Kyte's systems and controls and, given the seriousness of the concerns identified by the auditors and the FSA, those steps were in the circumstances inadequate.
- 5.11 It is the FSA's view that the weaknesses in Kyte's systems and controls continued from N2 and were manifested in Kyte's failings in respect of its holding of client money and the misstatement of Kyte's balance sheet for the years ended 30 April 2001, 2002 and 2003, as described below.

Warning signals about Kyte's systems and controls (post-N2)

- 5.12 Despite Kyte informing the FSA in November 2001 that it had improved its client money procedures to a level which complied with FSA requirements, in July 2002 Kyte's auditors subsequently issued their audit report for the year ended 30 April 2002, again with a number of qualifications relating to Kyte's holding of client money and assets.
- 5.13 Similarly, in August 2003 and August 2004, Kyte's auditors issued the audit reports for the years ended 30 April 2003 and 30 April 2004 respectively, again with a number of qualifications relating to Kyte's holding of client money and assets. In their report for the year ended 30 April 2004, Kyte's auditors concluded that the client money issues were rectified in October 2003.
- 5.14 In addition to the qualified audit reports, the FSA wrote to Kyte in August 2002 and September 2003 setting out its concerns in respect of Kyte's holding of client money and assets.
- 5.15 Kyte's auditors also provided Kyte with further warning signals in respect of its accounting systems and controls in the form of Highlights Memoranda in July 2002 and September 2003, a Management letter in December 2002 and a presentation in May 2003.
- 5.16 These warning signals are detailed further below.

Kyte's client money procedures and monitoring

- 5.17 Following its revision in March 2001, Kyte did not update its client money procedures until October 2002.
- 5.18 In April 2002, Kyte performed one compliance monitoring review of its client money procedures and systems although this was limited in that Kyte only reviewed two randomly selected client money calculations and did not check whether the appropriate transfer was made to ensure the correct amount of client funds was segregated.
- 5.19 In August 2002 and as part of the FSA's Risk Mitigation Programme, the FSA wrote to Kyte requiring Kyte's senior management to review its client money procedures and confirm that they were satisfied that the firm remained compliant with the FSA's Rules and that its clients' interests were protected in this area.
- 5.20 Working in conjunction with external advisors, Kyte subsequently revised its client money procedures in October 2002 and implemented a formal compliance monitoring plan. This detailed a number of "test areas" of Kyte's business, including client money and the frequency at which they were to be reviewed, in an attempt to ensure compliance with the FSA's Rules. Prior to this date, Kyte had no formal compliance monitoring plan in place.
- 5.21 Kyte advised the FSA in October 2002 that its senior management had reviewed its client money procedures and confirmed that there was no doubt that Kyte remained compliant with the FSA's Rules and that clients' interests were protected in this area.

- 5.22 However, Kyte's procedures failed to identify who at Kyte had responsibility for ensuring the client money calculation was performed and reviewed. Further, the procedures only provided limited information regarding the transfer of funds to ensure the correct amount of money was held in the client money segregated account and there was no procedure in place to verify whether the appropriate transfer had been made. These omissions in Kyte's procedures, particularly in light of the warning signals received by Kyte from its auditors and SFA/the FSA, as described in paragraphs 5.4 to 5.16 above, demonstrate that Kyte failed to take reasonable care to establish effective and appropriate systems and controls at this time.
- 5.23 Further, Kyte's auditors wrote to Kyte's directors in December 2002 making a number of observations and recommendations in respect of Kyte's compliance with the FSA's Rules concerning client money and providing more detail in respect of the qualifications in the audit report for the year ended 30 April 2002.
- 5.24 In particular, Kyte's auditors made observations in respect of the client money calculation, the trust status of client money accounts, the reconciliations of client money bank accounts and continuing risk assessments.
- 5.25 Kyte was specifically informed that there were a number of errors in respect of its holding of client money and the client money calculation and that these might result in inadequate segregation of customer assets. The letter specifically advised Kyte that not only was it a breach of the FSA's Rules but the failure to transfer funds out of the client money resource accounts tied up cash unnecessarily, and the failure to transfer additional funds to a client money deficit meant insufficient funds were allocated to protect clients' assets. Similarly, Kyte was advised that its clients' assets might not be adequately protected if continuing risk assessments were not completed.
- 5.26 Subsequently, in August 2003, Kyte's auditors made a number of qualifications in respect of Kyte's holding of client money in its report for the year ended 30 April 2003. On 29 August 2003, the FSA wrote to Kyte stating that it had fundamental concerns about the issues raised by the auditors. Following this, Kyte engaged external advisors in September 2003 to carry out a review of its client money procedures and to make recommendations as to what steps Kyte should take to ensure that it was fully compliant with the FSA's Rules in respect of client money.
- 5.27 Following this review, Kyte implemented new systems and controls in respect of its client money processes, including updating its procedures, and by 20 October 2003, Kyte's systems and controls in respect of its holding of client money were of the standard the FSA considers reasonable to be expected of a regulated firm.
- 5.28 Prior to this date, and in the period from 1 December 2001 to 17 October 2003, in the FSA's view Kyte did not take reasonable care to establish and maintain systems and controls appropriate to its business, or to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system, in breach of SYSC 3.1.1R and SYSC 3.2.6R, and failed to take reasonable care to organise and control its affairs responsibly and effectively, in breach of FSA Principle 3, in that in this period Kyte did not implement adequate procedures or undertake adequate reviews of its client money systems and controls to ensure it was complying with the FSA's Rules. As detailed below, Kyte significantly failed to comply with the FSA's Rules in respect of client money in this period.

Kyte's client money calculations

- 5.29 At all material times, Kyte was required to perform the client money calculation on a daily basis in order to check that the amount of client funds actually held on behalf of its clients ("Client Money Resource") was at least equal to the amount of funds it owed to and was therefore required to segregate on trust for its clients ("Client Money Requirement").
- 5.30 The purpose of the client money calculation was to act as a check that the amount of client money that was segregated at banks and third parties was sufficient to meet Kyte's obligations to its clients on a daily basis. The objective of each client money calculation was to identify the amount of money Kyte was required to transfer to or from its house accounts to segregated client accounts to ensure the correct amount of money was held in each segregated client account ("the Client Money Transfer").
- 5.31 Kyte's back office system, known as "ATIS", was fundamental to the performance of the client money calculation. ATIS was the trading system through which all Kyte's trades, including all interaction with the exchanges, were recorded. ATIS was used for recording, processing and settling all trades as well as producing information used to perform the client money calculation.
- 5.32 The client money calculation required the reconciliation of the amount of client money ATIS showed as being owed to clients (its Client Money Requirement), with the amount of client money Kyte was holding for clients either at the London Clearing House ("LCH"), third-party brokers, exchanges or in client money bank accounts (its Client Money Resource).
- 5.33 Kyte should have used its own records to ascertain the correct figures to be used in the client money calculation. However, ATIS was unable to provide a split between the balance of funds held in the house and client accounts at the LCH and the Deutsche Termin Borse (later renamed Eurex exchange, "DTB") but, instead, ATIS provided a total figure of the combined house and client balances at LCH and DTB. Accordingly, Kyte was dependent on the accuracy of the transaction account information from LCH and DTB to provide a figure representing the amount of client funds held at LCH and DTB.
- 5.34 Kyte's auditors also identified a number of limitations with Kyte's back office system and, in a draft report dated 24 July 2001, Kyte was informed that:
- "The systems do not facilitate the calculation of client money balances and requirements. Considerable manual adjustments are required to ATIS balances such as grouping backed trader balances and removing non-segregated balances in order to accurately complete the client money calculation."*
- 5.35 The FSA considers that Kyte was aware of the limitations of its back office system in respect of accurately performing the client money calculation, in particular the extent of manual adjustments required by ATIS to produce the figures required for the client money calculation and the inability of ATIS to identify the balance of funds held in the client and house accounts at the LCH and DTB, yet failed to have in place sufficiently robust systems and controls to work around these limitations.

Accordingly, Kyte failed to take reasonable care to establish and maintain appropriate systems and controls to ensure it was complying with the FSA's Rules.

- 5.36 COB 9.3.37R required Kyte to hold client money separate from its own money. However, the accounts Kyte held at FIMAT, (a wholly owned subsidiary of Société Generale, which provided clearing services to Kyte on all non-LIFFE exchanges) were originally established as segregated client accounts. Kyte did not have any house accounts at FIMAT and it therefore put house trades through the segregated client accounts. This resulted in Kyte's money and positions being combined with client money and positions in breach of COB 9.3.37R. This problem was rectified in October 2003 when Kyte opened its own house accounts at FIMAT.
- 5.37 The FSA has reviewed all of Kyte's client money calculations performed in the period from N2 to 23 January 2004. The review identified that in the period from 1 December 2001 to 7 July 2003:
- 5.37.1 Approximately 25% of client money calculations were not performed, in breach of COB 9.3.100R;
 - 5.37.2 Kyte failed to notify the FSA of those instances where it did not perform the client money calculation, in breach of COB 9.3.121R;
 - 5.37.3 Of those client money calculations performed, approximately 8% were performed late i.e. more than one business day after the day to which the calculation relates, in breach of COB 9.3.100R; and
 - 5.37.4 Of those client money calculations performed, approximately 21% were not reviewed or signed off by Kyte's senior management.
- 5.38 On 7 July 2003, Kyte installed a new back office system, known as UBIX. UBIX allowed for a fully automated data feed process and was able to identify client and house accounts held with LCH and DTB. Unlike Kyte's previous system, it significantly improved Kyte's ability properly to perform the client money calculation. The FSA's review of the client money calculations, however, revealed that of those client money calculations performed in the period from 8 July to 17 October 2003:
- 5.38.1 Approximately 1.5% of client money calculations were not performed, in breach of COB 9.3.100R;
 - 5.38.2 Kyte did not notify the FSA of those instances where it did not perform the client money calculation, in breach of COB 9.3.121R;
 - 5.38.3 Of those client money calculations performed, approximately 15% were performed late i.e. more than one business day after the day to which the calculation relates, in breach of COB 9.3.100R; and
 - 5.38.4 Of those client money calculations performed, approximately 13% were not reviewed or signed off by Kyte's senior management.
- 5.39 The FSA considers that Kyte failed to have in place sufficiently robust systems and controls to ensure that its client money calculations were properly reviewed and signed off in the period from N2 to 17 October 2003.

- 5.40 In order properly to perform the client money calculation, Kyte was required to identify those accounts where the client balance was negative, that is, where the account owed money to Kyte. Such accounts had to be excluded from the Client Money Requirement aspect of the calculation. Failure to exclude such accounts would result in the Client Money Requirement figure being incorrect, ultimately leading to over-segregation of client money. However, certain client accounts were "grouped" or "guaranteed" by other accounts and it was not always appropriate to exclude those accounts from the Client Money Requirement.
- 5.41 As stated above, Kyte's auditors made it aware in July 2001 of the limitations of ATIS in performing the client money calculation and pointed out that considerable manual adjustments were required to ATIS records in respect of grouping backed trader balances and removing non-segregated balances in order accurately to complete the client money calculation.
- 5.42 The FSA's review of the client money calculations in the period from N2 to October 2003 revealed some instances where Kyte failed properly to identify those accounts in overall deficit which should have been excluded from the Client Money Requirement and instead Kyte incorrectly included them in the Client Money Requirement contrary to COB 9.3.105R. By doing so, Kyte performed an inaccurate client money calculation. The failure to remove those accounts in overall deficit (and the subsequent making of the transfer on the basis of the incorrect client money calculation) would result in more funds being segregated than required and therefore posed more of a risk to Kyte than to its clients. The FSA's review of the client money calculations also identified that Kyte was inconsistent in its approach to excluding certain accounts from the Client Money Requirement.
- 5.43 Where, however, Kyte incorrectly excluded accounts with positive balances from the calculation of the daily Client Money Requirement, as identified by its auditors in its qualified audit reports for the years ended 30 April 2001 and 2002, this could lead to the under-segregation of client assets where the Client Money Transfer was made following the inaccurate client money calculation for each business day. This posed a risk to Kyte's clients and demonstrates that Kyte failed to take reasonable care to arrange adequate protection for the client money and assets for which it was responsible.
- 5.44 This problem was, however, removed in October 2003 by the creation of a report in UBIX which worked out these figures appropriately.
- 5.45 The FSA's findings in respect of the daily client money calculation are consistent with the issues identified by Kyte's auditors in the qualified audit reports for the years ended 30 April 2002, 2003 and 2004.
- 5.46 Kyte's auditors advised it of the importance of the daily client money calculation and the consequences of it being incorrectly performed. In particular, in its management letter to Kyte dated 19 December 2002, following its audit for the year ended 30 April 2002, Kyte's auditors specifically informed Kyte's board that:

"Errors in the client money calculation may result in inadequate segregation of customer assets, and breaches of the Financial Services and Markets Act 2000".

- 5.47 Accordingly, Kyte was alerted to the importance of the accuracy of the client money calculation in ensuring that client money was properly segregated and in accordance with the FSA's Rules, as well as to Kyte's breaches of the FSA's client money and client asset Rules.
- 5.48 Notwithstanding this clear warning signal from its auditors; the qualified audit reports; the importance of the proper protection of client money and assets generally and to Kyte's core business in particular and Kyte's regulatory obligations as an authorised person; Kyte breached FSA Principles 3 and 10 and COB 9.3.37R, COB 9.3.100R, COB 9.3.105R, COB 9.3.121R and SYSC 3.1.1R and 3.2.6R in the period from N2 to 17 October 2003 as detailed above.

Kyte's client money transfers

- 5.49 Following performance of the client money calculation, COB 9.3.100R required Kyte to make the Client Money Transfer to ensure that any shortfall in Client Money Resource was paid into a client bank account (or withdrawn where there was an excess) by close of business on the day the calculation was performed. The daily client money calculation revealed the amount of funds Kyte was required to transfer to or from its house account in order to ensure the correct amount of client money was segregated in the client money bank account.
- 5.50 The FSA reviewed a sample of 33 client money calculations in the period from December 2001 to March 2004 to review whether Kyte had made the requisite Client Money Transfers on the same day.
- 5.51 The FSA's review of these Client Money Transfers revealed that of the sample of 28 client money calculations from the period December 2001 to October 2003, Kyte failed to make approximately 61% of the Client Money Transfers.
- 5.52 In respect of the same sample, of the 11 Client Money Transfers made, two were made late i.e. later than close of business on the day the client money calculation was performed.
- 5.53 As part of its audit for the year ended 30 April 2003, Kyte's auditors reviewed a number of instances when Kyte was required to transfer funds into the client account to rectify a shortfall, or out of the client money account to remove an excess. The auditors' review made similar findings to those of the FSA. Kyte has acknowledged that discussions with its audit team suggested that the daily Client Money Transfer was made for only 50-60% of the year.
- 5.54 The FSA's review of the sample of Client Money Transfers from December 2001 to March 2004 indicated that, from September 2003, the appropriate Client Money Transfers were made on the correct day.
- 5.55 In its management letter dated 19 December 2002 for the financial year ended 30 April 2002, Kyte's auditors specifically informed Kyte that not only was it a breach of the FSA's Rules but the failure to transfer funds out of the Client Money Resource accounts tied up cash unnecessarily, and the failure to transfer additional funds to a client money deficit to ensure the correct amount of client money was

segregated in the client bank account meant that insufficient funds were allocated to protect clients' assets.

- 5.56 Notwithstanding the strong warning signals by its auditors alerting Kyte that daily Client Money Transfers were only made for 50-60% of the year and highlighting the importance of those transfers; and notwithstanding the importance of the proper protection of client money and assets generally and to Kyte's core business in particular; in the period from N2 to September 2003, Kyte failed on a number of occasions properly to segregate the correct amount of funds in client bank accounts in breach of COB 9.3.100R.

Kyte's client money balances reconciliations

- 5.57 At all material times, Kyte was required to perform, no less than once every 25 business days, a reconciliation of the client money balances which it held or for which it was responsible ("Client Money Balances Reconciliation"). The purpose of this was to ensure that it maintained accurate records of account balances on its own system, which reconciled with the client money actually segregated at the bank, LCH, exchanges and third-party brokers. This was to ensure that the figures used in the client money calculation were accurate.

- 5.58 The Client Money Balances Reconciliation consisted of two parts and was set out in COB 9.3.126R:

5.58.1 First, Kyte was required to compare the balance on each client bank account as recorded on its back office system with the records maintained by the bank where the accounts were held ("Client Bank Account Reconciliation"); and

5.58.2 Second, Kyte was required to compare the balances on clients' transaction accounts as recorded on its back office system with the records of the same maintained by the exchange, LCH and third-party brokers ("Client Transaction Account Reconciliation").

- 5.59 Prior to the implementation of its new back office system in July 2003, all of Kyte's Client Money Balances Reconciliations were performed by its back office staff reviewing print-outs from Kyte's back office system and statements from the bank, LCH, exchanges and third-party brokers and making manual adjustments to ensure they reconciled. However, although Kyte's back office system would generally allocate trades correctly, prior to July 2003 it was not able to identify the split of client and house trades at LCH and DTB, as described in paragraph 5.33 above. Accordingly, Kyte was reliant on LCH and DTB to provide this information and was therefore unable properly to perform any Client Transaction Account Reconciliations in relation to those accounts, in the period from 1 December 2001 to July 2003, in breach of COB 9.3.126R.

- 5.60 The FSA's review of Kyte's Client Money Balances Reconciliations in the period from N2 to March 2004 identified that in the period from 1 December 2001 to September 2003:

5.60.1 Approximately 42% of the Client Bank Account Reconciliations were not performed, in breach of COB 9.3.126R;

- 5.60.2 Approximately 69% of the Client Transaction Account Reconciliations were not performed, in breach of COB 9.3.126R;
- 5.60.3 Of those Client Bank Account and Client Transaction Account Reconciliations performed, Kyte failed to sign off or evidence that they had been reviewed.
- 5.61 The FSA considers that Kyte failed to have in place sufficiently robust systems and controls to ensure that its Client Bank and Transaction Account Reconciliations were properly performed, reviewed and signed off in the period from N2 to 1 September 2003.
- 5.62 As a result of its breaches of COB 9.3.126R in the period from 1 December 2001 to September 2003, Kyte failed in that period to perform Client Money Balances Reconciliations, which it was required to do no less than once every 25 business days, in breach of COB 9.3.123R.
- 5.63 The review of the Client Money Reconciliations also revealed that during the period from 1 December 2001 to October 2003, Kyte failed to notify the FSA of any instances when the Client Money Balances Reconciliations were not performed, in breach of COB 9.3.131R.
- 5.64 Kyte has stated that the main reason why the percentages for its Client Bank Account Reconciliations appears low is that Kyte had a large number of foreign currency accounts with minimal balances and almost no movement that were not reconciled every month. The FSA does not consider this to be reasonable justification for Kyte's failure to perform the Client Bank Account Reconciliations in accordance with the FSA's Rules.
- 5.65 Following the implementation of its new back office system, which allowed an automatic data feed from both LCH and DTB and which automatically identified and allocated funds to the segregated client and house accounts on its system, Kyte commenced, in September 2003, performing the Client Money Reconciliation on a daily basis and retained copies of those reconciliations in electronic format. Further, as part of its overhaul of its client money systems and controls, Kyte introduced, in October 2003, a procedure to notify the FSA of any non-performance of the Client Bank Account and Client Transaction Account Reconciliations.
- 5.66 The FSA's findings in respect of Kyte's Client Money Balance Reconciliations are consistent with the issues identified by Kyte's auditors in the qualified audit reports for the years ended 30 April 2001, 2002, 2003 and 2004. In particular, in each of the qualified reports, Kyte's auditors identified and informed Kyte that there had been instances during the year where Kyte's client money bank accounts had not been reconciled within the time specified by the FSA.
- 5.67 Further, in its management letter for the year ending 30 April 2002, which they provided to Kyte's board in December 2002, Kyte's auditors stated:
- "We noted several instances where there was no evidence of reconciling client money bank accounts within the time period specified by the FSA rules. This may result in reconciling items remaining undetected, leading to errors in the client money calculation".*

- 5.68 In this management letter, Kyte's auditors recommended that Kyte's management should ensure that all accounts were reconciled within 10 days of the period end and that this could be monitored by way of a "control schedule", which was signed off and dated by the personnel completing the reconciliations. Kyte's management responded that the reconciliations of client bank accounts would be evidenced on a checklist as part of the client money procedures.
- 5.69 Notwithstanding this response from Kyte, in the qualified audit report for the year ended 30 April 2003, Kyte's auditors identified, as in the previous two years, that Kyte did not complete Client Money Balances Reconciliations every 25 business days in breach of COB 9.3.123R. Further, because the completion of the reconciliations was not dated, there was no evidence that the reconciliations that were conducted were completed within 10 business days as required by COB 9.3.125R. Although there is no evidence that Kyte failed to comply with COB 9.3.125R, the FSA considers that Kyte's failure to evidence the date on which the Client Bank Account Reconciliations were completed demonstrates that Kyte failed to take reasonable care to establish and maintain such systems and controls as were appropriate to its business and to ensure that it was complying with the applicable requirements and standards under the regulatory system in breach of SYSC 3.1.1R and 3.2.6R.
- 5.70 Despite the qualified audit reports and the December 2002 management letter, which were warning signals alerting Kyte to its regulatory breaches in carrying out Client Money Balances Reconciliations and the importance of those reconciliations, Kyte failed (as detailed above) to comply with its regulatory obligations when carrying out Client Money Balances Reconciliations from N2 until September 2003.

Kyte's client money breaches

- 5.71 In the FSA's view, Kyte has breached COB Rules 9.3.37, 9.3.100, 9.3.105, 9.3.121, 9.3.123, 9.3.126 and 9.3.131 in the period from N2 to October 2003.
- 5.72 Further, the FSA considers that, having regard to the successive qualified audits in respect of Kyte's holding of client money and other clear warning signals, as referred to above from Kyte's auditors and the SFA/FSA, Kyte failed to take reasonable care to establish and maintain effective systems and controls as were appropriate to its business and to ensure compliance with applicable requirements and standards under the regulatory system, contrary to SYSC 3.1.1R and 3.2.6R in that:
- 5.72.1 The extent and frequency of Kyte's failings in respect of its client money calculations and reconciliations demonstrate that its systems and controls were inadequate;
- 5.72.2 Kyte failed to have in place sufficiently robust systems and controls to work around the limitations of ATIS;
- 5.72.3 Kyte failed to have in place sufficiently robust systems and controls to ensure that its client money calculations and Client Bank and Transaction Account Reconciliations were properly performed, reviewed and signed-off. Kyte further failed to evidence the date on which the Client Bank Account Reconciliations were completed.

- 5.73 The FSA is of the view that Kyte's failings, together with the strong warning signals and Kyte's failure to ensure that it had segregated the correct amount of client money in client bank accounts, amount to a failure by Kyte in the period from 1 December 2001 to 17 October 2003 to take reasonable care to organise and control its affairs responsibly and effectively and to arrange adequate protection for its clients' assets when it was responsible for them, contrary to Principles 3 and 10.

Kyte's accounting systems and controls

- 5.74 From N2 to July 2003, Kyte's principal systems comprised of ATIS, the back office settlement system, and the SAGE system ("SAGE"). SAGE was Kyte's accounting system and was used to produce Kyte's financial statements and management accounts.
- 5.75 There was no software interface between ATIS and SAGE so the process of recording the accounting transactions from ATIS to SAGE was a manual one. The accounting for non-trading transactions such as salaries, office expenses, fixtures and fittings was recorded directly onto SAGE.
- 5.76 Since N2, Kyte's finance department comprised the Chief Financial Officer, and two assistants. The Chief Financial Officer was a director and qualified accountant and had overall responsibility for the finance department and financial matters and for reporting accounting information to Kyte's board of directors ("the board"). It was agreed in January 2003 between the directors at Kyte that the Chief Financial Officer would leave the firm and he was replaced by a new Chief Financial Officer in July 2003.
- 5.77 Following the departure of the Chief Financial Officer, Kyte's new finance team performed a comprehensive substantiation of the balance sheet as at the end of September 2003. At the end of October 2003, the exercise identified that Kyte appeared to have approximately £7.2 million of assets on its consolidated balance sheet that it was unable adequately to explain.
- 5.78 Kyte subsequently appointed the Forensic Accounting Unit of KPMG to conduct an investigation into the balance sheet misstatement.

Findings of KPMG Forensic investigation

- 5.79 KPMG set out its findings in its letter to Kyte dated 8 March 2004. The findings relate back to Kyte's accounting years ended 30 April 2001, 2002 and 2003, at each of which Kyte's consolidated balance sheet was misstated ("the Balance Sheet Misstatement").
- 5.80 Kyte has subsequently accepted the findings of KPMG and confirmed that its consolidated balance sheet for the year ended 30 April 2003 was misstated by £7,182,980.
- 5.81 In summary, KPMG identified the following items contributing to the Balance Sheet Misstatement:

5.81.1 A net overstatement of Kyte's profits totalling £3,594,158;

- 5.81.2 Misallocation of expenditure items for Kyte Broking Limited totalling £2,491,859;
- 5.81.3 Misclassification of a director's trading debt of £324,294 as a loan; and
- 5.81.4 Overpayment of £772,669 in respect of the redemption of fund/account managed on behalf of three of Kyte's directors.
- 5.82 The effect of correcting the Balance Sheet Misstatement on Kyte's balance sheet for the year ended 30 April 2003, as stated in its filed accounts, was that Kyte's profits were reduced by £717,027 and the shareholders' funds and the profit and loss reserve was reduced by £4,077,598. The effect of correcting the Balance Sheet Misstatement on Kyte's consolidated balance sheet for the year ended 30 April 2003 was that Kyte's profits were reduced by £21,338 and shareholders' funds and the profit and loss reserve was reduced by £4,873,566.
- 5.83 KPMG concluded that the main reason for the Balance Sheet Misstatement was the use of a "format adjustment" to produce a trial balance rather than individual adjustments to each ledger account. No explanations were provided in the journals used to make the format adjustment. This led to reconciling problems with the opening balances on Kyte's balance sheet.
- 5.84 KPMG also identified accounts such as "other debtors", "suspense accounts" and "holding accounts" where Kyte's finance department would put items when it was not immediately clear to which accounts they should be allocated. However, no proper reconciliation was performed on the items in these accounts so the balances would build up. At the end of the financial year, these accounts should have had a zero balance so the balances that had built up had to be cleared. Accordingly, given that no proper reconciliation was performed on these accounts, when the balances were cleared down to zero, the items were misallocated which resulted in inaccuracies in Kyte's financial statements and ultimately in the Balance Sheet Misstatement.
- 5.85 Kyte's failure to perform and complete accounting reconciliations (that is including the identification, investigation and clearing of outstanding reconciling items) and to ensure that the board was aware if they were not done, allowed inaccuracies in Kyte's accounting records to continue uncorrected and demonstrate that Kyte failed to take reasonable care to make and retain adequate records (including accounting records) in breach of SYSC 3.2.20R.

Kyte's awareness of problems with its accounting systems and controls

- 5.86 Although the FSA recognises that for the years when the Balance Sheet Misstatement occurred, Kyte's auditors signed off Kyte's financial statements as in their opinion giving a true and fair view of Kyte's state of affairs, and did not identify the errors subsequently revealed by the KPMG Forensic investigation, Kyte's auditors did make a number of qualifications in respect of Kyte's holding of client money. Further, Kyte's auditors brought to the attention of Kyte's senior management a number of matters and concerns in respect of Kyte's accounting function. In the FSA's view, both the audit qualifications and the other concerns raised by the auditors were warning signals that alerted Kyte to the fact that its accounting systems and controls were not functioning effectively nor to the standard required to ensure that Kyte was

complying with the applicable requirements and standards under the regulatory system.

- 5.87 The FSA considers that Kyte failed to take reasonable care to establish appropriate systems and controls as were appropriate to its business in breach of SYSC 3.1.1R, or to take reasonable care to make and retain adequate or accurate accounting records in breach of SYSC 3.2.20R. In the FSA's view, Kyte's accounting systems and controls were seriously inadequate and failed to operate effectively to ensure that Kyte accurately reported its financial statements throughout the period in question.
- 5.88 The primary responsibility for ensuring its compliance with the FSA's Rules rests with Kyte itself, albeit acting through its employees and, in particular, its approved persons. The failings by the firm are set out below. Kyte has sought to pass responsibility for failings to the former Chief Financial Officer who was also a director. However, any actions or failings by the director responsible for the relevant area are clearly attributable to, and amount to actions/failures by, Kyte itself.
- 5.89 Kyte's board has stated that it relied on assurances provided by the Chief Financial Officer, in particular that its financial position was accurately recorded. However, as stated above, in the FSA's view the Chief Financial Officer's actions and failings are attributable to, and amount to, actions/failures by Kyte itself. Further and in any event, Kyte's senior management was aware that it placed too much reliance on certain key individuals at Kyte, in particular the Chief Financial Officer, throughout the period in question but nevertheless continued to rely on the Chief Financial Officer to assume responsibility for Kyte's financial statements and the management of all financial accounting within Kyte.
- 5.90 Further, although Kyte accepted that it was overly reliant on key individuals it only took steps to help resolve its resourcing difficulties in response to concerns raised by its auditors and SFA. Kyte's auditors made Kyte's board aware of its concerns regarding the reliance on key individuals and segregation of duties on separate occasions in April 2000, March 2001, July 2001, July 2002 and December 2002. SFA Supervision similarly raised concerns about the responsibilities assumed by staff and the Chief Financial Officer in Kyte's finance department in July 2000 and February 2001.
- 5.91 Kyte's auditors identified that the Chief Financial Officer assumed significant responsibilities and was required to provide significant input into a number of routine processes in Kyte's finance department, which decreased the effectiveness of him performing an independent review. Accordingly, the key control that Kyte had in place to ensure that its financial position was accurately recorded, failed to operate effectively.
- 5.92 Kyte accepts that the non-performance of reconciliations were crucial to the Balance Sheet Misstatement. Kyte's systems and controls should have operated to ensure that accounting reconciliations were performed and that it was made aware if they were not.
- 5.93 In the period from N2 to September 2003, the management information presented to Kyte's board each month provided only limited information and omitted to include any details of key control statistics such as the value and age of reconciling items and

instances of client money exceptions. Further, Kyte's board papers failed to provide regularly any details of compliance-related issues.

- 5.94 In March 2001, July 2001 and May 2003, Kyte's auditors made Kyte aware that the management information was limited as described above and in June 2002, Kyte's board itself recognised its need to be provided with clear, timely and accurate financial information.
- 5.95 However, in September 2003 and following its audit for the year ended 30 April 2003, Kyte's auditors made a presentation to Kyte's senior management which brought to Kyte's attention areas where the auditors believed improvement and continual monitoring was required. Matters identified for attention included problems in respect of Kyte's accounting records. In particular, during the year the monthly management accounts presented to Kyte's board were not agreed or reconciled to the financial information contained in the SAGE accounting system.
- 5.96 Further, there appeared to be little formal review process and controls surrounding journal posting. Kyte's auditors had for example identified a number of mis-postings of income/costs to the wrong entity and other journals were identified where the debits and credits were posted the wrong way around.
- 5.97 Kyte's auditors also identified in September 2003 that there was no audit trail being maintained to explain the balances posted to each account, or the rationale behind the journals. Certain classes of income and expenditure posted to a particular SAGE account one year/month were often posted to a completely different account the next year/month. Consequently, the ability to make useful comparisons between Kyte's performance at an entity level and to assess whether numbers corresponded to management's understanding of the business was severely curtailed.
- 5.98 Kyte's auditors also noted that inter-company accounts were not reconciled on a regular basis and discipline was not maintained to ensure that an entry in one entity's inter-company account was mirrored in the other entity's account.
- 5.99 Kyte was also informed that during the year there was no formal reconciliation process between ATIS and SAGE. This lack of reconciliation was a significant contributing factor in an invoice of £47,000 that was neither raised nor posted to SAGE. However, Kyte's auditors noted that with the replacement of ATIS by UBIX in July 2003, a formal reconciliation process would be implemented.
- 5.100 In its audit report for the year ended 30 April 2004, Kyte's auditors concluded that:
- "An in depth review of the accounting records during the year identified certain prior year adjustments. These resulted from a breakdown in the accounting procedures and controls and as a result, in our opinion, proper accounting records of [Kyte] were not maintained until the position was rectified on 1 September 2003".*
- 5.101 The FSA considers that Kyte received strong warning signals alerting it to problems with its accounting systems and controls and that Kyte should have been aware that its accounting reconciliations over the financial years ended 30 April 2001, 2002 and 2003 were inadequate. The failure to carry out and complete its accounting

reconciliations, which includes the identification, investigation and clearing of outstanding reconciling items, led to the Balance Sheet Misstatement.

- 5.102 In addition to the above warning signals including those relating to resourcing and management information, and the fact that from 2000 onwards, Kyte's auditors, SFA and the FSA made Kyte aware of serious issues in respect of its client money protection, Kyte was aware of a number of other concerns in respect of its accounting function that its auditors considered to be of sufficient importance to bring to Kyte's attention. Taken together, these were strong and repeated warning signals over the relevant period that alerted Kyte to fundamental problems with its accounting systems and controls. By failing to take adequate steps to address these problems in a timely fashion, and by failing in a proactive manner and in circumstances in which Kyte was a growing company to take reasonable steps to ensure that those problems did not recur and new issues did not arise, Kyte failed in the period from N2 to September 2003 to take reasonable steps to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3 of the FSA's Principles for Businesses.

Representations

- 5.103 In its representations in relation to the Warning Notice, Kyte informed the FSA that it took its regulatory responsibilities and the issues raised in this notice seriously. It had taken numerous steps to employ external advisers and extra internal staff to address the issues raised and did not seek to trivialise those matters. Nevertheless, Kyte represented that the issues arose at a time of significant business growth placing certain pressures on the business. Kyte accepted, with the benefit of hindsight, it did not deal appropriately with those aspects of business growth which challenged Kyte's handling of the matters referred to in this notice. Accordingly, Kyte accepted liability for breaches of the rules as set out in paragraph 1.2 above.
- 5.104 Having accepted the rule breaches, Kyte represented that the Warning Notice did not present a balanced view of Kyte's failings or the steps they had taken to remedy the situation.
- 5.105 Kyte represented it did not receive strong and repeated warnings from Kyte's auditors and the Chief Financial Officer. Kyte informed the FSA that the warnings received were muted and not delivered in a manner which would have alerted Kyte to the seriousness of the issues.
- 5.106 Kyte further rejected the allegation that it failed to heed the warnings and the implication that this represented a culture of complacency. Kyte represented that it was not complacent about rectifying client money issues although the firm accepted that some matters took longer to achieve full compliance than others.
- 5.107 Kyte represented that client money issues and the balance sheet misstatement issue are not linked and should not be represented as such in any statutory notice. They confirmed to the FSA that the backgrounds to both matters are different.
- 5.108 In relation to client money issues, Kyte further represented that the Warning Notice overstated the extent to which client money was put at risk. Kyte informed the FSA that while not a replacement for back office controls, it considered the front office to

be the primary protector of client assets. Kyte represented that it maintained stringent front office risk controls and that coupled with Kyte's largely professional customer base and the specialist nature of its transactions, made the likelihood of loss remote. Kyte informed the FSA that it had not suffered any default from its front office in the last 10 years.

- 5.109 Kyte accepted that its client money procedures were not as robust as they should have been. Kyte informed the FSA that at the material time Kyte was operating a back office system which was not sufficiently technically advanced to meet the demands of a growing business. This resulted in the client money issues raised and although Kyte accepted the matters had not been dealt with as swiftly as they should have been, Kyte represented that it was nevertheless not delinquent in its handling of the issue.
- 5.110 In relation to the management by the board of the issues raised in this notice, Kyte represented that the board exercised a detailed and significant degree of scrutiny of the management accounts. Kyte further informed the FSA that the board relied on the Chief Financial Officer and Kyte's auditors and sought and received assurances from both parties. Kyte represented that the board were misled by those parties.
- 5.111 In relation to legal matters, Kyte argued that there was a lack of coherence at the FSA in its policy on charging some firms under the rules only, others under the principles only and others under both. Kyte represented that in relation to this matter, the rules are sufficient to cover the breaches alleged.
- 5.112 Kyte also represented that public censure was the appropriate sanction. In the alternative, Kyte argued that the proposed penalty was grossly disproportionate.
- 5.113 Kyte informed the FSA that it took issue with the written representations made by Kyte's auditors.

FSA's Findings and Conclusions

- 5.114 The FSA acknowledges Kyte's admissions and notes that Kyte did attempt to redress some of the issues identified although not in as timely a manner nor as efficiently as the FSA considers appropriate.
- 5.115 The FSA notes the points made by Kyte in relation to its view of the Warning Notice. Where appropriate, the FSA's reasons, recorded in this Final Notice, have been amended to reflect those points
- 5.116 The FSA does not criticise the lack of consideration of topics by Kyte but finds that its actions were not timely, thorough or far reaching enough to deal adequately with the issues.
- 5.117 The FSA accepts that the client money issue and balance sheet misstatement issue are not causatively linked although both are illustrative of failures of systems and controls and a breach of Principle 3.
- 5.118 The fact that Kyte's independent auditors qualified their reports to the FSA relating to the firm's ability to comply with the firm's client money rules for the year ended 30 April 2000 and the subsequent years ended 30 April 2001, 2002 and 2003 alerted Kyte to the fact that it was experiencing serious problems with its systems and

controls in respect of the FSA's client money and client asset Rules. The qualified audits were also, in the FSA's view, warning signals to Kyte that it might not have in place proper systems and controls, including structure and resources, for its accounting function, generally.

- 5.119 There is clear evidence that since 2000 Kyte has been made aware on numerous occasions of concerns regarding its internal systems and controls, from its auditors, SFA and the FSA. The FSA found that the repeated warnings given to Kyte were such that they should have alerted it to the seriousness of the issues.
- 5.120 Those concerns related to many aspects of Kyte's business, including Kyte's client money systems and controls and accounting systems and controls as well as the failure of Kyte to address concerns previously raised in respect of those matters.
- 5.121 Kyte believes it always responded appropriately and proportionately to the concerns raised and that it was perfectly reasonable for it to rely on other parties (including its staff, its Finance Director and its auditors) in order to be satisfied it had taken reasonable care to establish and maintain effective systems and controls. Further, Kyte is of the view that the fact that SFA/the FSA did not revert to Kyte after it had raised concerns (to which Kyte had responded) meant it was reasonable for Kyte to conclude that SFA/the FSA was satisfied that Kyte had addressed the regulator's concerns and had taken reasonable care to establish and maintain effective systems for compliance with applicable standards and requirements under the regulatory system. The FSA considers that it was unreasonable for Kyte to hold this belief in the circumstances, particularly as SFA/the FSA raised similar concerns in successive years and that Kyte should have been proactive in ensuring that its systems and controls were of the standard reasonably to be expected of an FSA regulated firm.
- 5.122 The FSA considers Kyte's failure to ensure that accounting reconciliations were regularly performed and completed (that is, including the identification, investigation and clearing of outstanding reconciling items), and to ensure that the board were informed if they were not done, demonstrates Kyte's shortcomings in respect of its accounting systems and controls.
- 5.123 The FSA notes the points made by Kyte in relation to its front office systems and customer base. However, the shortcomings in Kyte's systems and controls and its failure to arrange adequate protection of client assets risked customer loss. That no actual customer loss arose does not excuse Kyte's conduct and to give too much weight to the factor detracts from the preventative policy behind the rule.
- 5.124 The FSA does not accept Kyte's representations on the robust nature of its front office systems being sufficient to minimise the impact on potential client money loss. The weakness of Kyte's back office systems increased the possibility of risk to client monies, the consequences of which would have been serious in the event of Kyte's failure. The inability of Kyte to identify, when required, client assets, without the assistance of external forensic advisers, illustrates the weakness of the system.
- 5.125 The FSA makes no finding nor makes any comment on the representations made by Kyte in relation to its auditors.

- 5.126 The FSA considers both the principles and rules apply to the issues in this matter and encapsulate the misconduct identified. In the context of this matter, the application of the principles and rules referred to above does not represent a duplication of charges. Furthermore, the applicability of either or both of the principles and rules does not indicate that the allegations are more serious than would otherwise be the case and has not resulted in an increased penalty.
- 5.127 The FSA finds that a fine is the appropriate penalty and does not consider the penalty of £250,000 disproportionately high.
- 5.128 For the reasons set out above, and having particular regard to the factors listed below, the FSA is of the view that in the period from N2 to October 2003, Kyte failed adequately to ensure that problems with its systems and controls did not recur and new issues did not arise. Accordingly, the FSA considers that Kyte failed to take reasonable care to organise and control its affairs responsibly and effectively, contrary to Principle 3 of the FSA's Principles for Businesses. The factors referred to are:
- 5.128.1 The period of time over which Kyte's failures occurred, namely December 2001 to October 2003;
- 5.128.2 Kyte's failure promptly and effectively to remedy issues raised in qualified audits and papers (such as management letters) its auditors addressed to Kyte's board;
- 5.128.3 The repeated warning signals made by its auditors and SFA/the FSA, both before and after N2, alerting Kyte to problems with its systems and controls; and
- 5.128.4 The fact that concerns were being raised about Kyte's systems and controls in circumstances in which Kyte was growing.
- 5.129 In addition, the FSA considers that the facts and matters and specific Rule breaches described in paragraphs 5.17 to 5.70 above in relation to Kyte's holding of client money demonstrates that Kyte failed to take reasonable care to organise and control its affairs responsibly and effectively and to arrange adequate protection for its clients' assets when it was responsible for them, contrary to Principles 3 and 10 of the FSA's Principles for Businesses.

6 PENALTY

- 6.1 The FSA's policy on the imposition of financial penalties is set out in Chapter 13 of ENF. The principal purpose of the imposition of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefits of compliant behaviour.
- 6.2 It is stated at ENF 13.3.4G that the criteria listed in Chapter 13 of ENF are not exhaustive and all relevant circumstances of the case will be taken into consideration.

- 6.3 Accordingly, in determining whether a financial penalty is appropriate and its level, the FSA is required to consider all the relevant circumstances of the case. The FSA considers the following factors to be particularly relevant in this case.
- 6.4 The matters set out in paragraph 5.128 above add to the seriousness of Kyte's breaches. In particular, in the FSA's view, Kyte received strong and clear warning signals over the relevant period yet, prior to October 2003, it failed properly to address the concerns or improve its systems and controls and failed sufficiently to arrange adequate protection for its clients' assets, thereby risking customer loss.
- 6.5 In mitigation of the seriousness of Kyte's failings, the FSA accepts that, despite Kyte having allowed the failings to persist over several years, its conduct was not deliberate. Further, Kyte cooperated with the Enforcement investigation and has taken remedial action to improve its systems and controls to a more appropriate standard. The FSA also recognises that no customers have suffered actual loss as a result of Kyte's failings.
- 6.6 In all the circumstances, and taking into account action taken by previous financial regulators and by the FSA, the FSA considers it appropriate and proportionate to impose a financial penalty on Kyte of £250,000.

7 CONCLUSION

- 7.1 The FSA considers the duty on firms to organise and control their affairs responsibly and effectively by putting in place proper systems and controls, not least to secure adequate protection for clients' assets, to be a key safeguard in promoting the FSA's statutory objectives of securing the appropriate degree of protection for consumers and of maintaining market confidence in the financial system. Any failure to arrange adequate protection for clients' assets gives rise to a risk of customer loss.
- 7.2 Kyte's failings in this regard, particularly when coupled with the matters set out in paragraph 5.128 above, and after taking into account the mitigation set out in paragraph 6.5 above, are such that the imposition of a financial penalty of £250,000 is proportionate and appropriate in all the circumstances.

IMPORTANT NOTICES

This Final Notice is given to you under section 390 of the Act.

Manner and time for payment

The financial penalty must be paid in full by Kyte to the FSA by no later than 5pm on 7 September 2006, being not less than 14 days from the date of this Final Notice.

If the financial penalty is not paid

If all or any of the financial penalty is outstanding on 7 September 2006, the FSA may recover the outstanding amount as a debt owed by Kyte and due to the FSA.

Publicity

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 or prejudicial to the interests of consumers.

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

FSA contacts

For more information concerning this matter generally, you should contact Pam Cross (tel: 020 7066 1216/fax: 020 7066 9748) or John Myers (tel: 020 7066 2388/fax: 020 7066 2389)

Georgina Philippou
Head of Retail 2
FSA Enforcement Division

1. COB 9.3.37R stated that:

A firm must, except to the extent permitted by the client money rules, hold client money separate from the firm's money.

2. COB 9.3.86R stated that:

A firm which undertakes any contingent liability investment for clients through an exchange, clearing house, intermediate broker or OTC counterparty must, before the client transaction account is opened with the exchange, clearing house, intermediate broker or OTC counterparty:

- (1) notify the person with whom the account is to be opened that the firm is under an obligation to keep client money separate from the firm's own money, placing client money in a client bank account;*
- (2) instruct the person with whom the account is to be opened that any money paid to it in respect of that transaction is to be credited to the firm's client transaction account; and*
- (3) require the person with whom the account is to be opened to acknowledge in writing that the firm's client transaction account is not to be combined with any other account, nor is any right of set-off to be exercised by that person against money credited to the client transaction account in respect of any sum owed to that person on any other account.*

Client money calculation

3. COB 9.3.100R stated that:

Each business day, a firm that adopts the normal approach in accordance with COB 9.3.42R must:

- (1) check whether its client money resource, being the aggregate balance on the firm's client bank accounts, as at the close of business on the previous business day, was at least equal to the client money requirement, as defined in COB 9.3.105R, as at the close of business on that day; and*
- (2) ensure that:*
 - (a) any shortfall is paid into a client bank account by the close of business on the day the calculation is performed; or*
 - (b) any excess is withdrawn within the same time period unless COB 9.3.39R or COB 9.3.40R applies.*

4. COB 9.3.105R stated that:

The client money requirement is either:

- (1) *(subject to COB 9.3.119R) the sum of, for all clients:*
 - (a) *individual client balances calculated in accordance with COB 9.3.106R, excluding:*
 - (i) *the individual client balances which are negative (that is debtors); and*
 - (ii) *clients' equity balance calculated in accordance with COB 9.3.113R; and*
 - (b) *the totalled margined transaction requirement, calculated in accordance with COB 9.3.115R; or*
- (2) *the sum of:*
 - (a) *for each client bank account:*
 - (i) *the amount which the firm's records show as held on that account; and*
 - (ii) *an amount that offsets each negative net amount which the firm's records show attributed to that account for an individual client; and*
 - (b) *the total margined transaction requirement, which is calculated in accordance with COB 9.3.115R.*

5. COB 9.3.121R stated that:

A firm must notify the FSA immediately if it is unable to, or does not, perform the daily calculation required by COB 9.3.100R or COB 9.3.101R.

Client money balance reconciliation

6. COB 9.3.123R stated that:

A firm must perform a reconciliation of the client money balances which it holds, or for which it is responsible, as frequently as is necessary to ensure the accuracy of its record of money so held, and no less than once in every 25 business days.

7. COB 9.3.125R stated that:

A firm must complete the reconciliation of client money within ten business days of the date to which the reconciliation relates.

8. COB 9.3.126R stated that:

A firm must compare:

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

(2) *the balance, currency by currency, on each client transaction account³ as recorded by the firm, with the balance on that account as set out in the statement or other form of confirmation issued by the person with whom the account is held;*

and identify any discrepancies between them.

9. COB 9.3.131R stated that:

A firm must notify the FSA as soon as possible if it is unable to comply with any of the requirements of COB 9.3.123R, COB 9.3.125R, COB 9.3.126R, COB 9.3.128R and COB 9.3.129R.

³ Definition of client transaction account – *"(in relation to a firm and an exchange, clearing house or intermediate broker) an account maintained by the exchange, clearing house or intermediate broker, as the case may be, in respect of transactions in contingent liability investments undertaken by the firm with or for its clients"*.