This article has been reproduced with the permission of Complinet Ltd (www.complinet.com). Complinet is the leading provider of critical financial services compliance information and technology solutions throughout the world.”

http://www.complinet.com/connected/

The Adam Samuel Report: The Square Mile compliance disaster

Jan 16 2008 Adam Samuel : www.complinet.com

Earlier this week the Financial Services Authority issued a final notice fining Square Mile Securities £250,000 for breaking almost every imaginable rule about selling small cap shares to consumers. The document leaves a sick taste in the mouth that the financial services industry continues to operate in this way almost 20 years after regulation came in. Even more so, the spirit weakens at the thought that, in spite of the multitude of appalling compliance breaches, the regulator appears to have taken no action against any individual. A total of 624 customers paid just under £4m between March and May 2006. Every one of them should be entitled to a refund.

The rap sheet - The sales culture

The firm created a highly pressured sales environment with remuneration incentivising sales at all costs. Staff were threatened with losing their jobs and their customer base if they did not achieve their target sales. Actually, these types of threats and remuneration packages were common in the life assurance sales environment of the late 1980s and most of the 1990s. Yet, the FSA's predecessor regulators did very little to stop them. Square Mile did pay its salesmen a basic wage, which is more than a number of insurers did to the "self-employed" consultants who were miss-selling endowments and pensions on an industrial scale. Equally, Square Mile's practice of holding meetings to discuss sales techniques and reinforce the need to make sales mirrors goings on in the life insurance industry in the 1990s. The firm continuously updated a whiteboard with the total value of the shares available and required to be sold that day. Advisers were required to stay after hours to meet the target. Commissions increased with the risk involved in each security. They were between five per cent and ten per cent of each share sold.

Advisers commented:
"In terms of the impact on the client … I won't know directly but we just give the client the stock that we get told to give them"; and

"When you're under pressure, you don't always [and] you cannot always say the correct thing [to customers] or [you are not] always balanced."

Client consent
In seven out of 55 transactions that were reviewed, advisers carried out orders without client consent. The customer later received contract notes requiring payment and a customer debt was created. Senior management knew of rumours of this and did nothing. Senior advisers entered into organised "pacts" to coordinate the writing of unauthorised trade tickets. This was known as "writing up rubbish". An 89 year-old was charged £75,000 from five transactions without his consent. A 79 year-old was charged £129,000 in the same way.

Pressure, pressure, pressure selling
Under the heading of "pressurised selling", there is some behaviour which looks more like a "con trick".
"Advisers used a tactic of revealing to customers that they knew of an upcoming investment opportunity to which the customer would have to act quickly to secure it. The advisers informed the customer they would be contacted again when the opportunity crystallised. A subsequent call would then be made by a "senior adviser" who would make a highly pressurised recommendation and actively encourage the customer to complete an immediate purchase of the Securities before the opportunity was lost. However, in reality there was no real urgency as Square Mile had already been recommending the Securities for a number of months prior to the Relevant Period and would continue to do so after the transaction."
Clients were falsely led to believe that they were part of a limited group to whom the shares were being offered.

Some transactions checked showed advisers recommending shares persistently in spite or repeated rejections and information that would suggest that the shares were unsuitable for the client. To overcome this, one adviser told a customer to sell London Stock Exchange-listed shares on the basis that they "were just going to go down and down and down."

An adviser rang twice in five hours to sell shares to a person who asked for more time on both occasions while dealing with the estate of a deceased spouse. Another rang eight times to sell to a customer who was not comfortable investing, promising that this would be the last time anyone from the firm would sell him anything. Sure enough, three weeks later, an adviser was recommending the shares.

One customer encountered 13 calls in eight days and was sold £7,000 of shares even though he only had £5,000 in cash. He was promised that this was the last sales call. He was rung four times in the next two days and pushed into buying another £3,000 worth. Eight calls in five days produced another £4,000 purchase.

Truth economies
The firm recklessly failed to conduct its own research into the small caps that it recommended. It had no fixed criteria for the shares recommended apart from client appeal. The only checks were done by an external supplier of the securities. It never had the right information about what it was selling and the risks involved, so it made up the information. In this information vacuum, advisers made statements beyond their knowledge.

Some advisers just fibbed, saying:

(1) ... the issuing company of one of the securities had an established and profitable business when … it was a 'cash shell' company;
(2) … the issuing company … had been in business for several years when, in fact, it had just been admitted to trading on an exchange and had no trading history;
(3) … about the issuing companies entering into new industries, making acquisitions and expanding its businesses when there was no basis to support such statements; and
(4) … speculative and incorrect information about the issuing companies' finances and profitability."

Similar economies with the truth concerned the expertise of the firm:

(1) A new customer who was 68 years old and retired was told … that the adviser was "…one of the top guys" and that "I look at everything in the financial markets, whether it's a blue chip share, contracts for differences or small cap. I look at absolutely everything for my clients." … Square Mile involved the offer of only a limited choice of small cap securities at any one time, for example, securities issued by two to four different companies and quoted on only two exchanges.
(2) A customer who described himself as a "completely new investor", "very cautious" and did not have "a lot of money" was told on four occasions by an adviser, … that they had been in the financial services market "nine years". In fact, at the time of making the statements, the adviser had been in the industry for only five years."

This approach extended to descriptions of the business' research activities. Success was attributed (falsely) to the firm's analyst who did not exist:

(1) A new customer was told that Square Mile had spent £6.8m on research and "…that's what separates us from any of the other companies out there". In fact, … Square Mile had only spent about £25,000 on research … that year; and
(2) One customer was told "I'll tell you why I'm excited about this one mate, very simply, I have worked with this analyst many, many times before, and he's given me some of the biggest winners." Another customer was told that "our analysts are very, very bullish".

This went on in spite of an e-mail from compliance telling advisers not to make such comments.
"We …do not have a registered analyst let alone 20." … Call monitoring had revealed that some advisers were telling customers that "our 20 analysts are excited about the said deal."

A total of 26 out of 55 cases reviewed involved prominent statements about future high returns based on pure guesswork or fibs.

(1) A 78 year old customer, who had trouble recalling the adviser's name and previous conversations he had held with advisers, was told that the price of the security had "gone up 50 per cent in one month. It went from 3½ pence to six pence … and within the next two to five years it may be about 40 or 50 pence".

(2) Another customer was told if … they invested £5,000 there was a potential return of "15 to 20 grand over the next 12 to 36 months"… an expected increase … of between 300 per cent and 400 per cent …

The predicted returns varied even when talking about the same share on the same day. Three advisers ranged from projected growth of between 363 per cent and 826 per cent .

Past performance

Past performance information was used prominently, inaccurately and in relation to incomparable investments.

(1) A new customer, who was 68 years old and retired, was told during the course of a recommendation that "the last ten recommendations, we've [Square Mile] had seven winners … okay" … "You know we are a profit making entity" ... Only one out of 15 securities sold by Square Mile had performed well; and

(2) One customer was told that the last time Square Mile received small cap securities from a particular stock provider they "… went up by 130 per cent over 12 months, and the one before that … went up 200 per cent over 12 months." The adviser then told the customer that such a rate of return was achievable for one of the securities. These statements were misleading as they placed emphasis on the past performance of unrelated securities without stating either that it might not be achieved in this case or that previous recommendations had not performed as predicted."

The firm failed to mention shares that had not done well. What a surprise! It does mess up the balance of the material provided, however.

Compulsory risk warnings

Advisers failed to provide the then compulsory risk warnings about the shares being issued. Similar warnings would be required now anyway. It is just that under the old rules there were some standard formulas that had to be uttered for penny shares. The firm actively discouraged advisers from giving customers information about the relevant risks and the negative aspects of higher risk securities.

The warnings should have covered the restricted market, the extra risk of losing money and the bid to offer spread involved in small cap shares. In 47 of the 55 transactions reviewed, the firm failed to provide this information.

(1) 29 of the 55 transactions reviewed, the references made to risk were largely cursory and the material risks ... disregarded or obscured. …One customer was told that small cap securities are "high growth, but it's classified as high risk";

(2) In 18 of the 55 transactions reviewed, advisers made statements that undermined, detracted or contradicted any reference made to risk or made speculative forecasts of significant increases in the price … For example, a Square Mile adviser told a 66-year-old customer, who purchased the securities for 4.7 pence per share, that they would provide "just the standard risk warning" and stated "…our stocks are a high degree of risk". The failure …was exacerbated when the adviser stated the "downside [to the securities is] limited to your initial investment, upside unlimited". The higher and particular risks ... were again diminished by the adviser stating that a previous Square Mile recommendation had returned 700 per cent ; and
(3) In 20 of the 55 transactions reviewed, advisers did not explain that the securities were long-term investments."

Know your customer and suitability — a hopeless cause
In this environment, know your customer and suitable advice did not stand a chance. In 49 of 55 cases, the firm did not have up-to-date information about the customer's personal and financial circumstances before giving advice. Only after the recommendation was made was information collected to enable the client to open an account.

In 51 out of 55 cases, information was inaccurate and insufficient to enable sensible recommendations to be made. In 23, the firm disregarded relevant information provided. Advisers did not the customers' agreed risk capital levels and their payment and trading histories which was vital material. In eight of 55 transactions, the customer was risk averse. In 19, affordability worries were ignored and the customers bludgeoned into buying.

Exceeding the agreed level of exposure to risk

Advisers continued to sell shares to individuals who had already exceeded their agreed level of exposure to risk. The 89-year-old referred to previously was sold £398,000 worth of securities although his agreed risk capital limit was £25,000. The 79-year-old was sold £284,000 of shares although his agreed limit was £10,000.

There were more examples of this:
(1) A recommendation to purchase £24,500 of the securities was made to a customer with an income of £100,000, net assets of £220,000 and an agreed risk capital level of £25,000 … The customer had already purchased securities costing £205,017. Although the client agreed to the purchase, which increased their total investment to £229,517, the adviser failed to seek the customer's consent to trade above the agreed risk capital level and did not obtain financial and personal information from the client to determine if the purchase was suitable; and
(2) A recommendation to purchase £2,000 of the securities was made to a 68 year-old retired customer with an annual income of £15,000, net assets of £220,000 and an agreed risk capital level of £1,725. The customer agreed …which caused the total cost of their Square Mile holdings to increase to £6,500. The adviser did not seek personal or financial information from the customer to determine whether the trade, which further increased their exposure above the agreed risk capital level, was suitable."

Mixing public and private information
The firm failed to tell advisers what information was public. Advisers mixed it all up and disclosed non-public material to customers. Advisers also received material about securities that was "outdated, inaccurate and incorrect". The firm needed procedures to govern the approval and monitoring of sales scripts.

Inevitably — systems and controls
When miss-selling on this scale is going on, one can rely on the FSA to blame systems and controls. Actually, immoral reckless management makes the creation of appropriate procedures mechanically impossible. Nevertheless ...

There was no apportionment of duties among senior management. Availability determined who did what. The firm had no apportionment and oversight officer between June 2003 and August 2006. The board met intermittently and only invited compliance along after the FSA turned up. No fixed agenda or any discussion of compliance was a feature. Management committee meetings where compliance attended were sporadic, as was the discussion of that subject when they did occur.

Square Mile failed to conduct ongoing risk assessments, identify and assess the risks to the business and its customers from the small cap business, establish robust operational procedures to manage, control and mitigate identified risks. It certainly could not establish and maintain appropriate compliance policies and procedures. Regular proper compliance and risk management information should have gone to the board.

Compliance had to raise issues repeatedly before anyone did anything. The board failed to define the authority and duty of that function and ensure that this was recognised within the firm. It did not establish proper procedures for the firm that were up-to-date. The compliance manual contained large chunks of irrelevant detail and only came into existence in the winter of 2003/4. It was never updated. In addition, employees did not have access to it and no effort was made to ensure that they knew about it and complied with it. That, of course, would have messed up the sales methodology! The board failed to review and assess the firm's compliance arrangements. That rather followed from what the FSA found on the ground.

Sales monitoring
Sales monitoring did not start until late 2004. Before then it was limited to complaints and was not assessed by compliance. In December 2004, the firm started looking at ten cases a month, a very small proportion of calls. In any event, the firm failed to assess the content of recommendations and could not assess what advisers said. Findings were not linked to previous work and complaints data. Unsurprisingly, the FSA found:

- "No comprehensive assessment or analysis of compliance findings to identify and understand the continuing and/or re-occurring failures to meet regulatory requirements;
- No established arrangement for the identified failings of individual advisers to be reported to line management … for … an assessment of competence and, where necessary, the identification of remedial training; and …
- No established arrangements for the formal reporting of findings to senior management until April 2006 or to provide for the periodic review of results to determine if any unacceptable trends or risks had been identified."

Monthly sales reviews simply stopped between November 2005 and March 2006.

Training and competence

Training and competence was unlikely to survive such an experience unscathed. The FSA found that the firm:

- "Failed to implement a training and competence programme … adequate for its business. …Square Mile … failed to establish robust operational procedures that measured the regulatory knowledge and skills of its advisers.
- Did not maintain records to show that it regularly and effectively assessed the training needs of its employees or that it set development timescales [or] adhere to its own internal procedures which required that all training must be documented.
- Did not have a structured induction programme and new advisers were not made aware of their individual training needs or regulatory responsibilities The limited training … consisted mainly of informal staff briefings that were unstructured and … orientated mainly towards sales practices. There was no formal training that was sufficiently focused on regulatory and compliance requirements.

- Failed to … ensure that the competence of its advisers was assessed and maintained. It did not have adequate competence assessment criteria … clearly understood by its advisers and their supervisors. There were no formal statements of competence or technical briefing papers to assess an adviser's competence. In practice, advisers were reclassified from trainee adviser (CF22) to investment adviser (CF21) without assessment or tests."

The bill

The bill, as usual, involves a remedial package, the effectiveness of which cannot be judged by the final notice. A novelty is a variation of permission to obtain independent approval of all transactions and the opening of any new client accounts. Sales must be restricted to £48,000 per customer, although over what period is unclear.

This final notice describes acts which constitute decent evidence of criminal offences of obtaining property by deception and conspiracy to defraud. The notice was agreed with the company. Now it is time to take action against the individuals involved, otherwise nobody will take the regulator seriously.

• ***Adam Samuel*** *advises and trains insurers, IFAs and various other types of intermediaries on complaint handling, financial promotions and other compliance issues. He can be reached through 0207 323 9171 and 07900 248150.*

Leas Bachatene
Managing Director – Middle East
Complinet | Connected Compliance™
DMCC (Dubai Multi Commodities Centre)
Union House, 5th Floor, Port Saeed Road,
PO BOX 43659,
Dubai, UAE

About Complinet

Complinet is the leading provider of solutions that dynamically deliver relevant compliance intelligence to industry professionals within the highly regulated global financial services community. Complinet enables customers to minimize their exposure to risk by providing the information and technologies they need to track and connect live external events such as regulatory or sanction changes with internal policy management and screening activities. Complinet was founded in 1997 and employs over 200 people in its offices in New York, London and Dubai.

Every day, industry professionals in more than 1,200 firms across 81 countries rely on Complinet to provide information, analysis and solutions that help them keep pace with changing industry regulations.

In August 2007, Complinet was named by Financial News as one of the 21 technology companies most likely to shape the future of the financial services industry.

Complinet has announced the launch of 2nd GCC Regulators' Summit on February 19th & 20th at the Ritz-Carlton, Bahrain: a unique opportunity to hear regional regulators' views on the market's developments. For more information, click on http://www.complinet.com/gatherings/gcc/summit/2008/

UK (Head Office): Third Floor, Vintners' Place, 68 Upper Thames Street, London, EC4V 3BJ - Tel - +44 (0)870 042 6400
USA: 1250 Broadway, Suite 1902, New York NY 10001 USA - Tel +1 212-758-7000

Complinet has achieved a ranking in the Sunday Times PwC Tech Track 100 of fastest growing companies. Only 3 companies have featured in the Tech Track 100 for four consecutive years and Complinet is one of these firms.

Complinet Ltd is registered in England. Registered office at Vintners Place, 68 Upper Thames Street, London EC4V 3BJ. Company number 3170722. VAT No. 749 324 021. Complinet Inc is a corporation registered in Delaware, USA.

2008 Complinet Ltd and its contributors. All rights reserved.