

18 May 2000

SFA Disciplines Natwest and 2 Individuals

SFA today announced it has concluded disciplinary proceedings against NatWest Capital Markets Ltd ("NWCM"), National Westminster Bank Plc ("NWB"), Kyriacos Papouis and Neil Dodgson.

The proceedings arose out of the mismarking of interest rate options by Mr Papouis and Dr Dodgson and related deficiencies in the control environment of NWCM and NWB.

The following penalties have been imposed:

- NWCM and NWB, in breach of Principles 2 & 9 and other SFA Rules, to be severely reprimanded and jointly pay a fine of £320,000 and a contribution to SFA's costs of £100,000.
- Mr Papouis, in breach of Principle 1, to be expelled from the Register of Representatives and Traders, pay a fine of £50,000 and a contribution to SFA's costs of £2,500.
- Dr Dodgson, in breach of Principle 2, to be reprimanded, pay a fine of £5,000 and a contribution to SFA's costs of £2,500.

Case Overview - Losses incurred on options books totalling £90.5 million

In February 1997 NatWest Markets (NWM) discovered, as a result of an internal review, a discrepancy in the Deutschmark (DEM) swaptions book. Following an investigation NWCM concluded that DEM, sterling (GBP) and other option and swaption books had been mismarked. This resulted in a write down which realised a loss of approximately £90.5 million in total. £55.6 million of this related to the DEM books run by Mr Papouis and £24.6 million of this related to the GBP books run by Dr Dodgson. The matters were investigated by SFA resulting in these proceedings.

Mr Papouis - Mismarking (Mar 1995 to Feb 1996)

Mr Papouis was employed by NWCM as an options trader in the Rate Risk Management business area of NatWest Markets ("NWM"). Mr Papouis, reporting to Dr Dodgson, traded DEM options and swaptions.

Between March 1995 and December 1996, Mr Papouis concealed losses which had occurred within the deutschmark ("DEM") options book by overvaluing his positions. Until February 1996 he over-valued the exchange-traded options held on the book. During 1995 the escalating losses he concealed rose as follows:

- March - £1.1 million
- June - £7.96 million
- September - £17.3 million
- December - £22.4 million.

By February 1996, the concealed losses had risen to £24.16.

On 7 February 1996, Mr Papouis was informed by a member of NWM's back office staff that the price recorded on NWM's back office system for the exchange traded DEM options appeared to

be off market i.e. the price was different to the Exchange price on the back office price feed and that "something had to be done about them".

Mr Papouis concealed this loss by, in effect, moving it to the swaptions book where he continued to conceal it by a series of inter-book transfers and also by over valuing positions. Mr Papouis continued to overvalue positions until he left NWM on 16 December 1996.

In February 1997 the mismarking was discovered resulting in the DEM options and swaptions books being written down by £55.6 million.

Dr Dodgson – Mismarking (Dec 1995 to Feb 1996)

- Dr Dodgson was employed by NWCM as Global Head of Interest Rate Options and traded
- GBP options and swaptions.

Between 28 December 1995 and 16 February 1996, Dr Dodgson consistently marked various exchange-traded options on the GBP options book at a level higher than the market price. In most cases the price differential was significant.

On 19 February 1996, Dr Dodgson made significant changes to the prices of his exchange-traded options in order to bring the mark-to-market valuation closer to the market price. These price adjustments resulted in a decrease in value of the GBP options book of £2.9 million. This was not apparent from Dr Dodgson's daily profit and loss figures as he realised approximately £3 million of "reserved profit" on the same day.

NWB& NWCM - Control failings (Jan 1994 - Feb 1997)

NWM, which was not a separate legal entity, was the corporate and investment banking arm of the NatWest Group. NWCM conducted trading activities on behalf of NWB: the resulting transactions (which included the business of NWM) were booked to the balance sheet of NWB. Between January 1994 and February 1997 various fundamental concerns relating to high level control issues had been notified to senior management on numerous occasions by reports from internal and external auditors as well as other internal reports. The concerns included the following:

- Back office procedures were not properly performed and as a result the discrepancies arising from the failure to mark exchange traded options to market between March 1995 and February 1996 were not identified.
- independent valuation of trading positions was inadequate.
- there was significant and widespread non-compliance with internal minimum control standards. No part of NWM fully adhered to the minimum control standards.
- the NWM control environment was not adequate.

Factors taken into account

SFA has taken into account that NWCM, NWB, Mr Papouis and Dr Dodgson have each co-operated fully with its investigation. It has also taken into account that:

- During the material period, efforts were being made to improve the control environment at NWB and NWCM and since February 1997 substantial progress has been made to strength the control environment.
- the mismarking did not result in loss to any third party.
- the mismarking and related control failures were voluntarily disclosed to SFA by NWB. They were investigated promptly and completely by NWB and all relevant reports and materials were provided to SFA.

Notes to editors:

1. OTC options and swaptions are highly complex financial products, which can be difficult to value. By comparison, exchange-traded options are straightforward products which can simply be valued by reference to the prices published by the relevant exchange.
2. A swaption is an option on a swap. Swaptions are over the counter (OTC) products.
3. Explanation of The Principles:
 - P1 requires a firm/individual to observe high standards of integrity and fair dealing;
 - P2 requires a firm/individual to act with due skill, care and diligence;
 - P9 requires a firm to organise and control its internal affairs in a responsible manner.
4. SFA is the regulatory organisation established under the Financial Services Act 1986 with responsibility for regulating members of the organised City investment markets, i.e. the stock market, eurobond, financial futures, commodity futures markets and also corporate finance specialists and off-market traders. Around 1,350 firms are regulated by the SFA.
5. The Government announced on 20 May 1997 that it would create a single regulator for all financial markets merging nine regulatory bodies including SFA. On 1 June 1998, the FSA began to supply regulatory services under contract to SFA and the other two Self Regulating Organisations (SROs). In addition, the staff of SFA, IMRO and PIA and the Supervision & Surveillance Division of the Bank of England took up their new posts as employees of the FSA.
6. A copy of the Board Notice is now available on this website.