
FINAL NOTICE

To: **THORNTONS LAW LLP**

Of: **Whitehall House
33 Yeaman Shore
Dundee
DD1 4BJ**

Date: **22 September 2010**

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS (the “FSA”) gives Thorntons Law LLP final notice about the imposition of a financial penalty:

1. PENALTY

- 1.1. The FSA gave Thorntons Law LLP (“Thorntons”) a Decision Notice on 21 September 2010 which notified Thorntons that pursuant to section 206 of the Financial Services and Markets Act 2000 (the “Act”), the FSA had decided to impose a financial penalty of £35,000 on Thorntons in respect of breaches of Principles 3, 7 and 9 of the FSA’s Principles for Businesses (the “Principles”) during the period between November 2007 and August 2008 (the “relevant period”).
- 1.2. Thorntons confirmed on 1 September 2010 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, the FSA imposed a financial penalty on Thorntons in the amount of £35,000.

- 1.4. Thorntons agreed to settle at an early stage of the FSA's investigation and therefore qualified for a 30% (Stage 1) discount under the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a financial penalty of £50,000 on Thorntons.
- 1.5. The FSA has required Thorntons to appoint a skilled person in accordance with section 166 of the Act to conduct a review of all sales of structured products backed by Lehman Brothers ("Lehmans") in the relevant period. Thorntons has committed to ensuring that appropriate redress will be provided to any customers that the skilled person identifies have received unsuitable advice.

2. REASONS FOR THE ACTION

- 2.1. The FSA has decided to impose a financial penalty on the basis of the facts and matters described in more detail in section 4, below. These failings relate to advice given by Thorntons in relation to structured products backed by Lehmans during the relevant period. In the relevant period, Thorntons made 32 recommendations to 22 of its customers to invest in Lehmans-backed structured products.
- 2.2. Specifically, during the relevant period, in relation to the sale of structured products backed by Lehmans, Thorntons failed to:
 - (1) take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3;
 - (2) pay due regard to the information needs of its customers, and communicate information to them in a way which was clear, fair and not misleading, in breach of Principle 7; and
 - (3) take reasonable care to ensure the suitability of its advice for customers who were entitled to rely upon its judgment, in breach of Principle 9.
- 2.3. These failings also amounted to breaches by Thorntons of the provisions of the FSA Handbook set out in the Annex to this Notice.
- 2.4. The FSA considers Thorntons' failings to be serious because:
 - (1) its failings exposed its customers, including customers with limited capacity for loss, to an unacceptably high level of risk in the event of the collapse of Lehmans;
 - (2) its failings resulted in an unacceptably high risk of customers being misled about the risks of investing in Lehmans-backed structured products and not being able to make an informed choice about whether or not to invest in such products; and
 - (3) the failings related not only to suitability and customer communication but also to compliance monitoring, record-keeping, the collation of sufficient management information and competence monitoring procedures.

2.5. In deciding the appropriate disciplinary sanction, the FSA recognises the following factors which mitigate the seriousness of the findings:

- (1) Thorntons took a proactive approach to ensure that its customers were kept informed about the situation regarding their investments in structured products backed by Lehmans following Lehmans' insolvency. In addition, Thorntons made changes to its suitability letters to explain the counterparty risk following the collapse of Lehmans and prior to the FSA's visit;
- (2) Thorntons made further changes to its systems and controls, record-keeping, training and competence and compliance arrangements after it was visited by the FSA. Thorntons also instructed an external compliance consultant to undertake a review of the systems and controls relevant to its sales procedures;
- (3) Thorntons has co-operated fully with the FSA's investigation; and
- (4) Thorntons agreed promptly to make appropriate redress to any customers identified as having received unsuitable advice by a skilled person imposed by the FSA.

3. RELEVANT STATUTORY AND REGULATORY PROVISIONS

- 3.1. The relevant statutory and regulatory provisions are as set out in the Annex to this Notice.

4. FACTS AND MATTERS RELIED ON

BACKGROUND

Structured products

- 4.1. The Lehmans-backed structured products referred to in this Notice were investment vehicles whose value was linked to an index or an asset class for a fixed period of time, and which used derivatives to provide a return based on the performance of the asset class/index over the period, usually with a full or partial guarantee of return of capital at maturity. The capital guarantee was provided by Lehmans.
- 4.2. The risks relating to these types of structured products included:
- (1) investment risk – investment returns and in some cases the return of capital were dependent on the performance of market indices;
 - (2) credit risk – the capital guarantee and investment returns were subject to counterparty risk; and
 - (3) liquidity risk – the restrictions on the ability to realise the investment during the investment term to meet a need for capital or according to market sentiment.
- 4.3. Further, the nature of structured products, and the risks stated above, highlighted the need for appropriate diversification of customer portfolios to mitigate concentration

risk i.e. the risk involved in the customer holding a significant percentage of their investments in one structured product, structured products backed by the same counterparty, or structured investment products as a product type, whether or not (in each case) the relevant products were capital-protected.

The Firm

- 4.4. Thorntons is a law firm consisting of 28 partners based in Dundee, Scotland, and which provides investment advice to customers under the brand name 'Thorntons Investment Services'. Thorntons was authorised by the FSA on 1 December 2004 to conduct designated investment business and regulated home finance business and from 6 April 2007 has also been permitted to conduct regulated business in relation to home reversion plans.
- 4.5. During the relevant period, Thorntons had two individuals approved by the FSA to conduct significant influence functions at Thorntons and two other individuals, also approved by the FSA, who gave investment advice to Thorntons' customers.

Thematic review

- 4.6. The FSA visited Thorntons on 12 August 2009 as part of its thematic review of advice given in relation to structured products backed by Lehmans between November 2007 and August 2008. During the relevant period, Thorntons sold 32 structured products backed by Lehmans to 22 of its customers. Of the 32 recommendations made by Thorntons, 20 were for products with a guarantee made by Lehmans of return of capital at maturity. These sales of Lehmans-backed structured products represented 2.46% of Thorntons' income from its regulated business and concerned less than 1% of its regulated client base. The FSA reviewed 15 of the 28 customer files, relating to the 32 transactions and concluded that recommendations to eight of the customers were unsuitable. Inadequate records in a further two files meant that the FSA could not reach any definitive conclusion. The FSA also identified concerns about Thorntons' systems and controls and monitoring of advice to customers to invest in structured products backed by Lehmans.

Investigation

- 4.7. Since the visit referred to above, the FSA has conducted an investigation into Thorntons to review its compliance with relevant regulatory requirements and standards in connection with its business systems in relation to the sale of Lehmans-backed structured products during the relevant period. As a result of this investigation, the FSA identified deficiencies in relation to the quality of advice provided by Thorntons on the sale of Lehmans-backed structured products and in its related compliance systems and controls, competence monitoring procedures and management information.

CONDUCT IN ISSUE

Suitability of advice

4.8. Thorntons breached Principle 9 during the relevant period in that, of the 15 files reviewed by the FSA, eight were found to contain unsuitable advice and the FSA believes that the evidence shows that Thorntons did not take reasonable care in this regard. Specifically:

- (1) Thorntons made recommendations of structured investment products to customers who had no capacity for loss or for whom the recommendations to invest in Lehmans backed structured products resulted in the risk level of their investment portfolio being at odds with their attitude to risk;
- (2) In some cases, Thorntons failed to ensure that it obtained sufficient personal and financial information about its customers to assess the suitability of its recommendations to enter into investment contracts. During the relevant period there were occasions on which the advisers failed to update pages of a customer fact find, including the attitude to risk, customer needs and customer circumstances sections. On one case, a letter making recommendations was sent out before the fact find was updated;
- (3) In some cases, Thorntons recommended a high concentration of customers' savings and investment portfolios were placed in structured products generally, which exposed customers to an avoidable higher risk of financial loss. One customer had 45% of his wealth invested in a single structured product; and
- (4) In some cases, Thorntons failed to consider or evidence that it had considered other products that may have suited the customers' needs.

Disclosure of risks to customers

4.9. Thorntons breached Principle 7 during the relevant period in that Thorntons failed to pay due regard to the information needs of its customers, and communicate information to them in a way which was clear, fair and not misleading. Suitability letters sent to customers contained such standard phrases as "*absolutely no risk to capital*" to describe Lehmans-backed structured products because, based on the A rating of the counterparty to the transactions, the advisers did not believe that there was any risk of counterparty failure. These phrases were misleading, as, in the event of counterparty failure, the customer's capital was at risk. This risk crystallised when Lehmans' insolvency led to Thorntons' customers losing some or all of the capital invested. This failing also led to an unacceptably high risk that customers could not make an informed choice about whether or not to invest in a structured product backed by Lehmans.

Hindsight

4.10. For the avoidance of doubt, as to both suitability and disclosure, the FSA has, in issuing this Notice, in accordance with its document entitled "*Quality of Advice on structured investment products*", issued in October 2009, not applied the benefit of hindsight to the period before Lehman's insolvency. As stated in that document "[w]here a customer was willing to take counterparty risk we believe that it was not

reasonable to expect advisers to distinguish between the different financial strength of different counterparties that were rated A or above in this period.”

Systems and controls

- 4.11. In accordance with Principle 3, Thorntons was required to take reasonable care to establish and maintain appropriate systems and controls to ensure that the advice that it gave to customers to invest in structured products backed by Lehmans was suitable. The investigation team has reviewed Thornton’s systems and controls and identified the following failings.

Record keeping

- 4.12. It was important that Thorntons had adequate systems and controls in place to ensure that its advisers gathered and maintained appropriate personal and financial information from customers and other information relevant to evidence the suitability of its recommendations. The investigation team’s review has established that Thorntons’ systems and controls were inadequate because:
- (1) advisers failed to retain evidence of consideration of alternative products which may have met a customer’s needs;
 - (2) in some cases, advisers failed to demonstrate that information on a factfind was updated in relation to each new recommendation. Rather, the adviser would confirm if anything had changed and update the client’s file accordingly. Compliance failings in relation to the fact finding process had been identified and raised with the adviser; and
 - (3) in one case, information about a customers circumstances was only collected after a recommendation had been made.
- 4.13. These failings occurred despite the fact that they were in breach of Thorntons’ documented procedures manual.

Compliance arrangements

- 4.14. Thorntons failed to put in place adequate compliance monitoring arrangements and controls in respect of its sales of Lehmans-backed structured products. As a consequence of this failing, Thorntons was unable properly to assess its sales of those products and to take reasonable care to ensure that the recommendations provided by its advisers were suitable for the needs of its customers.
- 4.15. The FSA has identified the following failings in Thorntons’ compliance arrangements:
- (1) Compliance staff did not always consider themselves to be sufficiently knowledgeable about structured products to challenge the recommendations

given to customers by advisers. Compliance staff stated that they would, if necessary, make use of external expertise to challenge recommendations on a technical basis. Whilst Thorntons did approach third parties for advice with regard to structured products after the relevant period and following the collapse of Lehmans, it does not appear that Thorntons had approached a third party prior to the collapse of Lehmans for advice specifically with regards to the suitability of recommendations made by Thorntons' advisers in relation to structured products;

- (2) file reviews were ineffective in identifying and/or rectifying failures to obtain and record pertinent customer information or product research. More detail on these advice process record-keeping failings is contained in paragraphs 4.12 and 4.13 above; and
- (3) file reviews failed to ensure that the proportion of each customer's savings and investment portfolio placed in Lehmans-backed products or structured investment products generally was not excessive in relation to that customer's needs and objectives. Of the 15 files reviewed by the FSA, six were found to have an unsuitable concentration of their portfolio invested in structured products.

Management information

- 4.16. Thorntons failed to put in place adequate systems and controls to collate sufficient management information about structured products such that it failed to highlight a material increase in recommendations to invest Lehmans-backed structured products in 2008.

Training and competence

- 4.17. Thorntons failed to implement an adequate process for reviewing the ongoing competence of advisers or compliance staff in relation to Lehmans-backed structured products:
 - (1) compliance staff had not discussed training needs regarding structured products with Thorntons' most experienced adviser; and
 - (2) ongoing competence of compliance staff was assessed largely through day to day interaction. However, this was ineffective as management were unaware of the level of knowledge of structured products within the compliance function during the relevant period and therefore failed to ensure that it was adequate.

5. ANALYSIS OF BREACHES

- 5.1. For the reasons set out in paragraphs 4.7 to 4.17 above, the FSA considers that in respect of the sale of Lehmans-backed structured products, Thorntons has failed to:
 - (1) take reasonable care to organise, control and risk-manage, responsibly and effectively, the suitability of its advice, management information, compliance

checking, record-keeping and competence monitoring procedures in relation to its investment business, in breach of Principle 3;

- (2) pay due regard to the information needs of its clients, and communicate information to them in a way which was clear, fair and not misleading, specifically by failing to adequately and consistently disclose the counterparty risk inherent in structured products and using misleading phrases to describe structured products in suitability letters to some of its customers, in breach of Principle 7; and
- (3) take reasonable care to ensure the suitability of its advice to customers in breach of Principle 9 by failing to:
 - (a) record sufficient personal and financial information about its customers to assess suitability;
 - (b) properly assess customers' attitude to risk;
 - (c) take account of every risk in the sale of Lehman-backed structured products; and
 - (d) consider or evidence that it had considered other products that may have suited the customers' needs more closely.

6. ANALYSIS OF SANCTION

- 6.1. The FSA's relevant policy on the imposition of financial penalties as detailed in this Notice is set out in Chapter 6 of the version of the FSA's Decision Procedure and Penalties Manual ("DEPP") in force prior to 6 March 2010, which formed part of the FSA Handbook during the relevant period. All references to DEPP in this section are references to that version of DEPP. In determining the appropriate level of financial penalty the FSA has also had regard to Chapter 7 of its Enforcement Guide.
- 6.2. The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring authorised firms who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches and demonstrating generally the benefits of compliant behaviour (DEPP 6.1.2G).
- 6.3. The FSA will consider the full circumstances of each case when determining whether or not to take action for a financial penalty. DEPP 6.5.2G set out, as guidance, a non-exhaustive list of factors that may be of relevance in determining the level of a financial penalty. The FSA considers that the following factors are particularly relevant in this case.

Deterrence (DEPP 6.5.2(1)G)

- 6.4. The financial penalty will deter Thorntons from further breaches of regulatory rules and Principles. In addition it will promote high standards of regulatory conduct by deterring other firms from committing similar breaches and demonstrating generally the benefit of compliant behaviour.

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

- 6.5. In determining the appropriate sanction, the FSA has had regard to the seriousness of the breaches by Thorntons, including the nature of the requirements breached, the number and duration of the breaches, the number of customers who have suffered or may suffer financial loss and the fact that the breaches revealed serious failings in Thorntons' systems and controls.

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

- 6.6. The FSA has determined that Thorntons did not deliberately or recklessly contravene regulatory requirements.

The size, financial resources and other circumstances of the person on whom the penalty is to be imposed (DEPP 6.5.2(5)G)

- 6.7. There is no evidence that Thorntons is unable to pay the financial penalty.

The amount of benefit gained or loss avoided as a result of the breaches (DEPP 6.5.2(6)G)

- 6.8. The FSA has taken account of the volume of relevant business done and income made by Thorntons from the sale of Lehmans-backed structured products in the relevant period which amounted to £25,733.43.

Conduct following the breaches (DEPP 6.5.2(8)G)

- 6.9. The FSA has taken into consideration the mitigating factors referred to in paragraph 2.4 above and that Thorntons has been open and fully co-operative with the FSA's investigation.

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

- 6.10. The fact that Thorntons has not been the subject of previous disciplinary action by the FSA has been taken into account.

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

- 6.11. In determining the level of financial penalty, the FSA has taken into account penalties imposed by the FSA on other authorised persons for similar behaviour.
- 6.12. The FSA, having regard to all the circumstances, considers the appropriate level of financial penalty to be £50,000 before any discount for early settlement.

7. DECISION MAKERS

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

8. IMPORTANT

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

Manner of and time for Payment

- 8.2. The financial penalty must be paid in full by Thorntons to the FSA by no later than 6 October 2010, 14 days from the date of the Final Notice.

If the financial penalty if not paid

- 8.3. If all or any of the financial penalty is outstanding on 7 October 2010, the FSA may recover the outstanding amount as a debt owed by Thorntons to the FSA and due to the FSA

Publicity

- 8.4. 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 Thorntons or prejudicial to the interests of consumers.
- 8.5. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

- 8.6. For more information concerning this matter generally, Thorntons should contact Mario Theodosiou at the FSA (direct line: 020 7066 5914 / email: mario.theodosiou@fsa.gov.uk).

Tom Spender
FSA Enforcement and Financial Crime Division

ANNEX A

RELEVANT STATUTORY PROVISIONS, REGULATORY REQUIREMENTS AND GUIDANCE

1. Statutory provisions

- 1.1. The FSA's statutory objectives, set out in section 2(2) of the Act, include the protection of consumers.
- 1.2. Section 206(1) of the Act provides:

“If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act ... it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate”.
- 1.3. Section 138 of the Act provides that the FSA may make such rules applying to authorised persons with respect to the carrying on by them of regulated activities as appear to it to be necessary or expedient for the purpose of protecting consumers.

2. Relevant Handbook provisions

In exercising its power to impose a financial penalty, the FSA must have regard to relevant provisions in the FSA Handbook. The main provisions relevant to the action specified above are set out below.

3. Principles for Businesses

- 3.1. Under the FSA's rule-making powers as referred to above, the FSA has published in the FSA Handbook the Principles, which apply in whole, or in part, to all authorised firms.
- 3.2. The Principles are a general statement of the fundamental obligations of authorised firms under the regulatory system and reflect the FSA's regulatory objectives. An authorised firm may be liable to disciplinary sanction where it is in breach of the Principles.
- 3.3. The Principles relevant to this matter are:
 - (1) Principle 3 which provides that:

“A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems”;
 - (2) Principle 7 which provides that:

“A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading”; and
 - (3) Principle 9 which provides that:

“A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.”

- 3.4. The procedures to be followed in relation to the imposition of a financial penalty are set out in section 207 and 208 of the Act.

4. Conduct of Business

- 4.1. The Conduct of Business Sourcebook (“COBS”), which is part of the FSA Handbook, applied to authorised firms with effect from 1 November 2007.

- 4.2. All of the provisions of COBS set out below apply in relation to designated investment business (which includes the advice provided by Thorntons in relation to the Lehmans-backed products they sold, which were designated investments for the purposes of COBS).

- 4.3. COBS 4.2.1R requires an authorised firm to ensure that a communication to a client is fair, clear and not misleading.

- 4.4. COBS 4.5.2R requires that information provided by an authorised firm to retail clients is accurate and, in particular, does not emphasise any potential benefits of an investment without also giving a fair and prominent indication of any relevant risks.

- 4.5. COBS 9.2.1R provides that:

“(1) A firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.

(2) When making the personal recommendation or managing his investments, the firm must obtain the necessary information regarding the client's:

(a) knowledge and experience in the investment field relevant to the specific type of designated investment or service;

(b) financial situation; and

(c) investment objectives;

so as to enable the firm to make the recommendation, or take the decision, which is suitable for him.”

- 4.6. COBS 9.2.2 R provides that:

“(1) A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:

(a) meets his investment objectives;

- (b) *is such that he is able financially to bear any related investment risks consistent with his investment objectives; and*
 - (c) *is such that he has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio.*
 - (2) *The information regarding the investment objectives of a client must include, where relevant, information on the length of time for which he wishes to hold the investment, his preferences regarding risk taking, his risk profile, and the purposes of the investment.*
 - (3) *The information regarding the financial situation of a client must include, where relevant, information on the source and extent of his regular income, his assets, including liquid assets, investments and real property, and his regular financial commitments.”*
- 4.7. COBS 9.2.6R requires that, if an authorised firm does not obtain the necessary information to assess suitability, it must not make a personal recommendation to the client.
- 4.8. COBS 9.4.7R requires that suitability reports provided to retail clients must at least specify the client’s demands and needs; explain why the firm has concluded that the recommended transaction is suitable for the client having regard to the information provided by the client; and explain any possible disadvantages of the transaction for the client.

5. Systems and Controls

- 5.1. During the relevant period, Chapter 3 of the FSA’s Senior Management Arrangements, Systems and Controls sourcebook (“SYSC”), also part of the FSA Handbook, applied to Thorntons.
- 5.2. SYSC 3.1.1R states that an authorised firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business.
- 5.3. SYSC 3.1.2G states, as guidance, that, to enable it to comply with its obligation to maintain appropriate systems and controls, an authorised firm should carry out a regular review of them.
- 5.4. SYSC 3.1.6R states that an authorised firm must employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.
- 5.5. SYSC 3.1.7R states that an authorised firm, when complying with SYSC 3.1.6R, must take into account the nature, scale and complexity of its business and the nature and range of financial services and activities undertaken in the course of that business

6. Training and Competence

- 6.1. The FSA's Training and Competence sourcebook ("TC") applies to authorised firms such as Thorntons advising on products such as the Lehmans-backed products in issue.
- 6.2. TC 2.1.12R requires that *"a firm must review on a regular and frequent basis employees' competence and take appropriate action to ensure that they remain competent for their role."*
- 6.3. TC 2.1.13G states, as guidance, that *"a firm should ensure that maintaining competence for an employee takes into account such matters as:*
 - (1) technical knowledge and its application;*
 - (2) skills and expertise; and*
 - (3) changes in the market and to products, legislation and regulation."*