
FINAL NOTICE

To: **Leopold Joseph & Sons Limited**

Of: **99 Gresham Street
London
EC2V 7NG**

Date: **1 June 2004**

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

1. THE PENALTY

- 1.1 The FSA gave you a further decision notice on 27 May 2004 which notified you that, pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to impose a financial penalty on you in the amount of £85,000 ("the Penalty").
- 1.2 Pursuant to section 206 of the Act, and having agreed with you the facts and matters relied upon and set out below the FSA imposes a financial penalty of £85,000 on you in respect of breaches of SYSC rule 3.1.1.
- 1.3 You have confirmed that you do not intend to refer the matter to the Financial Services and Markets Tribunal.

2. REASONS FOR THE PENALTY

2.1 In the period December 2001 to July 2002, Leopold Joseph & Sons Limited ("LJSL") acted in breach of SYSC Rule 3.1.1. by failing to take reasonable care to maintain adequate systems and controls for monitoring adherence to credit limits in the areas identified in this Notice.

2.2 In so doing, LJSL demonstrated serious failings in that:

- (1) LJSL was made aware in February 1999 by the FSA that additional monitoring of the system for reporting credit limit breaches was required, specifically that the Director responsible for the area should review on a random and occasional basis the report used to identify breaches of credit limits. LJSL agreed to implement this control in March 1999.
- (2) LJSL's internal auditors confirmed the recommendation of the FSA in a report produced in September 1999, which noted that there was no evidence of the control agreed with the FSA having been undertaken;
- (3) in addition, a further internal audit report produced in October 2001 found that the reviews had not occurred for a number of months prior to the audit;
- (4) notwithstanding this second internal audit report, LJSL failed to take effective action to ensure that the reviews were implemented or to introduce an alternative control;
- (5) the failure to introduce an effective control on the monitoring of adherence to credit limits was such as to increase materially the possibility of LJSL being exposed to unauthorised and unacceptable credit risk;
- (6) such unacceptable credit risk has the potential to reduce the ability of firms to repay depositors, thereby threatening both market confidence and the interests of consumers; and
- (7) the failure to maintain the control over the report to identify credit limit breaches was highlighted by a number of breaches of credit limits and a material loss on a discretionary foreign exchange dealing arrangement for a client, where, although the loss was borne by the client, the credit excesses were unauthorised and exposed LJSL itself to increased financial risk.

2.3 It was only after the limit excesses for this client had come to light that LJSL took decisive action to ensure the control was carried out.

2.4 The FSA recognises that the failure occurred because three members of staff (two of whom left shortly after the credit limit breaches were identified) did not properly carry out the responsibilities with which they had been specifically charged. However the FSA considers that LJSL's continued failure to take effective action, particularly after the October 2001 Internal Audit report stated that the relevant control had not been performed recently, remains a serious failing on LJSL's own part such as to demonstrate a material breach of SYSC Rule 3.1.1.

3. RELEVANT STATUTORY PROVISIONS AND REGULATORY RULES

- 3.1 The FSA's regulatory objectives established in section 2(2) of the Act include market confidence, that is maintaining confidence in the financial system, and the protection of consumers.
- 3.2 Section 138 of the Act authorises the FSA to make rules applying to authorised persons with respect to the carrying on of their business.
- 3.3 SYSC rule 3.1.1, which states "*A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business*", is imposed by virtue of section 138 of the Act.
- 3.4 The FSA may impose a financial penalty by virtue of section 206 of the Act which 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."

4. RELEVANT GUIDANCE

- 4.1 The SYSC rules are designed to enable firms to manage the risks to their business adequately. Failure by firms to do so increases the risk that the FSA will not achieve its objectives. SYSC encourages the directors and senior managers of firms to take appropriate responsibility for their firm's arrangements on matters relating to confidence in the financial system, the fair treatment and protection of consumers and the use of the financial system in connection with financial crime. In this case, the breach of SYSC gave rise to an increased risk that LJSL would take on credit positions that would reduce its ability to repay depositors. This would impact on the FSA's objectives to protect consumers and to maintain market confidence.
- 4.2 The SYSC rules are supported by SYSC and Interim Prudential Sourcebook ("IPRU") guidance, which states the FSA's expectation of how firms should comply with the rules to enable them to manage the risks to their business. This guidance is used to highlight particular aspects of regulatory requirements and to indicate the possible means of compliance with rules and requirements. It is not an exhaustive description of a firm's obligations. A departure from guidance is not in itself an indication of a breach of the rules provided the firm can otherwise demonstrate compliance.
- 4.3 SYSC 3.2.3 states:
- "(1) A firm's governing body is likely to delegate many functions and tasks for the purpose of carrying out its business. When functions or tasks are delegated, either to employees or to appointed representatives, appropriate safeguards should be put in place."*

- (2) *When there is delegation, a firm should assess whether the recipient is suitable to carry out the delegated function or task, taking into account the degree of responsibility involved.*
- (3) *The extent and limits of any delegation should be made clear to those concerned.*
- (4) *There should be arrangements to supervise delegation, and to monitor the discharge of delegates' functions or tasks.*
- (5) *If cause for concern arises through supervision and monitoring or otherwise, there should be appropriate follow up action at an appropriate level of seniority within the firm."*

4.4 SYSC 3.2.11 states:

- "(1) A firm's arrangements should be such as to furnish its governing body with the information it needs to play its part in identifying, measuring, managing and controlling risks of a regulatory concern. Three factors will be the relevance, reliability and timeliness of that information.*
- (2) Risks of a regulatory concern are those risks, which relate to the fair treatment of the firm's customers, to the protection of consumers, to confidence in the financial system and to the use of that system in connection with financial crime."*

4.5 ENF 11.5.1. states that the primary responsibility for ensuring compliance with a firm's regulatory obligations rests with the firm itself.

4.6 ENF 11.7.2 states that, in considering whether a firm has taken reasonable care in relation to a particular behaviour (including with respect to SYSC rule 3.1.1.), the FSA will consider all the circumstances of the case, and regards as particularly relevant the information the firm knew at the time of the behaviour and the information they ought to have known in all the circumstances, the steps the firm took to comply with the rule and the steps they ought to have taken in all the circumstances, and the standards of the regulatory system that applied at the time of the behaviour.

5. FACTS AND MATTERS RELIED UPON

Background

- 5.1 LJSL is an authorised deposit taking institution with some 2,000 depositors and has various investment business permissions. LJSL provides private banking and fund management services to private individuals, small pension funds and charities. LJSL also provides treasury services to institutional and private clients.
- 5.2 LJSL's pre-tax profit for the year ended 31 March 2003 was approximately £1.7 million and its capital and reserves at that date was approximately £24 million.

- 5.3 On 19 July 2002, LJSL notified the FSA of a significant unauthorised breach of a credit limit and a loss in respect of a discretionary foreign exchange dealing arrangement with a particular client.

The FSA's investigation

- 5.4 Investigators were appointed on 8 November 2002 and 7 March 2003 under section 168 of the Act to examine apparent failures in controls on the discretionary dealing arrangement in LJSL's Treasury Department and the monitoring of adherence to credit limits in respect of LJSL's counterparties. The investigation focused on the period from December 2001 to September 2002.
- 5.5 The FSA reviewed documents and information provided by LJSL. In particular, the FSA considered the contents and findings of the following reports produced by LJSL's internal auditors:
- The Report on Investigation of Client Limit Breach (AUD5502) of September 2002; and
 - The Report on Treasury Counterparty Limits (London) (AUD0702) of December 2002.

Controls to monitor credit limits

Credit limits breach report

- 5.6 The report produced by LJSL's IT system to identify credit limit breaches contained a significant amount of information that did not relate to true breaches of credit limits. A member of the Credit Department was required to review the computer-generated report, identifying the true credit breaches and produce a manual report which contained the true breaches. This manual report was reviewed by the Director responsible for the area on a daily basis and by the credit committee on a weekly basis.
- 5.7 The fact that the computer generated report contained information which did not refer to true breaches of credit limits made it important that controls were put in place to ensure that the credit committee received accurate information.
- 5.8 In February 1999, following a supervisory visit, the FSA recommended that the Director should personally review the computer-generated report which showed credit excesses in order to ensure that these were being identified correctly by the Credit Department and reported in line with LJSL's procedures. In March 1999, in response to this recommendation, LJSL agreed with the FSA that the Director would carry out occasional random reviews of the report and retain a record of the reviews for audit purposes.
- 5.9 In September 1999, an internal audit report repeated the recommendation that the daily computer-generated report should be formally reviewed on a random basis and signed off by the Director. This recommendation was again accepted.
- 5.10 In October 2001, an internal audit report noted that the additional reviews recommended and agreed in the September 1999 report had not been undertaken in recent months. The report made a further recommendation that the Director should

prepare details to reconcile any differences between the excesses on the computer-generated report and those excesses reported to the credit committee when he undertook his random review of excess reports. LJSL reminded the Director to undertake the review. It chose not to implement the revised recommendation because it considered that to do so would not be an appropriate use of resources as a new computer system was being introduced which might make the review of the computer-generated report unnecessary. The FSA recognises that this was a reasonable decision.

- 5.11 The new IT system, which was introduced in December 2001, did not in fact result in a computer-generated report that was significantly different to that produced by the previous computer system. The random review (agreed in 1999) by the Director therefore continued to be an essential control.
- 5.12 A September 2002 Internal Audit report was unable to verify whether the originally agreed control of random reviews of the daily excess reports had been carried out and noted that this issue had not been pursued further by LJSL's Internal Audit & Compliance Committee.
- 5.13 The absence of the Director's occasional random review of the computer-generated report meant that there was no check that the limit excesses were being correctly identified and included in the manually prepared report.
- 5.14 The failure by LJSL to ensure that the control agreed in March 1999 and further agreed in September 1999 and October 2001 was not implemented effectively during the period December 2001 to July 2002, demonstrates that the firm failed to take reasonable care to maintain appropriate systems and controls. LJSL was aware that there were grounds to suggest that the Director was not carrying out the reviews but did not take appropriate action to ensure that this control was implemented.

The discretionary foreign exchange dealing arrangement

- 5.15 The discretionary foreign exchange dealing arrangement was a unique arrangement for a client of the Treasury Department. It involved LJSL taking positions in foreign exchange on behalf of the client. The credit limit for this client and two other clients in the Treasury Department was a net limit. The computer systems reported the positions of these three clients on a gross basis (as for all other clients) and included some trades which had been closed out. The exposure for these three clients was therefore overstated. Although aware of the overstatement of exposure for the client, a member of staff in the Credit Department made incorrect assumptions about the reasons for it and therefore did not investigate or establish the true position for the discretionary foreign exchange dealing account.
- 5.16 LJSL was aware of the reporting of these accounts on a gross rather than net basis and used a manual process for calculating the exposure on the three accounts. LJSL's management judged that it did not pose an unacceptable risk for these three client's limits to be subject to an additional manual process.
- 5.17 However, between May 2001 and July 2002 the limit for foreign exchange transactions for the discretionary dealing account was exceeded a number of times and

on some occasions by more than five times the limit. These excesses were not reported to or authorised by senior management or the Group Credit Committee.

- 5.18 In July 2002, the client had incurred a material foreign exchange trading loss of which neither the client nor LJSL's senior management were aware. The loss on this account should have been identified if the review of the Limit Breach Report had been carried out as intended.

6. CONCLUSION AS TO BREACH

- 6.1 The facts and matters described in paragraphs 5.6. to 5.18. demonstrate that, in the areas identified in those paragraphs, LJSL did not take reasonable care to maintain or operate adequate systems and controls for the monitoring of adherence to credit limits. This failure and the increased risk that it posed to LJSL's ability to meet its liabilities to depositors was highlighted by a significant unauthorised exposure and trading loss on the discretionary dealing arrangement where, although borne by the client, the credit excesses were unauthorised and exposed LJSL itself to increased financial risk.
- 6.2 LJSL is required to take reasonable care to maintain such systems and controls as are adequate to enable LJSL to manage its business and the risks to its business. In failing to do so in those areas identified by this Notice, LJSL contravened SYSC rule 3.1.1.

7. FACTORS RELEVANT TO DETERMINING THE SANCTION

Relevant guidance on sanction

- 7.1 In determining whether a financial penalty is appropriate and its level, the FSA has had regard to all the relevant circumstances of the case and to the guidance set out in ENF 13.3.3 which indicates the factors that may be of particular relevance in determining the level of a financial penalty.
- 7.2 In determining that it is appropriate to impose a financial penalty on LJSL and that the amount proposed is proportionate to LJSL's breach of SYSC 3.1.1, the FSA considers the following factors to be particularly relevant.

The seriousness of the breach

- 7.3 The seriousness of the failures lies in the lack of care taken to ensure that appropriate systems and controls were operating over the monitoring of adherence to credit limits referred to in paragraphs 6.1. and 6.2. This failure had the potential to allow LJSL to run risks that went beyond limits agreed by senior management, as was illustrated by the case of the discretionary dealing arrangement.
- 7.4 The seriousness of this issue is further demonstrated by the fact that senior management had been made aware of the need for additional monitoring of credit limit excesses by the FSA in February 1999 and its own internal audit report in September 1999. It had also been made aware in October 2001 that the control established to mitigate this risk had not in fact been carried out for a number of months.

Conduct of firm after the breach

- 7.5 The trading loss incurred by the client on the discretionary foreign exchange dealing arrangement was promptly reported to the FSA's Domestic Firms Department (Deposit Takers Division). LJSJ co-operated fully with the FSA's investigation of the breach of SYSC. LJSJ has also taken remedial steps in line with those recommended by its Internal Auditors and two of the relevant members of staff left shortly after the credit limits breaches were identified. The FSA's supervision team is content that action has been taken or is being taken to rectify previous weaknesses.
- 7.6 Furthermore, the FSA takes into consideration that
- In October 2001, LJSJ reminded the Director responsible for the system for reporting credit limit breaches to undertake the occasional random reviews of the computer-generated report as originally agreed; and
 - LJSJ accepted that its systems and controls had not operated as they were intended to.

CONCLUSION

- 8.1 Taking into account the nature and seriousness of LJSJ's failings and the risks they posed but also the co-operation shown and remedial steps taken by LJSJ, as well as the fact that LJSJ has a good record in credit quality to date, the FSA has decided that a penalty of £85,000 is appropriate in all the circumstances.
- 8.2 The FSA considers the sanction to be a proportionate exercise of its enforcement powers and consistent with the FSA's publicly stated policies.

DECISION MAKER

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

IMPORTANT NOTICES

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

Manner of payment

- 10.2 The Penalty must be paid to the FSA in full.

Time for payment

- 10.3 The Penalty must be paid to the FSA no later than 15 June 2004, being not less than 14 days beginning with the date on which this notice is given to you.

If the Penalty is not paid

10.4 If all or any of the Penalty is outstanding on 15 June 2004, the FSA may recover the outstanding amount as a debt owed by you and due to the FSA.

Publicity

10.5 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.

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

FSA Contacts

10.7 For more information concerning this matter generally, you should contact William Amos at the FSA (direct line: 020 7066 1324/fax: 020 7066 1325).

Ian Mason
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FSA Enforcement Division