
FINAL NOTICE

To: **Carr Sheppards Crosthwaite Limited**

Of: **2 Gresham Street
London
EC2V 7QN**

Date: **19 May 2004**

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

1. THE PENALTY

- 1.1 The FSA gave you a Decision Notice dated 12 May 2004 which notified you that pursuant to section 206 of the Financial Services and Markets Act (the "Act") and for the reasons set out below, the FSA had decided to impose a financial penalty of £500,000 on Carr Sheppards Crosthwaite Limited ("CSC") in respect of serious failures of its compliance function leading to breaches of FSA Principles 2 and 3, Rules 3.1.1 and 3.2.6 of the FSA's Senior Management Arrangements, Systems and Controls Sourcebook ("SYSC"), and Rules 5.2.5 and 5.3.5 of the FSA's Conduct of Business Sourcebook ("COB") Rules.
- 1.2 You have confirmed in correspondence dated 12 May 2004 that you do not intend to refer the matter to the Financial Services and Markets Tribunal.
- 1.3 Accordingly, for the reasons set out below the FSA imposes a financial penalty on you in the amount of £500,000 (the "Penalty").

2. RELEVANT STATUTORY PROVISIONS AND REGULATORY RULES

- 2.1 Principle 2 of the FSA Principles states:

A firm must conduct its business with due skill, care and diligence.

- 2.2 Principle 3 of the FSA Principles states:

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

2.3 SYSC Rule 3.1.1R states:

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

2.4 SYSC Rule 3.2.6R states *inter alia*:

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.

2.5 COB Rule 5.2.5R states:

Before a firm gives a personal recommendation concerning a designated investment to a private customer, or acts as an investment manager for a private customer, it must take reasonable steps to ensure that it is in possession of sufficient personal and financial information about that customer relevant to the services that the firm has agreed to provide.

2.6 COB Rule 5.3.5R states:

(1) *A firm must take reasonable steps to ensure that it does not in the course of designated investment business:*

- (a) *make any personal recommendation to a private customer to buy or sell a designated investment; or*
- (b) *effect a discretionary transaction for a private customer (except as in (3));*

unless the recommendation or transaction is suitable for the private customer having regard to the facts disclosed by him and other relevant facts about the private customer of which the firm is, or reasonably should be, aware.

(2) *A firm which acts as an investment manager for a private customer must take reasonable steps to ensure that the private customer's portfolio or account remains suitable, having regard to the facts disclosed by the private customer and other relevant facts about the private customer of which the firm is or reasonably should be aware.*

(3) *Where, with the agreement of the private customer, a firm has pooled his funds with those of others with a view to taking common discretionary management decisions, the firm must take reasonable steps to ensure that a discretionary transaction is suitable for the fund, having regard to the stated investment objectives of the fund.*

2.7 Section 206(1) of the Act 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. REASONS FOR THE ACTION

Summary

- 3.1 Between December 2001 and October 2003 ("the relevant period"), CSC failed to put in place appropriate or adequate systems and controls to monitor and demonstrate compliance with FSA rules. In particular, the compliance function was not sufficiently focussed on the setting and monitoring of compliance standards.
- 3.2 During the relevant period, CSC did not have in place systems and controls appropriate to its business in relation to the performance of its compliance function. CSC did not document and maintain adequate compliance procedures. Furthermore, CSC's compliance manual which took the form of a "risk manual" and Personal Account Notice was incomplete and inadequate and in particular failed to address key compliance topics including communication with regulators, whistle blowing, financial promotions, outside business interests, out of hours and out of office trading.
- 3.3 Additionally, CSC's compliance monitoring programme failed to monitor adequately compliance with all relevant FSA rules, specifically those governing Approved Persons ("APER"), Training and Competence ("T&C") and SYSC.
- 3.4 CSC failed to adequately document personal and financial Know Your Client ("KYC") information in respect of its customers on a consistent and ongoing basis. In certain cases, CSC did not take reasonable steps to retain sufficient documented customer information to demonstrate that their portfolios remained suitable.
- 3.5 It is not alleged that there were any deficiencies in CSC's financial controls nor in the arrangements for the settlement and custody of its customers' assets.
- 3.6 CSC's failings are viewed by the FSA as particularly serious in that:
- (1) they involved a material failing in the maintenance of senior management arrangements, systems and controls. The FSA regards appropriate involvement of senior management in compliance arrangements as a key safeguard to ensure the proper application of FSA rules and principles and the protection of consumers;
 - (2) with the exception of one failing, CSC had previously been unaware of any failings, and did not itself uncover the inadequacies in its systems and controls. These were discovered by the FSA during the course of a visit in July and August 2003. The failures arose as CSC failed to fully appreciate the changes brought about by N2;
 - (3) the failings persisted for a considerable period of time, from December 2001 to October 2003; and
 - (4) the nature, scale and complexity of CSC's business were considerable, comprising almost £6 billion in funds under management, and about 20,000 private clients. For CSC to satisfy itself that its customers' records met the requirements of the FSA rules and to update the KYC information held, CSC has contacted all of its approximately 20,000 clients.

- 3.7 In deciding the level of the financial penalty, the FSA has however recognised that:
- (1) once advised of the FSA's concerns, CSC responded promptly, effectively and with due regard for the seriousness of those concerns. In particular, the Internal Audit Department of CSC's parent, Investec plc ("Investec"), undertook a specifically commissioned comprehensive review of the CSC's compliance arrangements and prepared a detailed written report, which was promptly provided to the FSA;
 - (2) CSC, with the assistance of a major accountancy firm, has developed a detailed compliance monitoring programme;
 - (3) CSC has initiated a project to contact all of its customers to ensure the KYC information it holds is complete and accurate and to ensure that all portfolios were suitable ("the KYC project"). Customer returns received to date have indicated a need for further enquiries to be made in 4% of cases. CSC has undertaken to take any appropriate remedial action that may prove to be necessary as a result of the KYC project;
 - (4) CSC has agreed to monitor, on an ongoing basis, its fulfilment of specific recommendations designed to ensure that its systems and control inadequacies are fully resolved and to prevent recurrence of those or any other systems and control inadequacies. CSC will provide the FSA with further reports setting out the findings in respect of this ongoing monitoring;
 - (5) CSC has co-operated fully with the FSA, and has moved quickly to agree the facts of the case and to settle the matter. CSC's positive and pro-active approach has assisted the FSA in bringing the matter to a satisfactory resolution. Without this significant level of co-operation, the financial penalty would have been substantially higher.

Facts and Matters Relied Upon

Background

- 3.8 CSC is a 100 per cent owned subsidiary of Investec, which purchased CSC in 1997. CSC's registered office is at 2 Gresham Street, London EC2V 7QN.
- 3.9 CSC is a private client stockbroking firm which provides discretionary, non-discretionary and advisory services to private clients and charities. About two thirds of CSC's business is discretionary, and about one third of its business is advisory.
- 3.10 CSC has about 20,000 discretionary and advisory clients on its books, of which about 15,000 are managed on an active basis. CSC's customer base falls into three main categories: (1) private clients generally with more than £200,000 to invest, who are offered a bespoke investment management service; (2) private clients generally with under £200,000 to invest, who are not offered a bespoke service, but whose funds are managed on a collective portfolio basis; and (3) smaller charities.
- 3.11 CSC has about 350 employees, most of whom work in the London head office. The firm operates a small network of branches outside London. A rationalisation exercise in early

2003 reduced the number of branches from seven to four (the remaining branches are in Cheltenham, Worcester, Farnham and Reigate). All dealing and settlement for the branches occurs through the London office.

FSA Visit and Investec Review

- 3.12 In July and August 2003, the FSA conducted a visit of CSC, which included holding meetings with a number of key CSC staff and conducting a limited review of files and other documentation.
- 3.13 As a result of this visit, the FSA was concerned about the adequacy of compliance arrangements at CSC, and in particular, was concerned about the apparent lack of a consolidated and complete compliance manual and that CSC did not have a sufficient compliance monitoring programme. The FSA communicated its concerns to CSC, which agreed to commission an internal audit review.
- 3.14 During September and October 2003, the Internal Audit Department of Investec undertook a review of CSC's Compliance Department and arrangements, and produced a detailed written report, which was provided to the FSA. The report focussed on two main areas: an assessment of the adequacy of CSC's compliance policies and procedures; and, where significant shortfalls were identified, a review of CSC's compliance with FSA rules and regulations. The Internal Audit report was provided to the FSA on 31 October 2003. This report was consistent with the findings from the FSA visit.
- 3.15 In its report, the Investec Internal Audit Department found that CSC's compliance policies and procedures along with the monitoring of them were inadequate and incomplete. Reporting to management was informal. The Investec Audit Department concluded that compliance arrangements instigated by CSC had not been enhanced sufficiently to keep pace with regulatory developments, most notably N2. It also found that CSC documentation of ongoing KYC for client suitability was of inconsistent quality and standard.
- 3.16 The report concluded that, although staff at CSC had applied a positive approach to the policies and procedures advised to it by the compliance function, a number of issues needed to be addressed for the compliance environment to be considered satisfactory.

CSC's Compliance Arrangements

- 3.17 CSC's Compliance Department consisted of a Head of Compliance (Compliance Officer), three Compliance staff and one secretarial support person. These employees carried out a number of day to day monitoring tasks as detailed in CSC's monitoring procedures. The Compliance Officer reported verbally to CSC's Chief Executive Officer on a regular basis. The Compliance Officer reported to the CSC's Management Committee on a monthly basis and his reports were minuted in the meeting minutes.

(a) Roles, Responsibilities and Reporting Lines

- 3.18 CSC had not established detailed departmental procedures setting out the responsibilities of the Compliance Department, reporting mechanisms, or the roles of team members.
- 3.19 During its review, the Investec Internal Audit Department noted a lack of clarity in relation to the roles and responsibilities of CSC's compliance functions. The resources of CSC's Compliance Department were spread across a variety of roles, including operational roles,

which could have been performed by other CSC departments. These operational roles included monitoring of pension portfolio suitability, periodic review of suspense accounts and the administration of client lending, among others.

- 3.20 There was only very limited written reporting in respect of compliance matters. Prior to September 2003, the reports made by CSC's Compliance Officer at the monthly CSC Management meetings were verbal and noted in the Committee minutes. This lack of detailed written reporting meant that: CSC could not provide evidence that its management had been made fully aware of and had considered all key compliance issues; there was no evidence to show that management had sufficient tools with which it could measure future progress and monitor compliance issues; and CSC could not demonstrate compliance to third parties, including auditors and regulators.
- 3.21 CSC's Compliance Officer reported directly to CSC's Chief Executive Officer. There was no formal reporting line to an Investec Group Compliance Officer nor to the Head of Corporate Governance in Johannesburg, South Africa, who had overall responsibility for the compliance function in the group. The CSC Compliance Officer's formal interaction with the group was limited to the preparation of a written compliance report for the Investec Audit Committee. There was, therefore, only limited opportunity for CSC to learn of issues identified elsewhere in the group and for the group to become aware of any compliance issues within CSC.

(b) Compliance Manual

- 3.22 CSC did not have a complete and adequate compliance manual. The manual, which consisted of sections of two other documents, the risk manual and the Personal Account Notice, failed to adequately address a number of key compliance topics, including communication with regulators, financial promotions, whistle blowing, outside business interests, out of hours trading and out of office trading. The manual was out of date, and included copies of documents from the Securities and Futures Authority Handbook (which had been superseded at N2), and an authorised signature list which contained the names of former CSC employees. Whilst the risk manual was available on each desk, there was no procedure or register in place to reflect the fact that staff had read or understood the content of the manual. There was however, evidence that the Personal Account Notice document was read and understood by staff.

(c) Monitoring

- 3.23 CSC failed to appreciate the extent of the changes brought about by N2 and, as a result, the compliance function failed to appreciate its responsibility to monitor CSC's compliance with all FSA rules. The Investec Internal Audit Department report also noted this concern and while it was found that, with the advent of N2 changes, certain sections of the rules (such as COB) had been formally mapped against the business to assess compliance, the process had not considered all sections of the regulatory sourcebooks and manuals in particular APER, T&C and SYSC.
- 3.24 CSC had not established and implemented a detailed monitoring programme covering all aspects of FSA rules and regulations, and CSC's business. CSC's compliance monitoring was focussed on the basic COB requirements. Whilst CSC failed to formally monitor certain FSA Rules, (namely, APER, T&C and SYSC), annual checks were carried out in connection with both APER and T&C issues.

3.25 CSC's branches outside London were not subject to regular visits by CSC's Compliance Department. As of October 2003, the Cheltenham office had last been visited in October 2001, Worcester in March 2002 and Farnham in January 2003.

KYC Requirements and Suitability

3.26 CSC failed to ensure that it could demonstrate that it had all relevant facts about its customers, and in so doing, failed to demonstrate that it had taken reasonable steps to ensure that its customers' portfolios or accounts remained suitable.

3.27 CSC failed to document adequately ongoing personal and financial KYC information. The Investec Internal Audit Department reviewed a sample of 70 client files from CSC's London head office and 50 files from CSC's branch offices. It found that ongoing KYC was not generally being formally documented and that there were inconsistencies in the standard of documentation held. Of the files sampled, the majority were found to have little or no additional information on the client's background and current circumstances beyond that found on the application form. While the application form provided basic information on the client, it did not allow for the collection of ongoing KYC. Whilst in a small number of cases sampled, information about the clients could be obtained from the file by reading client correspondence, this had not been consolidated in a schedule standardised across the files.

3.28 Risk levels were not attributed accurately to all CSC customers:

(1) The Investec Internal Audit Department identified that of 21,216 customer records, 635 discretionary customers did not have a risk level attributed to them (either high, moderate or low). These customers were rated as moderate risk by default. All customers were contacted. CSC has had a 97% response rate. Only 5 customer responses required further review and will be dealt with as part of the KYC project; and

(2) Prior to June 2003, 693 customers previously classified as low risk had not been reclassified as moderate risk following the introduction by CSC of a new risk definition. Generally the portfolios consisted of largely UK equities, when the new definition stipulated that low risk customers should have the majority of their monies invested in Government bonds. Prior to June 2003 (when the new risk definitions were introduced) these portfolios would have complied with the broader definition of low risk. CSC should have contacted the customers to verify whether they were content to change to a moderate risk rating. These 693 customers will be dealt with as part of the KYC project.

3.29 To ensure that its KYC information is complete and accurate, CSC has sent letters to its approximately 20,000 customers. As part of this process, CSC has sought to re-confirm the appropriate risk level for each customer.

CSC's Remedial Action

3.30 Upon being advised by the FSA in August 2003 of concerns regarding the effectiveness of its compliance function, CSC management responded in a timely fashion. CSC confirmed that the Investec Internal Audit Department would undertake a comprehensive review of CSC's compliance function and arrangements.

3.31 While the failings in this case merit a significant financial penalty, the FSA considers that these failings have been mitigated by the pro-active co-operation demonstrated by CSC once the failings were drawn to its attention. CSC has taken prompt and effective remedial action to address issues identified by the FSA visit and Investec Internal Audit review by:

- (1) strengthening the resources in the Compliance Department;
- (2) establishing a detailed procedures manual for the Compliance Department;
- (3) developing, with the assistance of a major accountancy firm, a detailed compliance monitoring programme;
- (4) instigating the KYC project, and agreeing to take any necessary remedial action as a result of this; and
- (5) co-operating with the FSA's investigation in order to reach a swift resolution of the matter.

4. RELEVANT GUIDANCE

4.1 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.

4.2 In determining whether a financial penalty is appropriate and the level of the financial penalty, the FSA is required to consider all the relevant circumstances of the case. The FSA Enforcement Manual section 13.3.3 indicates the factors that may be relevant in determining the level of a financial penalty, as discussed below.

5. FACTORS RELEVANT TO DETERMINING THE SANCTION

5.1 In determining that a financial penalty is appropriate and the amount imposed is proportionate to CSC's breaches, the FSA considers the following factors to be particularly relevant.

The seriousness of the misconduct or contravention

5.2 The level of financial penalty must be proportionate to the nature and seriousness of the contravention. The breaches arose because of a failure to appreciate fully the extent of the changes brought about by N2 and the need to ensure that appropriate systems and controls in respect of all aspects of CSC's compliance function were in place.

5.3 CSC's compliance manual was inadequate and out of date. It contained documents that had not been updated to reflect N2 changes. In addition, CSC failed to uncover most of the inadequacies in its systems and controls, the vast majority of which were brought to its attention by the FSA.

5.4 CSC failed to ensure the appropriate involvement of senior management in its compliance arrangements, and thereby did not ensure the full application of FSA rules and principles.

The extent to which the contravention is deliberate or misconduct was deliberate or reckless

- 5.5 Whilst CSC's contraventions were not deliberate, CSC failed to appreciate the extent of the changes brought about by N2.

The amount of profit accrued or loss avoided

- 5.6 There is no evidence that CSC made additional profit or avoided additional loss through its actions.

Conduct following the contravention

- 5.7 Although CSC did not identify the contraventions, CSC ensured that the issues of concern were fully investigated once the FSA brought those matters to its attention. In particular, CSC commissioned Investec's Internal Audit Department to undertake a comprehensive review of CSC's compliance arrangements and then promptly provided the report to the FSA.
- 5.8 CSC has acknowledged its systems and control weaknesses and has acted effectively to remedy these weaknesses.
- 5.9 CSC has taken steps to resolve this matter expeditiously, and has agreed to pay a penalty. CSC's positive and pro-active approach has led to the satisfactory resolution of the matter, and has assisted the FSA in achieving its regulatory objectives.

Disciplinary record and compliance history

- 5.10 CSC has not previously been the subject of disciplinary action by the FSA.

Action taken by other regulatory authorities and the FSA in relation to similar failings

- 5.11 In setting the level of the penalty, the FSA has taken into account penalties levied by previous regulators and the FSA.

6. CONCLUSION

- 6.1 Taking into account the seriousness of the breaches and the risk they posed to the FSA's statutory objectives, but also having regard to the effective remedial action taken by CSC and the early settlement of the case, the FSA has decided to impose a financial penalty of £500,000.

7. DECISION MAKER

- 7.1 The decision which gave rise to the obligation to give this notice was made by the Regulatory Decisions Committee.

8. IMPORTANT NOTICES

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

Manner of payment

8.2 The Penalty must be paid to the FSA in full.

Time for payment

8.3 The Penalty must be paid to the FSA no later than 2 June 2004, being not fewer than 14 days from the date on which the notice is given to you.

If the penalty is not paid

8.4 If all or any of the Penalty is outstanding on 2 June 2004, the FSA may recover the outstanding amount as a debt owed by you and due to the FSA.

Publicity

8.5 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

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

FSA contacts

8.7 For more information concerning this matter generally, you should contact Martin Weir (direct line: 020 7066 1874/fax: 020 7066 1875) or Yvonne Chisholm (direct line: 020 7066 0692/fax: 020 7066 0693) at the FSA.

Julia Dunn
FSA Enforcement Division