

---

## FINAL NOTICE

---

**To: Hargreaves Lansdown Asset Management Limited**

**Of: Kendal House  
4 Brighton Mews  
Clifton  
Bristol  
BS8 2NX**

**Date: 2 June 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 26 May 2004 which notified you that pursuant to Section 206 of the Financial Services and Markets Act 2000 (“FSMA”), the FSA had decided to impose a financial penalty of £300,000 on Hargreaves Lansdown Asset Management Limited (“HLAM”) in respect of breaches of the Statements of Principle made by the Securities and Investments Board (“the Principles”) by reference, additionally, to the Rules of the Personal Investment Authority (“the PIA Rules”), including the Adopted Rules of FIMBRA (the “Adopted FIMBRA Rules”), as follows:

- (1) Principle 2 (Skill, Care and Diligence):
  - (a) PIA Rule 4.1 (Communication); and
  - (b) Adopted FIMBRA Rule F18.7(1) (Advertising);
- (2) Principle 9 (Internal Organisation):
  - (a) PIA Rule 5.1.1(1) (Record Keeping); and
  - (b) PIA Rules 7.1.2(1) and (2) (Compliance Procedures).

- 1.2 You have confirmed that you do not intend to refer this 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 £300,000 (the "Penalty").

## **2. RELEVANT STATUTORY PROVISIONS AND REGULATORY REQUIREMENTS**

- 2.1 Section 206 of FSMA provides:

*"If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate."*

- 2.2 The Financial Services and Markets Act 2000 (Transitional Provisions and Savings) (Civil Remedies, Discipline, Criminal Offences etc) (No2) Order 2001 ("the Pre N2 Misconduct Order") provides, at Article 8(2), that the power conferred by Section 206 of FSMA can be exercised by the FSA in respect of failures by a firm to comply with any of the provisions specified in Rule 1.3.1(6) of the Rules of the Personal Investment Authority ("PIA") as if the firm had contravened a requirement imposed by FSMA.
- 2.3 PIA Rule 1.3.1(6) provided that a PIA Member which failed to comply with PIA Rule 1.3.1(2) or any of the Principles was liable to disciplinary action.
- 2.4 PIA Rule 1.3.1(2) obliged a PIA Member to obey the PIA Rules, which included the Adopted FIMBRA Rules, and the Principles.
- 2.5 The Principles are a universal statement of the standards expected of firms, which were issued by the Securities and Investments Board and applied to PIA Members.
- 2.6 Extracts from the Principles and Rules referred to in paragraph 1.1 are attached at Appendix 1.

## **3. REASONS FOR THE ACTION**

### **Summary**

- 3.1 (1) During 2001, HLAM acted in breach of the Principles and Rules referred to in paragraph 1.1 in matters connected with its Secure Growth Portfolio ("the SGP") and with the related issues of the organisation and management of its internal affairs. Throughout its life, the SGP comprised shares of a number of split-capital investment trusts ("splits").  
  
(2) For the avoidance of all doubt, the FSA's reasons for the action do not include any allegation against HLAM concerning the structuring, management or pricing of any constituent share of the SGP, nor collusive behaviour.
- 3.2 Following the collapse of a number of split-capital investment trusts the FSA undertook themed visits to authorised firms which were significant participants in the sector. HLAM received such a visit. This concentrated on the SGP which had been

offered by HLAM as a discretionary management service in zero class shares of split capital trusts ("zeros") between 1992 and 2002. Until 2000 the zeros in the SGP were confined to shares issued by traditional trusts, which were properly, and universally, regarded as carrying lower risk than equities. However, in the late 1990s splits were introduced which were structured very differently from their predecessors and the changed characteristics of these newer trusts had the implicit potential of exposing their shares, including the zeros, to significantly increased risk. The advertised purpose of the SGP was the provision of only "lower risk" investment (with which HLAM persisted without any change for the whole period between 1992 and 2002) but over time a number of the zeros included in the SGP were of the new style.

3.3 During 2001 HLAM's conduct was in breach of the Principles, the PIA Rules, including the Adopted FIMBRA Rules, as follows:

- (1) Principle 2 - in that it failed to conduct its business related to its customers with the required levels of skill, care and diligence by reference, additionally, to:
  - (i) PIA Rule 4.1 and Adopted FIMBRA Rule F18.7(1) – in that it failed to ensure that its communications with investors and potential investors were clear and fair and not misleading and that, among other things, it failed to ensure that the information contained in brochures for the SGP disclosed fairly the risks involved and only contained information that was accurate and up-to-date and not misleading when issued;
- (2) Principle 9 - in that it failed to organise and control its internal affairs in a responsible manner by reference, additionally, to:
  - (i) PIA Rule 5.1.1(1) – in that it failed to keep records which were sufficient to show that it had complied with the requirements of the PIA Rulebook and did not have appropriate procedures and controls relating to such records; and
  - (ii) PIA Rules 7.1.2(1) and (2) – in that it failed to establish procedures with a view to ensuring that its investment staff and employees complied at all times with the Rules and Principles.

3.4 In particular, for a period during 2001:

- (1) the information that it provided for its existing and potential customers was not clear or fair;
- (2) the systems and controls in place relating to the general management of the SGP were inadequate and ineffective.

- 3.5 In so conducting itself, HLAM demonstrated failings which demand a financial penalty. These failings are viewed by the FSA as serious in the light of the following factors:
- (1) the SGP was marketed principally by direct offer, a method which requires special care in the preparation of brochures. This is a method of which the senior management of HLAM has considerable, long-standing experience, making HLAM's failures all the more of concern;
  - (2) from its inception HLAM characterised the SGP as a "low risk" service and marketed it accordingly;
  - (3) HLAM supplied its direct-offer SGP customers with regular bulletins describing the general characteristics, performance and prospects of their investments. HLAM was slow to appreciate the special implications, for those customers, of changes in the characteristics of many splits and may have provided reassurance to customers which was unjustified;
  - (4) HLAM is unable adequately to substantiate its relevant conduct in relation to the SGP nor can it adequately explain key decisions affecting customers' interests and its own obligations;
  - (5) HLAM failed to act appropriately upon potential, and subsequently, actual risks and failed to take the action necessary to protect the interests of existing and prospective SGP customers.
- 3.6 HLAM has readily agreed with the FSA to implement a review, acceptable to the FSA, of the accounts of all SGP customers which will identify losses attributable to HLAM's failings and subsequently to redress them.

### **Facts and Matters Relied On**

#### **HLAM's activities**

- 3.7 HLAM, a wholly owned subsidiary of Hargreaves Lansdown plc, was authorised by PIA to conduct investment business from 27 March 1995 until 30 November 2001. Since then, HLAM has been an authorised person for the purposes of FSMA.
- 3.8 HLAM's business is predominantly execution only in nature. HLAM operates a "Discount Desk" service that allows clients to buy investments at discounted prices without receiving investment advice. This business is conducted mainly by mail. HLAM regularly mails customers and potential customers with publications entitled "Investment Times", which has a circulation of over 100,000, and "Performance and Discount Review", which carries performance data on over 750 funds and individual comments on over 150 of the more popular funds in which HLAM clients have invested. HLAM also issues occasional promotional or information brochures such as "The HL Guide to Zeros" - first issued in February 1999. These widely distributed mailings generate a large proportion of its execution only business.

- 3.9 The Secure Growth Portfolio was in fact a discretionary management investment service. This matter concerns HLAM's conduct related to services provided to direct-offer customers of the SGP, specifically:
- the provision of information for existing and potential customers of the SGP; and
  - the firm's internal organisation and procedures relating to the SGP.
- 3.10 This service was introduced in September 1992 and wound up in June 2002. The conduct in issue occurred for a period during 2001 whilst HLAM was a member of PIA.

### **The Characteristics of the Secure Growth Portfolio**

- 3.11 With few exceptions, HLAM marketed the SGP service by direct offer advertisement. Direct offer sales are non-advised. A firm advertising a product by direct offer must include within the advertisement itself all of the requisite information and warnings necessary to permit a customer to make a decision on the proposal. The firm is not entitled to rely on ancillary marketing material or to infer or impute knowledge or expertise on the part of the customer. The customer responds to the advertisement by returning a coupon or form attached to the advertisement. In the case of the SGP the coupon contained the complete wording of a discretionary management agreement which then formed the sole basis of the customer's continuing relationship with HLAM.
- 3.12 HLAM was authorised by PIA as an independent financial adviser and, although it functioned as an asset manager, it was governed by conduct of business rules applying to financial advisers, for whom asset management, if carried on at all, was often a peripheral activity. The SGP was a service which provided discretionary investment management. Under the Adopted FIMBRA Rules, which applied to its conduct of investment business, HLAM was obliged to conduct investment management subject to a regime which prescribed, among other things, that discretionary portfolio management required a belief by the firm that its customer understood the risks to which he would be exposed. In this case the establishment of such belief required reference to the SGP direct offer advertisement, which contained the totality of the information from which HLAM was able to establish each customer's understanding of risk.

### **HLAM's Failure to Act with Due Skill, Care and Diligence**

#### ***The Marketing of the SGP***

- 3.13 The SGP was described as having a "lower equity risk" rating and as being composed of securities with a lower risk rating. Nothing in the brochure suggested that the portfolio might at any time include securities with a risk rating other than "lower". (HLAM has accepted that in this respect no distinction is to be drawn between "low" and "lower" as categorisations of risk.)
- 3.14 The SGP held zeros in splits with new characteristics which did not conform to the sector's traditional characteristics. The typical changes exhibited by these trusts were

increased gearing, holdings in other splits and investment trusts and increased allocation of charges to capital. These factors had the potential to increase the risk factors affecting the SGP.

- 3.15 In November 2000, the SGP's manager decided to trim holdings in BFS Income & Growth ("BIG") and CGU Quarterly High Income ("QHI"). It proved difficult to dispose of the portfolio's holding in BIG and impossible to dispose of its holding in QHI. Subsequently, in December 2000, BIG's own managers changed its published risk rating (which was by reference to equity investments) from "low" to "low to medium". These events were not reflected in any consequential change to the SGP brochure, which continued to describe a "lower risk" portfolio composed only of "lower risk" zeros. HLAM accepted fresh investments into the SGP on the basis of that brochure until as late as 5 September 2001. HLAM did not communicate a change in risk rating to customers until October 2001.
- 3.16 The FSA has concluded that the substantial analysis and data available to HLAM, and of which it was aware, warned of the possibility of impending difficulties in the split-capital market. However, HLAM failed to recognise that its unusual relationship with direct-offer SGP customers implied an obligation to alert them to the potential risks created by split-capital sector changes, nor did HLAM revise its brochure in the light of those potential risks. These failures may have resulted in SGP customers suffering losses.

#### *Information for Customers*

- 3.17 SGP Customers were sent copies of the firm's "Investment Review" for the SGP for January, April and July 2001. The FSA has concluded that the information contained in these three editions was unrealistically optimistic regarding the zeros market and lacking in objectivity. Customers would not have been able to deduce that their funds were no longer invested exclusively in "traditional" securities of the type contemplated by the advertisement upon which their relationship with the firm was based. Customers were reassured rather than alerted to the potential for market turbulence and possible losses. Direct offer customers were not provided with balanced information that might have provided them with an opportunity to reassess their investments, taking into account their individual circumstances and requirements.
- 3.18 Ultimately, in October 2001, HLAM revised the SGP's formal risk rating. This fact was simply contained in a quarterly Review for customers which continued to describe the SGP as "lower risk" on its first page but described it as "low/medium" under the heading "Technical Factors" at the end of the document. The Review was accompanied by a personal letter from the Chairman, Stephen Lansdown, seeking to explain the problems which the SGP had encountered and the risks involved going forward.

#### *Specific Conduct Illustrative of Failure to Act with Due Care, Skill and Diligence*

- 3.19 At no time did HLAM suggest to its direct-offer customers that they should review the degree of risk that they were prepared to accept in connection with the SGP. In particular, customers were not alerted to the various changes occurring in the split-capital market which had the potential to increase the degree of risk to which their investments were exposed.

## **HLAM's Internal Organisation**

### ***Record Keeping***

- 3.20 There were insufficient records to permit a reconstruction or verification of the HLAM's conduct, in particular there were inadequate records of the approval of the change in the SGP's risk rating. This is a serious failing because the making and safeguarding of adequate and appropriate records by firms is a key requirement in ensuring that firms comply with their obligations to customers.

### ***Specific Conduct Illustrative of HLAM's Failure to Organise Itself Properly***

- 3.21 In October 2001, HLAM's investment managers concluded that the position of the SGP had been materially affected by events affecting certain constituent zeros, and it was decided that the portfolio could no longer be regarded as being "lower risk". It has not been possible to establish when that decision was taken. The recollection of HLAM's own staff concerning the decision is vague. HLAM is unable to state who decided to formalise the change to the rating or who authorised the notification to customers.
- 3.22 Further, there is no evidence that HLAM at any time had in place a system which identified the issue of whether or not the constraints of its relationship with the SGP's direct-offer customers required that they should be provided with comprehensive information concerning market changes and their potential implications, nor whether customers' investment management agreements might perhaps require renewal.

## **4. ANALYSIS OF SANCTION**

- 4.1 In determining whether a financial penalty is appropriate and its level, the FSA is required to consider all the relevant circumstances of the case. Paragraph 13.3.3 of the Enforcement manual and Annex D of "PIA's Approach to Discipline – Statement of Policy" that was issued in December 1995 indicate the factors that may be of particular relevance in determining the level of a financial penalty. These are discussed below by reference to the circumstances of this case.
- 4.2 Targeted disciplinary action is appropriate in circumstances such as those described in this Notice for the purposes of supporting the FSA's objectives of maintaining public confidence in the financial system and the protection of consumers. There is also a significant potential deterrent effect from this action. Regulated firms need to be aware of the importance the FSA places on the correct promotion of financial products and services and the importance of applying appropriate skill and care to their investment activities, all within the context of appropriate internal systems and controls.
- 4.3 Article 8(4) of the Pre-N2 Misconduct Order provides that, where the FSA proposes to impose a financial penalty, it must have regard to:

*"any statement made by the self regulating organisation...which was in force when the conduct in question took place with respect to the policy on the taking of disciplinary action and the imposition of, and amount of penalties (whether issued as guidance, contained in the rules of the organisation or otherwise)."*

4.4 In all material respects the relevant PIA guidance, contained in Annex D of “PIA’s Approach to Discipline – Statement of Policy” issued in December 1995, required consideration of the same factors as are identified in Chapter 13 of the Enforcement manual. Both have been taken into account by the FSA in determining the appropriate sanction in this case.

4.5 PIA’s Statement of Policy made it clear, however, that the criteria for determining the level of sanction were not to be applied rigidly, as stated in paragraph 2 of Annex D:

*“Each case is different and needs to be treated on its own merits. It is not possible to apply a mechanistic approach to the determination of the circumstances in which disciplinary action should be taken or of the sanctions to be applied. The criteria... should not be treated as exhaustive. Nor should it be assumed that regard would necessarily be had to a particular criterion in any given circumstances.”*

4.6 Similarly, it is stated in Chapter 13 of the Enforcement Manual at paragraph 13.3.4 that the criteria listed in the manual are not exhaustive and all relevant circumstances of the case will be taken into consideration.

4.7 In determining whether a financial penalty is appropriate and its level the FSA considers all the relevant circumstances of the case. The FSA considers the following factors to be particularly relevant in this case.

***ENF 13: The seriousness of the misconduct or contravention***

***PIA Guidance: The seriousness of the breaches. The scale of any investor losses and/or the extent to which investors were exposed to the risk of such losses.***

The level of financial penalty must be proportionate to the nature and seriousness of the contravention. HLAM’s failings are viewed by the FSA as serious in light of the factors set out in paragraph 3.5 of this Notice.

***ENF 13: The extent to which the contravention or misconduct was deliberate or reckless***

***PIA Guidance: Whether the member intentionally or recklessly failed to meet PIA’s requirements.***

4.8 There is no indication that HLAM’s breaches of the Principles and the PIA and Adopted FIMBRA Rules were deliberate or reckless.

***ENF 13: The size, financial resources and other circumstances of the firm or individual***

***PIA Guidance: The member’s ability to pay: The scale of any investor losses and/or extent to which investors were exposed to the risk of such losses.***

4.9 There is no reason to believe HLAM will be unable to pay the penalty.

4.10 The exact scale of investor losses has not been accurately quantified at this stage.



***ENF 13: The amount of profits accrued or loss avoided***

***PIA Guidance: The extent to which, as a result of the breaches, the Member gained a benefit or avoided a loss.***

- 4.11 There is no evidence that HLAM deliberately set out to accrue additional profits as a result of its failings.
- 4.12 HLAM has agreed to review SGP business for the relevant period and to pay redress to any customer of the SGP who has suffered identifiable loss as a result of the failings described in this Notice.

***ENF 13: Conduct following the contravention***

***PIA Guidance: The firm's response once the breaches were identified***

- 4.13 HLAM has agreed to work with the FSA to address the FSA's concerns.
- 4.14 The breaches described above were identified as a result of the examination of HLAM's conduct by the FSA's Supervision and Enforcement Divisions, rather than by HLAM itself.

***ENF 13: Action taken by other regulatory authorities and the FSA in relation to similar failings***

***PIA Guidance: The way in which PIA has dealt with similar cases in the past***

- 4.15 HLAM's previous regulator, PIA, also took action against other firms for advertising, competence and organisational failings. This included the imposition of financial penalties.

***ENF 13: Disciplinary record and compliance history***

***PIA Guidance: The firm's regulatory history***

- 4.16 There is no entry of previous disciplinary action on the public record.

**5. DECISION MAKER**

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

## **6. IMPORTANT NOTICES**

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

### **Manner of payment**

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

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

6.3 The Penalty must be paid to the FSA no later than 21 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**

6.4 If all or any of the Penalty is outstanding on 21 June 2004, the FSA may recover the outstanding amount as a debt owed by you and due to the FSA.

### **Publicity**

6.5 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 these 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.

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

### **FSA Contacts**

6.7 For more information concerning this matter generally, you should contact Roger Marsh at the FSA (direct line: 020 7066 5068/fax: 020 7066 9720).

**Julia Dunn**  
**FSA Enforcement Division**

### **Principle 2: Skill, Care and Diligence**

A firm should act with due skill, care and diligence.

#### ***PIA Rule 4.1 Communication***

A Member must ensure that anything said or written, or any document sent, given or shown, to an investor or potential investor by the Member or on its behalf in the course of its relevant business is clear and fair, and is not misleading, either in design or content.

#### ***Adopted FIMBRA Rules: F18 Advertising and Promoting Your Business***

##### *F18.7*

- (1) The advertisement must
  - (a) be presented in a way that is likely to be understood by the persons to whom it is addressed;
  - (b) describe clearly the investment or investment service to which it relates;
  - (c) disclose fairly the risks involved.

### **Principle 9: Internal Organisation**

A firm should organise and control its internal affairs in a responsible manner, keeping proper records, and where the firm employs staff or is responsible for the conduct of investment business by others, should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures.

#### ***PIA Rule 5.1 Record-keeping Requirements***

##### *5.1.1*

- (1) A Member must
  - (a) keep records which are sufficient to show at any time that it has complied with the requirements of the Rule Book, and
  - (b) establish procedures and controls to ensure that those records are made promptly and accurately and, where appropriate, brought up-to-date at regular and frequent intervals.

***PIA Rule 7.1.2 Compliance Procedures***

- (1) A Member must establish procedures, including procedures for complying with the training and competence requirements in accordance with Rule 2.6, with a view to ensuring that its investment staff and other employees and its appointed representatives and their employees carry out their functions in such a way that the Member complies at all times with the Rules and Principles.
- (2) It must keep those procedures under review and revise them as appropriate from time to time.