Financial Services Authority

FSA

FINAL NOTICE

To: **Knowlden Titlow Financial Services Limited**

Of: **36 Unthank Road, Norwich, Norfolk, NR2 2RB**

Date **9 October 2008**

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 Knowlden Titlow Financial Services Limited ("the Firm") a Decision Notice on 9 October 2008 which notified the Firm that for reasons given in this Notice, and pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), and on the basis that the Firm has agreed to certain remedial action, the FSA has decided to impose a financial penalty of £35,000 on the Firm in respect of breaches of the FSA's Principles for Business ("Principles") and related FSA Rules between 17 January 2002 and 3 December 2007 ("the relevant period"). The Firm must stop selling Geared Traded Endowment Policies ("GTEPs") and contact all customers sold potentially unsuitable GTEPs informing them of the fact and offering redress where appropriate.

1.2. The Firm has breached:

(1) Principle 9 (customers: relationships of trust); and

(2) Principle 7 (communications with clients),

in relation to failings in the Firm's advice and sales processes in respect of GTEPs during the relevant period.

1.3. The Firm has also breached FSA Rules 5.2.5R and 5.4.3R in the part of the Handbook in force at the time of the relevant transactions entitled Conduct of Business ("COB").

1.4. The Firm agreed to settle at an early stage of the FSA's investigation. It 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 the Firm.

1.5. The Firm confirmed on 1 October 2008 that it will not be referring the matter to the Financial Services and Markets Tribunal.

2. REASONS FOR THE PENALTY

Introduction

2.1. The FSA has decided to impose a financial penalty on the Firm for breaches of the FSA Principles and Rules identified in Section 1 above that occurred during the relevant period. These breaches relate to failings in the Firm's systems to ensure the suitability of its advice and the firm's correspondence and communications for its customers. Consequently, the Firm's advisers demonstrated a lack of understanding of the product and the regulatory requirements governing their advised sales. As a result of this and flawed customer documents, clients were advised to purchase GTEPs in default of evidence that the nature and characteristics of the product had been explained or that such sales were suitable.

2.2. In breach of Principle 9:

(1) the Firm failed to undertake adequate or independent product research and as a consequence failed to ensure that its advisers fully understood GTEPs and their inherent risks prior to recommending them;

(2) the Firm failed to take steps to ensure the suitability of its advice by failing to take steps to adequately address issues regarding the quality of advice arising from its client file reviews;

(3) the Firm failed to demonstrate that clients' attitude to risk was commensurate with the recommended product's risk profile; and

(4) the Firm failed to gather or record adequate Know Your Customer ("KYC") information to support its assessment of suitability also breaching COB 5.2.5R.

2.3. In breach of Principle 7 the Firm failed to communicate:

(1) why it had concluded that GTEPs were suitable; or

(2) the characteristics of and risks associated with GTEPs to clients in a clear and fair way, also breaching COB 5.4.3R;

2.4. These failings are set out in more detail in paragraphs 4.6 to 4.18 below.

3. RELEVANT STATUTORY PROVISIONS

3.1. The FSA's statutory objectives, set out in section 2(2) of the Act, include the protection of consumers.

3.2. Section 138 of the Act provides that the FSA may make such rules applying to authorised persons as appear to it to be necessary or expedient for the purpose of protecting consumers.

3.3. The FSA has the power, pursuant to section 206 of the Act, to impose a financial penalty of such amount as it considers appropriate where the FSA considers an authorised person has contravened a requirement by or under the Act.

Principles for Businesses

3.4. Under the FSA's rule-making powers as referred to above, the FSA has published in the Handbook the Principles which apply either in whole, or in part, to all authorised persons.

3.5. The Principles are a general statement of the fundamental obligations of firms under the regulatory system and reflect the FSA's regulatory objectives.

3.6. Principles which are relevant to this matter are set out below:

3.7. **Principle 9** (Customers: relationships of trust)

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.

3.8. **Principle 7** (Communications with clients)

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.

3.9. The relevant provisions of the module of COB (which was in force at the time of the relevant transactions) are as follows:

COB 5.2.5R requires that before a firm gives a personal recommendation concerning a designated investment to 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; and

COB 5.4.3R provides that a firm must not, amongst other things, make a personal recommendation of a transaction to a private customer unless it has taken reasonable steps to ensure that the private customer understands the nature of the risks involved.

4. FACTS AND MATTERS RELIED ON

GTEP Products

4.1. Traded endowment policies ("TEPs") are with-profits endowment policies[1] which are no longer required by their original holder and have been sold on the secondary

[1] A long term, regular premium savings plan with a life policy attached, which is designed to achieve at least a pre-determined figure on maturity, with additional profits added. They are most often associated with interest-only mortgages.

market. The purchaser of such policies agrees to pay the remaining premiums on the policy and in return receives the value of the policy at maturity or when the original owner dies, depending on which occurs first. This payout will include both bonuses declared at the time of the sale and subsequent bonuses, though such bonuses are not guaranteed.

4.2. Investment in GTEPs involves gearing as part of a two stage investment process. At the first stage, an investor purchases a portfolio of TEPs (typically using cash savings, funds raised through a mortgage on the investor's home or a charge on a bond already owned by the investor). In the Firm’s case, no investment was funded by means of a mortgage on a client’s home. For the second stage, the newly-acquired TEPs are secured against a loan, which is used to invest in more TEPs. These varying levels of gearing are effectively using the strategy of borrowing to invest, which can be a high risk strategy. In order for the investor to make a profit, the product has to outperform the interest rate payable on the loan. In addition, gearing introduces an interest rate risk, increases exposure to the usual risks of the investment (such as fluctuations in performance and secondary market demand), and if the ratio of loan to confirmed surrender value becomes too high, the lender may withdraw or reduce the loan facility, or require an additional injection of capital or security. There is no generic level of risk which can be applied to all clients of GTEPs as each portfolio of TEPs is constructed individually.

4.3. In respect of the GTEPs sold by the Firm, clients, on the basis of an illustration, are required to state whether they wish to proceed. A portfolio of TEPs is then constructed for them. The product construction process is lengthy, taking up to 18 months, and there is no 'cooling off' period meaning that clients who decide not to proceed may incur a penalty fee.

The Firm

4.4. The Firm’s main business is the provision of investment advice, including pension planning, retirement planning, estate preservation and protection. It also conducts some mortgage and insurance intermediary business. The Firm has held permissions to advise and arrange designated investment business since January 2002. The Firm has 12 advisers, 3 of whom are currently deemed competent to sell GTEPs.

4.5. During the relevant period, the Firm made 28 recommendations, of which 5 did not proceed to completion (an additional 3 products were sold on an execution-only basis), earning commission in the region of £80,000 to date. As a result of concerns raised by the FSA, an independent reviewer was appointed by the Firm to examine client files for the remaining 23 recommendations. The reviewer concluded that 16 of these 23 recommendations were potentially unsuitable, 6 were suitable and 1 could be classified as an insistent client. Of the cases reviewed, 9 raised the initial capital by charging a bond, 10 by using cash, 3 used a combination of charging a bond and cash and 1 used a combination of charging an existing endowment policy and cash.

4.6. As a result of its investigation, the FSA found evidence of the breaches set out below.

Background

4.7. Compliance consultants warned the Firm as early as 2002 about issues regarding the completion of fact finds, adequacy of explanations of its recommendations and risk warnings in suitability letters. It was noted in the Firm's compliance consultants' report of August 2002 that the fact find form had been changed and the section relating to attitude to risk had been modified in line with the recommendations made in their May 2002 report. However, file reviews carried out by compliance consultants during their external visits, between 2002 and 2006, continued to reveal deficiencies in relation to the firm's suitability letters, completion of fact finds, product research and adequacy of explanations of its recommendations.

4.8. These concerns were encapsulated in the compliance consultant's comments in his April 2006 report -"*the overall picture did cause me some concern, though my examination of the files indicated that some of your advisers are operating to a satisfactory level of compliance… I found a number of instances where there was no record of the client's personal and financial circumstances on the file, or records that were far too out of date to be accepted as adequate*". The same report included the following comments about the suitability letters-*"whilst I am sure that all the advisers are aware of their clients' circumstances and provide only suitable advice this is not demonstrated for the record at present, which would, I believe be viewed in an extremely negative light by the FSA…"*

4.9. Despite the issues raised by the compliance consultants since 2002 and the changes implemented by the Firm to address these concerns, a number of failings in relation to the Firm's systems and controls were identified, as set out below.

Suitability of advice

4.10. Prior to promoting GTEPs, the Firm failed to ensure, through independent due diligence or otherwise, that its advisers fully understood GTEPs and their inherent risks. On the basis of a review of client files, it appears that, as a result of the failure to ensure that the nature of the product was fully understood, the Firm's advisers were unable to explain the characteristics and risks of GTEPs properly to clients. As acknowledged by the independent reviewer, *"some of the advisers had failed to fully understand the nature of the product, and as a result had not explained the risk and product features properly..."* This was compounded by the lack of clarity in the product literature provided with the product (as considered further below). For example, a file note on one case recorded that the adviser had to again explain the plan and the loan facility to the clients. The file note indicates that this discussion took place after the clients had completed the application for the plan, provided a cheque for the investment and signed the loan facility agreement.

4.11. The Firm exercised inadequate control over its GTEP sales process by failing to gather and record sufficient client information. The following breaches were noted:

(1) fact finds were not routinely completed, with relevant sections left blank, including details of the clients' needs, retirees' medical information and details of the clients' outgoings and expenditure;

(2) fact finds did not record that alternatives to an investment in GTEPs had been discussed and in the majority of cases, there was no evidence of research into alternative products on file; and

(3) fact finds did not routinely establish whether there were sufficient funds available, which clients were prepared to use, if a future capital injection into GTEPs was required.

4.12. Despite having procedures in place to monitor quality of advice (for example conducting competency tests on a six monthly basis and meetings on a quarterly basis to discuss the findings of file reviews) problems with two of the three GTEP advisers' fact finds identified in 2003 were identified also in 2004. Further, there is no record over the period of how these problems were being addressed.

4.13. There were a number of failings demonstrating that the advisory process was unclear in respect of the Firm's recommendations to invest in GTEPs, as set out below.

4.14. The Firm could not demonstrate that it had considered the needs and circumstances of each client prior to making a recommendation to invest in GTEPs as there was no evidence that alternative investments had been considered in order to provide the required level of income at a lower risk. For example, in one case clients, with a balanced attitude to risk, wanted to draw more income from their existing portfolio which included two investment bonds. Whilst the return from the existing investment bonds was explored, there was no consideration of alternative products. The independent reviewer stated "*this plan represents a higher risk than needed to be taken to achieve your aims…had the funds been switched out of With Profits (either within the existing plans or by way of new plans) and into an alternative fund, this level of income would have been achievable…*"

4.15. As noted at paragraph 4.11 above, information recorded on the files was incomplete, for example, relevant sections of the fact find had not been filled in and/or the risk rating of the product did not match the client's attitude to risk at the time the recommendation to invest in GTEPs was made and no explanation was provided for the difference.

The following examples demonstrate that the recommendation made by the Firm does not appear to have regard to the inherent risk of GTEPs and the facts disclosed by the relevant client:

(1) In one case the clients' objective was to protect their capital from erosion and maintain their income for their lifetime. They were elderly clients who had retired and had a cautious attitude to risk. The fact find did not include

information regarding the clients' medical information and expenditure. The clients would be aged 98 and 94 years old at the time that the plan matured.

(2) One client was a 70 year old widower with a "middle of the road" attitude to risk. The client was in financial difficulty and wanted to draw an additional £100 per month from her portfolio income. The client had insufficient funds available to invest in the plan and secured a loan for £10,000 at a cost of £130 per month to proceed with the investment. During the arrangement of the plan, the level of income to be drawn down had to be increased to cover the cost of the loan repayments.

(3) Another client was 65 years old with a "middle of the road" attitude to risk. The client needed additional income as her pension income was insufficient. The plan performance review for March 2007 stated that the loan to value ratio had increased to 86.65%. As a result the client was initially asked to consider reducing the level of income taken from the plan from 10% to 5%. In a further 14 cases the loan to value ratio was in excess of 70% at some point between the start of the client's plan and the production of the report by the independent reviewer.

Communications with clients

4.16. A number of failings were identified in respect of documentation provided to the Firm's clients, as set out below.

4.17. Documents sent out to clients were often long and complicated and lacked sufficiently clear information for a client to make an informed decision as to whether to accept the advice or not.

4.18. In respect of the Firm's suitability letters, the following issues were identified:

(1) They contained a generic explanation of GTEPs, their advantages and disadvantages, failing to explain in particular why the Firm had concluded that GTEPs were a suitable investment for the particular client, on the basis of personal and financial circumstances disclosed to it. For example, in the majority of the suitability letters reviewed, there was a disparity between the

risk profile of the product compared to the risk profile of the client and no explanation of why the product was nonetheless suitable. Furthermore, there was no explanation of why the level of required income justified the risk inherent to GTEPs over and above any alternative investment.

(2) The risk warnings were inadequate. Again, they were generic rather than tailored to the clients' situation and placed at the end of the suitability letter, which served to dilute their message. In particular, the suitability letters failed to make clear that the gearing element of GTEPs increased the risk for each client, for example, by drawing the client's attention to the fact that the product had to outperform the interest rate payable on the loan in order for the investor to make a profit, or that if the loan to confirmed surrender value ratio becomes too high, the lender may withdraw or reduce the loan facility, or require an additional injection of capital or security.

(3) In the majority of client files reviewed, there was no reference to alternative products considered in the suitability letter nor any evidence on the client file of research into any such products.

(4) The Firm's suitability letters routinely did not warn clients about the lack of a 'cooling off' period and that clients ran the risk of incurring costs of several hundred pounds if they changed their mind and decided not to proceed with the investment.

5. ANALYSIS OF BREACHES

5.1. By failing to ensure its advisers were properly informed and fully understood the characteristics of the GTEP product; to adequately address persistent issues arising from client file reviews and to ensure that these concerns were not repeated in its sale of GTEPs, the Firm failed to take reasonable steps to ensure the suitability of its advice, in breach of Principle 9.

5.2. By failing to gather and record sufficient personal and financial information about clients, or explain why it concluded that GTEPS were suitable for each client, the

Firm was not able to demonstrate that its recommendations to invest in GTEPs were suitable. Taking these deficiencies together, the Firm failed to take reasonable care to ensure the suitability of its advice, in breach of Principle 9 and COB 5.2.5R.

5.3. By failing to ensure documentation provided to clients was sufficiently clear and balanced, in particular by failing to ensure that its suitability letters explained the characteristics of and risks associated with GTEPs and why the Firm had concluded that an investment in GTEPs was suitable, the Firm failed to pay due regard to the information needs of its clients, or communicate with them in a way which was clear, fair and not misleading, in breach of Principle 7. By failing to ensure that clients understood the nature of the risks involved, the Firm breached COB 5.4.3R.

6. ANALYSIS OF PROPOSED SANCTION

6.1. The FSA's policy on the imposition of financial penalties as at the date of this notice is set out in Chapter 6 of the Decision Procedures and Penalties Manual ("DEPP"), which forms part of the FSA Handbook. In addition, the FSA has had regard to the corresponding provisions of Chapter 13 of the Enforcement Manual ("ENF") in force during part of the relevant period. The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have committed breaches from committing further breaches, and helping to deter other firms from committing similar breaches, as well as demonstrating generally the benefits of compliant business.

6.2. In determining whether a financial penalty is appropriate, and if so, its level, the FSA is required to consider all the relevant circumstances of a case. DEPP 6.5.2 sets out a non-exhaustive list of factors that may be of relevance in determining the level of a financial penalty.

6.3. The FSA considers that the following factors are particularly relevant in this case.

Deterrence

6.4. When determining the appropriate level of penalty, the FSA will have regard to the principal purpose for which it imposes sanctions, namely to promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches

from committing further breaches and helping to deter other persons from committing similar breaches, as well as demonstrating generally the benefits of compliant business. In this case, a financial penalty is necessary because of the importance of firms: ensuring that its advisers fully understand a new and complex product, the risk of which is augmented by gearing; obtaining sufficient KYC information; matching a client's attitude to risk to the risk profile of a product; and explaining the characteristics of and risks inherent to a product properly to a client to ensure the suitability of advice. In addition, a financial penalty demonstrates the importance of compliance with regulatory standards, when non-compliance has been highlighted by internal and external reviewers.

The nature, seriousness and impact of the breach in question

6.5. In determining the appropriate sanction, the FSA has had regard to the seriousness of the breaches, including the nature of the requirements breached, the duration and frequency of the breaches, whether the breaches revealed serious failings in the firm's systems and controls and the number of clients who were affected and/or placed at risk of loss. For the reasons set out below the FSA considers that the breaches in this case are of a serious nature.

6.6. The Firm's failings are viewed as being particularly serious because:

(1) inadequate collection of KYC information, assessment of risk and a failure to warn clients of risks meant that the Firm was not able to demonstrate that clients were sold a product which was suitable for their risk profile and personal circumstances;

(2) in half the client files reviewed, the Firm's clients are retired with a pension as their primary source of income and no significant assets other than their home should a further capital injection be required; and

(3) the Firm failed to adequately address the concerns identified repeatedly in a number of its compliance reports (as set out in paragraph 4.7 and 4.8 above). This failure is considered more serious given the fact that the concerns arose in respect of simpler investment products and yet, when the Firm embarked on the initiative to recommend a more complex and inherently higher risk

product, GTEPs, it neglected to address existing concerns regarding its advice and sales processes. A review of 3 GTEP client files was carried out by the Firm's compliance consultant in March 2007, in advance of the FSA's visit in May 2007. He commented that *"the suitability letters go into detail in relation to the structure of the investment and the borrowing, and does specify risk warnings"*. He, however, goes on to say that *"I am not sufficiently experienced with the product to decide whether the warnings are adequate…"* A subsequent comprehensive review of all the Firm's GTEP files by the Firm's compliance consultant, in January 2008, concluded that of the 23 clients sold GTEP products, 16 were potentially unsuitable.

6.7. The FSA has also taken in to account the following steps taken by the Firm which have served to mitigate its failings:

(1) the Firm has accepted that there were issues with its sales processes, and taken steps to rectify these shortcomings, including the appointment of a new compliance officer and external compliance consultants and the implementation of updated procedures;

(2) the Firm has undertaken to cease recommending GTEPs; and

(3) as yet, there is no evidence of financial losses suffered by any clients of the Firm who purchased a GTEP, although the term of the product (7-15 years) means that losses may still be incurred.

The extent to which the breach was deliberate or reckless

6.8. The FSA has found no evidence to show that the Firm acted in a deliberate or reckless manner.

The size, financial resources and other circumstances of the firm

6.9. In determining the level of penalty, the FSA has been mindful of the need to ensure that the interests of clients are protected. The FSA has also considered the following issues:

(1) the cost of the independent reviewer report incurred by the Firm prior to the Enforcement investigation; and

(2) the need for the Firm to be able to afford the cost of paying financial redress to those clients who choose to seek it within the three year timescale permitted by the Financial Ombudsman Service.

Having considered the above issues, the FSA considers that a financial penalty of £50,000 (subsequently discounted by 30% to £35,000 for early settlement) is appropriate.

The amount of benefit gained or loss avoided

6.10. The FSA notes that the Firm made approximately £80,000 in commission from the sale of GTEPs during the relevant period and continues to earn trail commission.

Conduct following the breach

6.11. The Firm has undertaken to cease recommending GTEPs and has agreed to the remedial action set out at paragraph 1.1 above.

Disciplinary record and compliance history

6.12. The Firm has not been the subject of previous disciplinary action.

Other action taken by the FSA

6.13. 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.

7. DECISION MAKER

The decision which gave rise to the obligation to give this Final Notice was made by the Settlement Decision Makers.

8. IMPORTANT

8.1 This Final Notice is given to the Firm 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 the Firm to the FSA by no later than 23 October 2008, 14 days from the date of the Final Notice.

If the financial penalty is not paid

8.3 If all or any of the financial penalty is outstanding on 24 October 2008, the FSA may recover the outstanding amount as a debt owed by the Firm and due to the FSA.

Confidentiality and 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 Final Notice relates. Under those provisions, the FSA must publish such information about the matter to which this final notice relates 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 Knowlden Titlow or prejudicial to the interest 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 please contact Russell Clifton at the FSA (direct line: 020 7066 5304).

Jonathan Phelan

Head of Department

FSA Enforcement Division