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EU Financial Services Group Briefing

30 April 2003

ABN Amro - The True Significance of the FSA's Recent Punitive Action is Being Missed

On 15 April 2003 the UK Financial Services Authority ("FSA") fined ABN Amro Equities (UK) Limited ("AAE") £900,000. The final notice stated the fines were in respect of breaches of former Principle 3 and Principle 9 of the FSA's Statements of Principles.

The press coverage of the fines has focused on improper activities of the AAE traders, which occurred between April and October 1998 relating to trades in the shares of Carlton Communications plc, British Biotech plc, Volkswagen AG and Metro AG intended to ensure share prices were higher at the close than normal market trading would dictate. Comment has also been focused on the fact that the FSA has fined the former joint head of AAE's Equity Trading £70,000 for market misconduct.

This coverage, however, obscures the true significance of the AAE incident which has much wider potential impact for regulated firms. Two key lessons can be drawn from the incident, one from the text of the final notice itself, the other from the larger circumstances surrounding it.

Background

Principle 3 of the former FSA Principles provides that :-

> "a firm shall observe high standards of market conduct. It should also, to the extent endorsed for the purpose of this principle, comply with any code or standard as in force from time to time and as it applies to the firm either according to its terms or by rulings made under it."

Principle 9 of the former FSA Principles provides that :-

> "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."

In the Final Notice, the FSA sets out two main causes justifying its punitive action against AAE.

Firstly, it states that AAE breached former Principle 9 by failing to :-

(a) allocate adequate resources to compliance policies and procedures to enable its compliance functions to be carried out effectively and kept up-to-date;
(b) maintain well-defined policies and procedures; and
(c) maintain proper compliance and monitoring of its staff.

Secondly, the FSA final notice recites three separate trading incidents which amounted to breach of Principle 3.

The FSA, then, importantly, comments that the breaches of principle were aggravated by the fact that AAE was aware and was made aware at a Senior Management level of deficiencies in the firm's compliance resources, policies, procedures and training, but despite having been made so aware, no adequate remedial steps were taken.

The FSA itemised the offences with regards to the compliance failings as follows :-

1. Compliance manpower resources: the compliance team was, in the FSA's view, far too small to deal with the compliance procedures, policies and training required for the size and nature of the businesses for which the compliance team had oversight responsibility. This was against the light of the fact that the compliance officer had requested an increase in his team but that had not been actioned.

2. Compliance policies and procedures: the FSA noted that individual compliance manuals for AAE had not been prepared, consistent with ABN AMRO's general policies and procedures, and that there was no local compliance manual in place for the UK equities trading arm during the period in which the defaults occurred. The FSA also noted that there was no evidence of routine monitoring of trades on the floor during the relevant period. This is ascribed to the fact the "front line" compliance team were redeployed from routine monitoring and assistance to "non-routine" tasks. This is seen as a systemic failure by the FSA.

3. Training: the FSA noted that there was no ongoing training provided by AAE to existing employees, particularly with regard to market abuse and the correct identification of potentially abusive training.

The FSA conclude that, during the relevant period, AAE suffered from serious weaknesses in its management systems and internal controls. It concludes that the failure to allocate adequate resources to compliance policies and procedures, to maintain well-defined polices and procedures and to maintain proper compliance and monitoring and training meant that AAE fell seriously short of the standards required by the rules then in force. The FSA states expressly that the failure was made all the more serious because AAE failed adequately to address the compliance under-resourcing despite being alerted to the problems by its own internal audit department and compliance officer.

To quote the FSA :-

> "Although the firm's compliance officer brought the compliance issues to the attention of AAE's senior management and advised them of the likely effect of failing to address the regulatory issues, they failed sufficiently to act within a reasonable period to remedy the breaches. AAE had resources at its disposal to meets its regulatory obligations. However it did not devote sufficient of those resources to compliance and accord compliance sufficient priority to ensure it kept pace with the firm's growth."

The FSA also noted that AAE had been less than entirely candid in its relationships and disclosures to FSA– FSA's comment being that it was not informed of the internal review of compliance and control procedures conducted in the first quarter of the year 2000 until August 2000.

The fact that the FSA accord more importance to the failure of systems and controls than to the lapse in market standards can be seen from the proportion of the fines which are attributed to the different breaches. With regard to the proposed contravention of former Principle 3 (the "market conduct" Principle), the appropriate financial penalty as determined by the FSA was to be £500,000. With regard, though, to the contravention of Principle 9, the FSA determined the appropriate fine should be £750,000–indicating that it attributed much greater significance and greater blame to the breach of the "systems and controls" requirements than to the "market conduct" strictures. The overall fine was adjusted to £900,000 in light of financial penalties already imposed by the London Stock Exchange.

This point was emphasised by Carol Sergeant, Managing Director of FSA in the related FSA press announcement, where she said :-

> "The compliance environment within a financial institution is a fundamental protection against the spread of poor standards of conduct. We view with particular seriousness mis-conduct that occurs in the context of a firm's inadequate investment in compliance procedures, policies and training."

The second point to note is that the investigation by the FSA commenced in February 2001, following a tip off from the SEC, which had conducted its own separate probe into the firm.

Conclusion

The FSA's action provides strong weapons for any compliance director or general counsel arguing against headcount freezes or cuts.

There has been some debate about the importance ascribed by the FSA to its current General Principle 3, which provides that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems and which is then built upon by the section of the FSA Handbook entitled "Senior Management Arrangements, Systems and Controls." Previously, though, there were no precedents of the FSA taking high profile severe enforcement action to address what it saw as default in this area of conduct.

There were, however, warnings of the tack the FSA might take. The FSA previously commented that they will

take a particularly serious look at the back-office and compliance and legal functions of firms and, during a recession, where head-counts are being frozen or cut, would take a dim view of firms that seek economies in their compliance department.

The FSA, in its judgment on AAE, is doing two things: firstly it is making it clear that it sees a properly staffed compliance department, armed with both compliance manuals, policies and procedures for monitoring trades, with ample resources for dealing with "non-routine" tasks as well as day to day monitoring, leaving behind it an audit trail of its activities as being an essential part of a firm's risk management armory and secondly it is indicating that it will punish defaults in this area, particularly if they exacerbate other actionable breaches and that a slenderly resourced compliance department will be a key indicator to the FSA in its investigations of possible risk and, more crucially, potentially a lack of a "compliance culture."

It is also interesting to note that FSA were willing to state publicly that it was an SEC prompt that got them going. One can only anticipate similar prompts in different areas in due course!

Firms would be well advised to take a hard look at the adequacy of their procedures, staffing levels, appropriateness of their surveillance reports and processes to see how their current compliance structures and training would measure up to the FSA's clearly stated high hurdle and, if they fall short, ensure commitment of budget and manpower to bring things up to scratch.

Even when economic and business considerations constrain compliance resources, firms can nevertheless assure that they are applying their resources wisely and effectively. WCP has a leading practice in advising securities firms regarding supervisory and compliance procedures and its clients include some of the largest broker dealers, investment banks and financial services firms operating in the United States, Europe and globally. It has assisted clients in similar reviews and is well placed to support clients in response to this drive from the FSA.

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