

20 December 2001

SFA Expels Brandeis for mispricing and misuse of information

The Securities and Futures Authority (SFA), a subsidiary of the Financial Services Authority, has settled disciplinary proceedings against BBL (Brokers) Ltd ("BBL"), Stewart Penfold and Robert Swain in relation to BBL's dealings on behalf of Herbert Black and his associated companies ("the Black Customers"), with the following outcome:

- **BBL has been expelled from SFA authorisation**
- **BBL has agreed to compensate certain customers in the amount of £1.75 million and agreed to pay a contribution to SFA's costs of £317,568**
- **Stewart Penfold, BBL's copper dealer until September 1996, has been found to be not fit and proper and has been required to pay costs of £5,000**
- **Robert Swain, BBL's aluminium dealer in 1996 and 1997, has been suspended from the Register of Representatives for two years, required to pay a fine of £25,000 and required to pay costs of £10,000**

SFA has taken into account in determining the level of penalty that BBL has agreed to compensate the Black Customers in the amount of £1.75 million. Had such compensation not been agreed, SFA would have imposed a fine in addition to expelling BBL.

The SFA Enforcement Committee settled this case before the FSA received its full powers on 1 December 2001.

The full details of the case are set out in the SFA Board Notice that follows.

SFA Board Notice 609

BRANDEIS (BROKERS) LIMITED

In July 2001 SFA commenced disciplinary proceedings against Brandeis (Brokers) Ltd ("BBL") which were concluded by settlement before N2 with the following outcome:

- **BBL has been expelled from authorisation**
- **BBL has agreed to compensate certain customers in the amount of £1.75 million**
- **BBL has agreed to pay a contribution to SFA's costs of £317,568**

BBL was a Ring Dealing Member of the London Metal Exchange ("the LME"). These proceedings arose out of BBL's dealings on behalf of Herbert Black and his associated companies ("the Black Customers") in 1996 and 1997. The Black Customers were non-private customers of BBL and were very active traders in LME copper contracts. They were BBL's largest customer during 1996 and 1997. The Black Customers traded frequently in large volumes and were known by other market participants to do so. Certain of the Black Customers' orders were very substantial and likely to have market impact. Mr Black was a very experienced metals trader whose expertise was recognised by the market as a whole.

The Black Customers customarily placed orders with BBL for the purchase and sale of copper. At the material time BBL ran a proprietary copper trading book as well as executing orders for customers. In addition, three other proprietary trading books also traded copper. The BBL copper dealer would execute trades for the copper book for which he was responsible, trades for other

BBL proprietary trading books run by other BBL traders and trades with and for customers. BBL earned income from customer orders through commission charged at pre-agreed levels.

Much of the trading in LME copper contracts effected by BBL on behalf of the Black Customers had the following characteristics:

- while BBL carried out such transactions as a principal in form, it was a riskless principal (save for credit and operational risk involved in dealing with the Black Customers and the counterparty). The risk of going short or long attached to the Black Customers;
- BBL received a commission for effecting the transaction;
- the Black Customers gave BBL a considerable amount of discretion;
- BBL had assured the Black Customers that it would always attempt to transact business with them on the best terms available at the relevant times (although BBL had, in its terms of business, also notified the Black Customers of the inherent conflict arising from its proprietary dealings and had excluded best execution).

In such circumstances, BBL's relationship with the Black Customers was in substance that of an agent, or that of a fiduciary, owing the following obligations:

- to act in the best interests of the Black Customers, putting their interests ahead of its own;
- to be truthful, open and fair with the Black Customers;
- to attempt to procure for the Black Customers the best terms available at the relevant times;
- where the Black Customers entrusted confidential information to BBL, to deal with that information for the purposes authorised by the Black Customers and not otherwise;
- to charge the Black Customers prices which reflected the prices at which BBL had filled the order plus or minus the agreed commission;
- where BBL received an order from the Black Customers, not to take advantage of that order so as to obtain an undisclosed benefit for itself or for a third party.

On frequent occasions in 1996 and 1997 BBL deliberately mispriced the Black Customers in respect of their copper orders. BBL frequently profited substantially from the deliberate mispricing of the Black Customers' orders, at the Black Customers' expense. In particular BBL overcharged the Black Customers by charging them prices which did not reflect and were higher than the prices at which their copper orders had been executed; BBL did not deal with the Black Customers' orders fairly and in due turn; and BBL did not allocate orders fairly. In addition, on a number of occasions in 1996 and 1997, BBL took advantage of confidential information in that: BBL traded ahead of the orders of the Black Customers and subsequently allocated tonnage to the Black Customers at prices higher or lower than the prices at which BBL itself had traded; and BBL allocated tonnage to the Black Customers from its own book at prices higher or lower than BBL had transacted the executions in the market.

Further, on occasions in 1996 and 1997 BBL deliberately misused confidential information relating to the intentions and orders of the Black Customers. In particular, BBL disclosed the Black Customers' intentions and orders to BBL proprietary traders; disclosed the Black Customers' intentions and orders to certain third parties; traded ahead of the Black Customers for its own benefit or for the benefit of others; misused information as part of its mispricing of the Black Customers' orders.

There was an unrestricted passage of information between certain BBL employees as to the Black Customer orders. BBL profited substantially from its misuse of confidential information relating to the intentions and orders of the Black Customers.

SFA has concluded and, for the exclusive purpose of achieving a settlement of these proceedings, BBL has admitted the following:

- that in 1996 and 1997 it deliberately mispriced and misused confidential information in breach of Principle 1 of FSA's Statements of Principle (high standards of integrity and fair dealing);
- that on other occasions in 1996 and 1997 it failed to act with due skill, care and diligence in relation to the pricing of the Black Customers' orders and the use of confidential information in relation to those orders in breach of Principle 2 of the FSA's Statements of Principle (due skill, care and diligence);
- that in 1996 and 1997 it was frequently in breach of Rules 5-37 (customer order priority) and 5-42 (fair allocation) of SFA's Rules by failing to deal with and by failing to allocate the orders of the Black Customers and own account orders fairly and in due turn;
- that without effective Chinese Walls, there were obvious conflicts of interest between BBL, which ran proprietary trading books as well as executing orders for customers, and the Black Customers and that notwithstanding the obvious nature of these conflicts BBL:
 - (i) provided no specific training or guidance on the management of such conflicts of interest, particularly in relation to the dual capacity nature of the market;
 - (ii) implemented no specific procedures to manage such conflicts of interest;
 - (iii) undertook no compliance monitoring to ascertain the manner in which conflicts of interest were being managed;
- that in 1996 and 1997 it was frequently in breach of Principle 6 of the FSA's Statements of Principle (conflicts of interest) by failing either to avoid conflicts of interest arising or failing to ensure fair treatment to the Black Customers and further by unfairly placing its interests above those of the Black Customers. BBL made substantial profits to the detriment of the Black Customers;
- that BBL had no procedure to enable independent verification that the prices charged to the customers reflected the prices of the deals comprised in that allocation. BBL did not provide any specific guidance or training to staff on allocation or mispricing. BBL did not prohibit, discourage or monitor the sharing of confidential information. BBL gave only limited guidance on confidentiality, and no additional guidance was given in relation to the need to keep matters such as client orders confidential from fellow dealers, account executives and other employees in particular circumstances;
- that in 1996 and 1997 it was in breach of Principle 9 of the FSA's Statements of Principle (internal organisation) in that it failed to organise and control its affairs in a responsible manner; failed to have adequate arrangements to ensure that its staff were properly supervised; failed to have well-defined compliance procedures, including appropriate Chinese Walls; and failed to maintain adequate records;
- that it is no longer fit and proper to be authorised by SFA.

SFA has taken into account that all relevant employees have left the company; that new management has been appointed; that BBL has ceased trading on the LME and is in the final stages of irreversibly winding down its operations; and that BBL has co-operated with all aspects

of SFA's investigation. SFA has also taken into account in determining the level of penalty that BBL has agreed to compensate the Black Customers in the amount of £1.75 million. Had such compensation not been agreed, SFA would have imposed a fine in addition to expelling BBL.

Metals firms are reminded of the guidance contained in Board Notice 578 as to the customer relationship and other conduct of business requirements.

SFA also commenced proceedings against various former employees of BBL in July 2001. Of those, proceedings against the following have now been concluded by settlement with the following outcome:

- **Stewart Penfold has been found to be not fit and proper and has been required to pay costs of £5,000**
- **Robert Swain has been suspended from the Register of Representatives for two years, required to pay a fine of £25,000 and required to pay costs of £10,000**

Mr Penfold was BBL's copper dealer until September 1996. Mr Penfold has admitted that:

- in 1996 he frequently and deliberately mispriced orders placed with BBL by the Black Customers and deliberately misused confidential information relating to the intentions and orders of the Black Customers in breach of Principle 1;
- on other occasions in 1996 he failed to act with due skill, care and diligence in relation to the pricing of the Black Customers' Orders and the use of confidential information in relation to those orders in breach of Principle 2;
- in 1996 he was frequently in breach of Principle 6 in that he failed to avoid conflicts of interest arising between BBL and the Black Customers; failed to ensure fair treatment to the Black Customers; and unfairly placed BBL's interests above those of the Black Customers;
- in 1996 he caused BBL to be frequently in breach of Rules 5-37 and 5-42 of SFA's Rules by failing to deal with, and by failing to allocate, the orders of the Black Customers and BBL's own account orders fairly and in due turn;
- in 1995 and 1996 he accepted cash payments from a third party in return for which he traded on behalf of the third party at the expense of BBL and disclosed confidential information about customer orders to the third party, in breach of Principle 1.

Mr Swain was BBL's aluminium dealer in 1996 and 1997. He was the senior member of BBL's LME floor trading team. Mr Swain has admitted, for the purposes of concluding a settlement with SFA, that:

- In 1997 he deliberately mispriced orders placed with BBL by the Black Customers in breach of Principle 1;
- In 1996 and 1997 he deliberately misused confidential information relating to the intentions and orders of the Black Customers in breach of Principle 1;
- In 1996 and 1997 he was in breach of Principle 6 in that he failed to avoid conflicts of interest arising between BBL and the Black Customers; failed to ensure fair treatment to the Black Customers; and unfairly placed BBL's interests above those of the Black Customers;
- In 1997 he caused BBL to be in breach of Rules 5-37 and 5-42 of SFA's rules by failing to deal with, and by failing to allocate, the orders of the Black Customers and BBL's own account orders fairly and in due turn.

SFA has taken into account that Mr Swain has co-operated fully with all aspects of its investigation.

NOTE TO EDITORS

1. 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. The Financial Services Authority replaced the SFA on 30 November 2001.
2. SFA is a subsidiary of the FSA. SFA was 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 were regulated by the SFA.
3. Ring Dealing Membership entitles the member to sit in the LME 'Ring' and participate in the open outcry trading sessions, ring dealing members also have the right to issue client contracts.

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