Reference number FS/2010/33

PERFORMANCE OF REGULATED ACTIVITIES - Conduct – Disciplinary powers – Misconduct – Financial penalty – Whether CEO guilty of misconduct – FS&MA 2000 s.66

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
FINANCIAL SERVICES

JOHN POTTAGE **Applicant**

- and -

THE FINANCIAL SERVICES AUTHORITY **Authority**

UBS AG (1) **Interested Parties**
UBS WEALTH MANAGEMENT (UK) LTD (2)
JEREMY PALMER (3)

TRIBUNAL: SIR STEPHEN OLIVER QC
CHRISTOPHER BURBIDGE
SANDI O'NEILL

Sitting in London on 16-18, 21-25 and 28-30 November and 1 and 2 December 2011 and 4-6 January 2012

Guy Philips QC and Henry King, counsel, instructed by Stephenson Harwood, solicitors, for the Applicant

Andrew Hochhauser QC and Edward Brown, counsel, for the Authority

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Edward Sparrow of Ashurst, LLP, solicitors, for Interested Party (3)

DECISION

PART 1 : INTRODUCTION

Introduction

1. Mr John Pottage, the Applicant, has referred a decision of the Financial Services Authority to impose a penalty for misconduct on him (of £100,000) pursuant to section 66 of Financial Services and Markets Act 2000 ("FSMA"). The misconduct to which the decision relates is particularised as Mr Pottage's failure to comply with Statement of Principle 7 (SP7) of the Statements of Principle and Code of Practice for Approved Persons ("APER") in the period 4 September 2006 to 31 July 2007 ("the Relevant Period").

2. Throughout the Relevant Period Mr Pottage held both the CF3 and CF8 controlled functions for UBS AG and for UBS Wealth Management (UK) Ltd (we refer to these collectively as "UKWM" and, where appropriate, as "the Firm"). Mr Pottage's CEO functions related to the wealth management business of those two corporate entities through which UKWM operates. The front office of the Firm itself comprised two business divisions. One is the UK domestic business; this managed the affairs of UK resident clients who were advised in the UK. The other is the London International Business ("LIB"); this dealt with non-UK resident clients advised in the UK. The UK domestic business accounted, at the relevant time, for 70% of the assets under management.

3. The case against Mr Pottage is that he had failed to take reasonable steps to ensure that the business of the Firm ("the Business") complied with the requirements and standards of the regulatory system; his conduct had not therefore complied with Principle 7. The Statement of Case specifies the reasons for the FSA's decision to impose the penalty for misconduct. It sets out all the matters and facts upon which the FSA relies in support of that decision. That is required by Schedule 3 paragraph 4(2)(c) of the Upper Tribunal Rules 2008. As our decision is founded on the particulars of the alleged offence, as set out in the Statement of Case, we refer to it in some detail. The Statement of Case was amended at the Tribunal's direction requiring the FSA to provide better particulars of its allegation of misconduct. The reply for Mr Pottage was amended to deal with those particulars. Whenever we refer to the Statement of Case in this Decision we are referring to the "amended" Statement of Case.

4. Statement of Principle 7 (SP7) contains the principle which, the FSA says, Mr Pottage has breached such that he is guilty of misconduct. It reads as follows:

> "An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which

he is responsible in his controlled function complies with the relevant requirements and standards of the regulatory system."

5. Paragraph 6A(5)(G) of the Statement of Case summarises the particulars relied upon by the FSA. It is said that Mr Pottage should have:

> "(i) carried out an adequate Initial Assessment and, in particular,
> (ii) questioned effectively the assurances he received that there were no fundamental deficiencies with the design and operational effectiveness of the governance and risk management frameworks;
> (iii) carried out Continuous Monitoring and, in particular, considered adequately the wider implications for the governance and risk management frameworks of the warning signals set out … below; and
> (iv) recognised (either following an Initial Assessment or Continuous Monitoring) that there were such fundamental deficiencies and implemented the Systematic Overhaul sooner than he did."

The particulars include the following, in paragraph 80:

> "The serious and widespread deficiencies in systems and controls throughout the period from September 2006 to July 2007 demonstrate that the governance and risk management frameworks in place in the Business failed to operate effectively. This meant that the Business did not comply with regulatory requirements and standards. Given his controlled function and, in particular, his role as chairman of the Executive Committees, the Applicant failed to take reasonable steps to satisfy himself that it did."

6. The term "fundamental deficiencies" (with the design and operational effectiveness of the governance and risk management frameworks) is replaced by the term "serious flaws" in paragraphs 65-70 which contain the details of the FSA's reasons for its contention. Those paragraphs particularise a number of "serious flaws in the design and operational effectiveness of the governance and risk management framework in place in the Business". Paragraph 65 of the Statement of Case specifies three such "serious flaws" alleged to have existed before and throughout the Relevant Period. These were:

> (1) flaws in the operation, structure and terms of reference of the executive committees:
> (2) serious deficiencies in the management information available to Mr Pottage and other members of the senior management team and
> (3) weaknesses in the Operational Risk Framework (ORF).

A further deficiency relied upon by the FSA in paragraph 68 was "in the compliance monitoring arrangements in place in UKWM in 2007".

This Decision

7. We will approach the issues raised in this Reference by examining in Part II the relevant business activities of the Firm in order to determine whether, as alleged, the "serious flaws" existed at the relevant times. If and to the extent that we are satisfied on that score, we will proceed in Part III to examine and determine whether Mr Pottage committed misconduct by failing to take the reasonable steps required in APER 7. The term "serious flaws in the governance and risk management frameworks" is not, we understand, drawn from the FSA's Handbook. Whether our finding that one or more of the alleged "serious flaws" existed has any implications as regards the Firm itself, so far as the adequacy of its systems and controls are concerned, is not a matter on which we are required to express a view. We are concerned only with the allegation of misconduct against Mr Pottage. Our conclusion, as will appear from Part III, is that the charge of misconduct is not supported by the evidence.

Summary of the "charge" and Mr Pottage's response

8. Mr Pottage's case is directed at the charge of regulatory misconduct alleged against him: specifically –

- his failure to "to take reasonable steps to identify and remediate the serious flaws in the design and operational effectiveness of the governance and risk management frameworks at UKWM" and to take reasonable steps to ensure that the Business of the Firm complied with the relevant requirements of the regulatory regime (see para 5 of the Statement of Case);
- his failure to initiate a comprehensive bottom-up review of systems and controls across the whole business "sooner than he did" (paragraph 6A(5)).

The charge was particularised in paragraph 76 of the Statement of Case where the FSA uses these words as to the appropriate steps it says Mr Pottage should have taken, having identified certain "warning signals":

> "He should have appreciated the need to focus on addressing and resolving the serious flaws … by way of the Systematic Overhaul. However, the Applicant did not initiate the Systematic Overhaul to examine the wider implications of these issues either as they arose or in response to increasing levels of concern being voiced by the Authority's supervision team until the review at the end of July 2007".

The "sooner than he did" element in the charge against Mr Pottage is also contained in the following words in the FSA's opening speech. Referring to the state of the Business in late March 2007:

> "… remember, we say by this stage there had been two significant disasters that had already taken place: the client money incident and the significant payment fraud. The LORR should already have been commenced."

(We explain later what was meant by the "two significant disasters" and the "LORR" (the London Operational Risk Review). It is enough to say at present that the LORR was initiated by Mr Pottage with the advice of his specialist team as a comprehensive project "to review processes for identification and escalation of operational risks" at the Firm : (we refer to paragraph 1.1 of the Management Summary in the Final Report of the LORR).)

9. The FSA's charge regarding the "sooner than he did" element is based on certain things that Mr Pottage should have learned on his 'initial assessment' of the Business on becoming CEO. Relying on the expert evidence of Mr Jonathan Hayward, a director of Independent Audit Limited (a consultancy specialising in corporate governance), the FSA points to (a) an inadequate monitoring of the risk management framework and (b) ineffective oversight of that monitoring by the Firm's "Risk Committee". The FSA then points to five specific and detailed control failures (which will be examined later) as being matters that Mr Pottage should have been prompted by to act earlier. These were referred to in:

- Group Internal Audit ("GIA") Report on Operations and IT of 27 October 2006;
- a report into "the payment fraud" dated 16 February 2007;
- the compliance review of the Asia II Desk of 23 February 2007;
- the Ernst & Young (E&Y) report into "client money arrangements" of 2 March 2007 followed by the identification of control failures in the area of client asset reconciliations in May 2007 (leading to a report by PricewaterhouseCoopers (PwC) dated 25 July 2007); and
- a GIA Report on Life & Pensions dated 14 May 2007.

The evidence, argues Mr Pottage, does not sustain the FSA's case; it points the other way. He emphasises that he had taken a considerable range of steps to discharge his controlled functions responsibilities including initiating the LORR. Every control failure identified in the Business (most of which had arisen in "Operations" where remedial steps had been taken and were in the process of being further addressed) had, he points out, been investigated and were being remedied in accordance with a detailed plan. It had been agreed at an early point in the Relevant Period that the staffing and scope of the compliance monitoring team needed to be strengthened and a recruitment process had been started in early 2007. Moreover, he relies on the fact that no one responsible for internal audit, for risk control or compliance (locally or at the Group Headquarters of UBS AG based in Zurich) or the FSA itself had been suggesting that it was necessary or appropriate to carry out a wider review of systems and controls than had in fact been undertaken.

10. Regarding the charge that he had failed to learn of weaknesses in monitoring when carrying out his initial assessment, he argues that those weaknesses were not breaches by the Business of its regulatory obligations. Nor were they matters that should have been obvious to him let alone prompt a reasonable person to initiate an investigation of processes and controls earlier than he (Mr Pottage) in fact did.

11. Regarding the charge that he had failed to react to the specific and detailed control failures, those were not, he contended, matters that (either individually or collectively) would have prompted a reasonable person to set up an investigation into whether there were further specific detailed control failures in other areas of the Business sooner than Mr Pottage in fact did.

The position of Interested Parties (1) and (2)

12. UBS AG and UBS Wealth Management (UK) Ltd, as Interested Parties to these proceedings, challenge the allegation (in paragraph 80 of the Statement of Case) that they did not comply with regulatory requirements because of serious and widespread deficiencies in systems and controls throughout the Relevant Period which demonstrate that the governance and risk management frameworks failed to operate effectively. They deny that the matters relied upon by the FSA as "serious flaws" in paragraphs 65-69 (and in parts of paragraph 75) amounted to "serious flaws in the Firm's governance and risk management framework".

The "serious flaws" issue

13. The FSA says that all the parties have already agreed the question of whether, as it contends, there were serious flaws during the Relevant Period. This, we were told, had been done to narrow the issues. Reference was made by Counsel to the FSA to a document headed "List of Agreed Issues and Issues for Expert Determination". This was said to have been produced in response to a direction by the Tribunal to agree the issues for the experts. The following matter is said to have been common ground:

> "By the end of July 2007, Mr Pottage had identified that there were serious flaws in the design and operational effectiveness of the governance and/or risk management framework of [the Firm], such that it was necessary to carry out a Systematic Overhaul …"

The Tribunal's direction had related only to the expert evidence. If it really had been common ground that the issue was limited to the words of the above extract, the Tribunal would have been in a difficult position. It was not clear to us that the parties from their different standpoints had any common understanding of the meaning of the phrase "serious flaws in the design and operational effectiveness of the governance and/or risk management framework of the Firm". Did that mean that Mr Pottage acknowledged that all the alleged "serious flaws" existed and that the Business of the Firm was not compliant with the requirements of the regulatory system? Clearly the Interested Parties did not. We refer to this in the next paragraph. We think, therefore,

that it would be both in the interest of justice and in line with section 133(3) and (4) of FSMA to examine the question of Mr Pottage's compliance with SP7 by reviewing and taking account of all the evidence rather than being tied down by the loose terms of the alleged agreement as to the "common ground". That requires us to determine, as a first issue, whether the FSA has made out its case that the alleged serious flaws existed. We refer to that as "the serious flaws issue" and it is dealt with in Part II.

14. UBS AG has already accepted that it had been in regulatory breach as a result of weaknesses in the systems and controls in place within the LIB to mitigate the risk of unauthorised transactions and/or detect such transactions in a timely manner. Reference is made to the UBS AG Final Notice issued by the FSA on 5 August 2009 and published in November 2009. These weaknesses came to light as a result of an internal investigation, following the discovery of unauthorised trading by various members of a desk within the LIB (the "Asia II Desk fraud"). That fraud, which is said to have started from at least 2002, occurred (according to UBS AG) as a result of collusion between four employees of the Firm who deliberately abused the trust placed in them and concealed their behaviour from. As a result of the Asia II Desk fraud, UBS AG compensated affected clients and agreed to pay a regulatory penalty of £8m.

15. UBS AG has also acknowledged that it failed in certain respects to comply with client money and asset reconciliation regulatory requirements in 2006 and 2007 respectively. This, UBS stressed, was known to the FSA at the time of the UBS Final Notice, yet neither issue formed the basis of enforcement action against UBS AG.

16. Those acknowledgements were set out in the written Opening Submissions on behalf of UBS AG and UBS Wealth Management (UK) Ltd as Interested Parties.

Summary of the relevant parts of the FSA's Statement of Case

17 The events occurring during the Relevant Period and the circumstances existing in the Business at the time are wide-ranging. They form the basis on which the FSA have relied in making the referred Decision. What follows, as explained in paragraph 3 above, is a reasonably detailed summary of the contents of the Statement of Case. The summary is applicable to both "the serious flaws issue" and to the issue of whether Mr Pottage failed to take reasonable steps as required by APER 7 ("the reasonable steps issue").

18. In paragraphs 12-17 of the Statement of Case the FSA explains the conduct expected of approved persons. We will address this topic when we move on to the reasonable steps issue.

The Firm, its business and its clientele

19. The Firm is part of a major global financial group (UBS AG) with its headquarters in Zurich, UBS AG has had three principal business divisions. These

were the Investment Bank, Global Asset Management and Global Wealth Management Business Banking. The last of those three divisions includes the Firm.

20. The "front office" of the Firm was divided into two business sectors. One of these was the UK Domestic Business, which (as already noted) dealt with UK-resident customers advised in the UK. The other was the LIB which (as noted) dealt with non-UK-resident customers advised in the UK. Both the UK Domestic Business and the LIB were organised into desks run by a "Desk Head" and staffed by "Client Advisers". Risks inherent in a wealth management business include the risk of fraud: for example where payments are made to third parties without the authority of the client. Another example is the risk of accounts being used for money laundering. Clients must also be protected from receiving unsuitable advice and from investments and transactions being entered into on their behalf which are inappropriate for their risk profile. In the light of those risks the FSA (the Statement of Case records) "considers that robust and effective governance and risk management frameworks ensuring the effective control of the Business and the mitigation of the risks inherent in the Business are essential for the proper protection of customers".

21. The Statement of Case points to a number of particular risks inherent in the LIB that heightened the core risk profile of the Business. These included the features that the customers and investments were offshore, many customers subscribed to a "retained mail facility" and many transactions undertaken by the relevant desk had to comply with multiple regulatory and tax regimes. Those risks, claims the FSA, were further heightened by the impact of the Firm's global matrix management structure (described below). This, it was said, meant that the LIB was subject to external demands, influence and oversight and that it required stronger controls than other parts of the Business. The Statement of Case also draws attention to the absence of an independent middle office. That, it was said, meant that there was an increased risk of inadequate segregation of the front and back office and an increased opportunity for undue front office influence.

The global matrix management structure

22. During the Relevant Period the Firm was part of a global matrix management structure whereby many key individuals had two reporting lines: a "functional" reporting line (which determined objectives and remuneration, including bonuses) and a "local" reporting line. The functional reporting lines would ultimately report into a global function head based outside the UK. The Statement of Case draws attention to the fact that the global matrix management structure had particular consequences for the LIB. The staff working on those desks were primarily managed by a functional manager who was based abroad. Each member of staff had to ensure that local regulatory requirements were met, even where these conflicted with the demands of overseas functional managers who, the Statement of Case alleged, were often unfamiliar with local regulations. Cost control and resource tensions were said in the Statement of Case to have arisen because of conflicts between the demands of functional management, charged with delivering revenue and profit, and geographically based management who had, inter alia, the responsibility to meet local

regulatory requirements. In addition, the nature of the business conducted by the desks in the LIB had a high risk profile within the Firm and required stronger controls and substantially closer supervision and oversight than the more traditional UK domestic business.

23. Those were factors which, according to the Statement of Case of the FSA, were matters and facts which the FSA had taken into account in reaching their decision that Mr Pottage was guilty of misconduct.

24. Specifically, it is said, they were matters that should have increased Mr Pottage's awareness of the need to spend substantial and sufficient time to ensure that the governance and risk management frameworks in place in the Business operated effectively.

Governance and risk management frameworks

25. Paragraphs 32-39 of the Statement of Case contain a summary of the relevant features of the governance and risk management frameworks. These are taken from the Firm's Operational Risk Framework ("the ORF") and the terms of reference of the Executive Committees, being the Firm's "Management Committee" and the "Risk Committee".

26. We will refer to all of those in more detail below. The Statement of Case says of the ORF that it was an integral part of the matrix structure; it had been designed to ensure that all operational risk in the particular location, e.g. the area of business of the Firm, had been thought about and addressed. The ORF required that each of the functions in the Firm should identify its key operational risks in "clusters". These clusters were divided into sub-categories and, for each sub-category, there would be Control Standards. Linked to the Control Standards were Control Objectives which covered the key risks of each function. The Control Objectives, Control Standards and actual controls were "below" the ORF, as we will explain later. Those control features were originally defined functionally and centrally but were refined and adapted to the location over time. There were, alleged the FSA, a number of weaknesses in the ORF which meant that it was not adequate to meet the local regulatory requirements and standards. (We will return to the ORF and its ingredients, including the actual controls which were "below" the ORF, in Part II.)

27 The Executive Committees were the responsibility of Mr Pottage as CEO. These were, as noted, the Management Committee and the Risk Committee; they were central components of the Firm's governance and risk management frameworks. The Management Committee was the senior body responsible for running all business originating from the Firm's location. It was, says the Statement of Case, intended to be the equivalent of a board of directors and it had members from each of the functions within the UK location. Its overall responsibility was strategic management. The Risk Committee was responsible for monitoring the status of the risk of the UK location and reviewing significant changes. Where appropriate, the Statement of Case asserts, risk issues should have been "escalated" from the Risk

Committee to the Management Committee. (The term "escalate" is regulatory vernacular for passing on, usually upwards, to the person or entity with particular responsibility for the relevant matter: "escalation" does not, unless otherwise explained in this Decision, have its common meaning of "aggravation: being made worse".)

28. The Risk Committee has as its main function to discuss and approve the Quarterly Risk Review (the QRR) and formally to approve the overall risk status of a location. A significant part of the QRR was the Location Risk Inventory (the "Risk Inventory"). The Risk Inventory was a log of risks that had already been identified in the Business and its main purpose was to track the implementation of action plans agreed in respect of identified risks.

The appointment and remit of Mr Pottage

29. At the time of his appointment as CEO in September 2006, Mr Pottage was already familiar with the Business. He had joined UKWM in 1999 as Head of Wealth Planning and, in 2000, he had become deputy head of the UK Domestic Business. In October 2005 he had been appointed Head of Products and Services.

30. Paragraph 41 of the Statement of Case identifies what the FSA have regarded as Mr Pottage's regulatory responsibilities. The FSA contend, and this is not disputed, that on assuming his role as CEO Mr Pottage had a responsibility to carry out an adequate Initial Assessment of the governance and risk management framework in place. In paragraph 43 of the Statement of Case the FSA alleges that "it had been made clear to Mr Pottage, at the time of his appointment, that he had had a specific remit to strengthen internal processes and controls across the Business on a front to back basis". This feature will also be examined when we come to deal with the reasonable steps issue.

The 2010 Plan

31. The Statement of Case records that prior to his appointment as CEO on 4 September 2006, Mr Pottage had been "deeply involved" in developing the 2010 Plan for the Business. This had been approved in October 2006. Mr Pottage was directly responsible for its implementation. The 2010 Plan envisaged substantial growth across the Firm's domestic and international business with a view to tripling, by 2010, the amount of invested assets by the Firm. At the same time the 2010 Plan recognised significant weaknesses in the existing control framework. Consequently, one element of the 2010 Plan had been a long term "change programme" designed to address weaknesses in the "operating platform", the infrastructure and the IT systems. The purpose of the programme was, says the Statement of Case, to improve operational efficiency rather than achieve fundamental enhancement of the governance and risk management frameworks; it did not address "the substantial deficiencies in the governance and risk management frameworks".

32. The Statement of Case goes on, in paragraph 47A, to clarify the difference between the "control framework" of the Business and the "risk management" framework of the Business. The risk management framework of the Business is said to be narrowly defined as being the framework which sets out how risks will be managed in the Business; it includes areas such as risk identification, risk appetite and risk mitigation. The "control framework", however, is said to have a much broader definition, having regard to all the internal control mechanisms within the Business including risk management.

The FSA's expectations of Mr Pottage

33. Paragraphs 48-55 of the Statement of Case explain the FSA's expectations of Mr Pottage. He should have performed an Initial Assessment that gave him an accurate and thorough understanding of six aspects of the Firm and its Business. These six aspects covered the state of the Business, including the design, operational effectiveness and strengths and weaknesses of the governance and risk management frameworks: the operational risks of the Business and the current systems of control: the quality of management information available to assist in the assessment of whether the governance and risk management frameworks of the Business were operating effectively: significant risks or compliance issues that had occurred during Mr Pottage's predecessor's tenure: the practical implications of the global matrix management structure and the strengths and weaknesses of the individuals who reported to him.

34. In paragraph 52 the FSA states that, in carrying out his responsibilities for the operation and management of the Executive Committee, Mr Pottage should have ensured that the duties, purposes and agendas of the Executive Committees were clearly defined. He should have ensured that items raised were fully discussed and that effective actions were agreed and tracked. He should have ensured that the implications of the implementation of the business strategy were "actively considered on a cross-functional basis". He should have ensured that the Executive Committees tracked and analysed risk effectively on a front to back basis. He should have ensured that significant risk issues identified by the Risk Committees were escalated appropriately. He should have ensured that the Executive Committee "had before them a comprehensive suite of appropriate management information from all areas of the business which went beyond business and financial performance."

35. In paragraph 55 it is said that had Mr Pottage initiated an adequate Initial Assessment, "it would have been apparent that there were serious flaws in the design and operational effectiveness of those [governance and risk management] frameworks". Mr Pottage "should have then implemented the Systematic Overhaul". (For reference, the expression Systematic Overhaul is not defined, but it is accepted that the LORR, initiated at the end of July 2007, was such an overhaul.)

FSA, expectations of Mr Pottage's initial approach on assuming the CF3 and CF8 controlled functions

36. In paragraph 56 of the Statement of Case the FSA says that Mr Pottage "took up his appointment as CEO at a time when there were serious flaws in the design and operational effectiveness of the governance and risk management frameworks in place in the Business throughout the Relevant Period, as set out in more detail at paragraph 65 below." The Statement of Case goes on in paragraph 57 to observe that at the time of taking up his appointment "there were various matters that should have increased Mr Pottage's awareness of the need to spend substantial and sufficient time to ensure that the governance and risk management frameworks "the Business operated effectively". These were said to cover "a number of inherent risks in the Business, which were heightened in relation the LIB", the absence of an independent middle office, the operation of the global matrix management structure, "cultural issues in the Business concerning responsibility for risk management" and the fact that Mr Pottage had approved a significant expansion of the business at the time when there were "known operational issues which had arisen prior to his appointment".

37. The Statement of Case (paragraph 57(7)) identifies as those "known operational issues" certain particular problems that related to a stockbroking business that had been acquired by the Firm some years before. That business had previously been carried on by the Laing & Cruickshank firm of stockbrokers. A GIA Report (explained later) identified certain weaknesses including "the lack of independence of the back office, no back office independent verification of client instructions; lack of dual control over amendments of client data and making of payments." There had also, the report said, been "lack of oversight over front office". Other known operational issues included weaknesses in the control framework recognised by the 2010 Plan, two incidents of unauthorised trading that had occurred in 2005 and 2006 and a qualified audit of the Financial Intermediary Business published in April 2005 which had raised, among other things, issues concerning suitability documentation. Moreover, it was said, Mr Pottage's awareness of those known operational issues should have caused him to pay particular attention to resolving these issues upon appointment as CEO.

The FSA's acknowledgement of the steps taken by Mr Pottage

38. Paragraph 59 of the Statement of Case acknowledges that on appointment to CEO, Mr Pottage "took a number of informal steps which resulted in him being provided with assurance that there were no issues in the Business that he needed to be particularly concerned about". There then follows a list of eight such steps. He had held a series of detailed interviews with all members of the Firm's Management Committee. He had held a number of meetings with senior staff concerned with "Risk Management" and "Legal, Risk and Compliance". He had sought clarification of the organisational chart for Legal, Risk and Compliance and had discussed the teams and the roles with the head of the Risk and Compliance functions in the Business. He had held a meeting in Zurich with the heads of Legal, Risk and Compliance for the region in which the Firm operated as well as the relevant global

heads. He had held a meeting with GIA to understand their perception of the Firm's business strategy and risks and he had discussed the possible agenda for 2007 internal audits. He had held a meeting with the Chief Operating Officer ("COO") of the Firm to discuss issues emerging in Operations. He had had a brief meeting with his predecessor who had not made him aware of any matters to which he need pay particular attention. And finally (to use the FSA's words) he had had a "meeting with the Firm's Business Unit Head (who was the most senior person in the UK location for the Business and the other holder of the apportionment and oversight (CF8) controlled function) to understand whether there were any key issues arising in the Business of which he should be aware."

39. In paragraphs 60 and 61 the Statement of Case notes that, given his previous participation in the Management Committee (of which he had been a member on account of his previous offices with the Firm) and his involvement in the 2010 Plan, Mr Pottage "was of the view that he understood the issues facing the Business sufficiently well. He therefore assumed that the existing governance and risk management frameworks were appropriate and further assumed that they would continue to be appropriate to support the expansion in the Business envisaged by the 2010 Plan". The Statement of Case goes on to state as follows:

> "The [FSA] considers that as CEO, and being responsible for the operation and management of the Executive Committees, [Mr Pottage] should have performed an adequate Initial Assessment. He failed to do so. As a result, he failed to identify the need for the Systematic Overhaul."

40. In paragraph 62 the Statement of Case records the conclusion of the FSA that Mr Pottage had been "too accepting of the assurances he received that there were no fundamental deficiencies with the design and operational effectiveness of the governance and risk management frameworks". Mr Pottage "should have questioned more vigorously the assumption that the frameworks were fit for purpose and that they had been implemented properly locally." In those circumstances, the Statement of Case records, the FSA had concluded that the steps taken by Mr Pottage had not been reasonable in all the circumstances.

41. In paragraph 63 the Statement of Case recites 18 steps that Mr Pottage had taken during the Relevant Period "as part of his overall responsibility to assess the design and operational effectiveness of the governance and risk management frameworks". These steps included:

> (1) Mr Pottage invited the head of Operations in the UBS Wealth Management Germany location to assess and carry out a peer review of the Operations function in the UK location.
>
> (2) He had addressed concerns about the effectiveness of two of the senior staff in the Operations function of the Business. (Both of those senior staff were in due course moved to other functions and replaced.)

(3) In October 2006 he appointed a single head of the Firm's Legal, Risk and Compliance function (Miss Abigail Topley), whereas previously Risk and Compliance had been under separate leadership.

(4) Following the discovery, in October 2006, of a breach of the client money rules ("the Client Money breach") in the former Laing & Cruickshank part of the Business, Mr Pottage had taken steps to "remediate the immediate issue" and had initiated an investigation of the incident by the Chief Risk Officer (Mr Shaun Challis) and the introduction of new controls. Mr Pottage subsequently engaged E&Y in November 2006, to undertake a wider review of client money arrangements.

(5) Following the introduction of new "Desk Head" controls in October amendments to the Desk Head staff manual were made in January 2007. These required risk objectives to be included in all client advisers' objectives. Those controls required "Desk Heads" to obtain and document evidence that supported their certification of the adequacy of controls in place; that certification was to be followed up and monitored by the Risk Control Committee.

(6) Following the discovery on 17 January 2007 of a payments fraud ("the Payments Fraud"), Mr Pottage took steps to raise the risk rating for the UK location from green to amber and he took steps to introduce a manual "call-back" process to act as a short term solution to the problem. He also "accelerated steps to introduce a longer term strategic solution by way of an electronic payments authorisation process".

(7) In the first half of 2007, Mr Pottage commissioned and sponsored a review of client adviser training and appointed a compliance expert to run the Business' training and education departments.

(8) On 1 February 2007 Mr Pottage required that risk be added as the standing item at the monthly Management Committee meetings to ensure that key risk issues were addressed by both the Management Committee and the Risk Committee.

(9) In March 2007, in conjunction with the Business Unit Head (Mr Matthew Brumsen), Mr Pottage sent an email to all the Firm's staff highlighting the importance of operational risk management and emphasising that all staff had a responsibility to be aware of risks and to manage them appropriately: and this put "operational risk excellence" at the heart of the Business.

(10) On 30 March 2007, and as a result of increasing concern that there were gaps in the governance and risk management frameworks which were prompted by a number of problems arising without prior warning to management, Mr Pottage initiated an informal "risk strategy" brainstorming meeting to be attended by the heads of compliance, risk management and risk control. This meeting, which took place on 19 April 2007, resulted in a number of generic issues being identified. Mr Pottage later said in interview that he had concluded that the Business had been "fire-fighting" rather than

proactively identifying risk issues and that there might be "material unknown unknowns". The Statement of Case goes on to record that "the fact that the three heads could not identify specific risks provided [Mr Pottage] with comfort that the structure of the ORF meant that there was no gap in the risk management framework in place in the business."

(11) A follow-up meeting had been held on 30 May 2007 to enquire about the progress of actions coming out of the previous meeting.

(12) At a meeting of the Management Committee on 26 April 2007, Ms Topley, Head of Legal, Risk and Compliance, had been tasked with making a presentation on how the Firm should move from an ad hoc approach to more proactive and co-ordinated approach to risk.

(13) The E&Y report into client money arrangements was dated 2 March 2007. Its principal findings, that there had been breaches in the CASS client money rules, had been discussed within the Firm in January. E&Y had also indicated that there were "issues relating to asset reconciliations" ("the Asset Reconciliations issue"). The report recommended a wider review which should cover the topic of compliance with the CASS custody rules. A new Head of Operations had been engaged to take over from his predecessor (about whose effectiveness Mr Pottage had had concerns from the start). The new Head (a Mr Donald Reid) arrived at his post in late April 2007 and, with the authority of Mr Pottage, engaged PricewaterhouseCoopers ("PwC") to assist with the investigation into the Asset Reconciliations issue and to carry out an independent review of asset reconciliations in general in an attempt to capture all of the wider implications. The scope of that independent review had, records the Statement of Case, been agreed with the FSA. PwC reported on 25 July 2007.

(14) Among the other things introduced or endorsed by Mr Pottage and intended to change the culture of the business had been the encouragement of a whistle blowing culture, a series of "road shows" designed to activate a move away from a "silo mentality" as between different departments. He had increased the number of risk-related communications. He also increased the number of dedicated risk management staff in both the UK Domestic and the London International businesses.

42. The Statement of Case records (at paragraph 64) the conclusion of the FSA that those steps had not been "sufficient to identify and remediate the serious flaws in the design and operational effectiveness of the governance and risk management frameworks in place in the Business" and had not constituted the Systematic Overhaul. (The term "to remediate" is regulatory vernacular for (i) to remedy or put right and (ii) to compensate an affected customer for loss arising from a regulatory breach. In the circumstances of this reference, we take it to have the same meaning as "to remedy".)

The Serious Flaws as alleged in the Statement of Case

43. Paragraph 65 alleges certain "serious flaws in the design and operational effectiveness of the governance and risk management frameworks in place in the Business such that the Business did not comply with the regulatory requirements throughout the Relevant Period". Those serious flaws are said to have existed since before Mr Pottage's appointment in early September 2006. A further serious flaw, confined to 2007, is alleged in paragraph 68. These are dealt with in Part II. In summary they are as follows:

(i) The structure and operation of the Executive Committees: paragraph 65(1)-(3). Several examples of shortcomings were given and will be addressed later; those related to the Committees generally. The Risk Committee was said to be deficient in that the terms of reference were insufficiently detailed in several respects such as a lack of effective coordination and lack of effective oversight of risk.

(ii) The deficiencies in management information available to Mr Pottage and other members of the senior management team meant that the supervision of the Business and management of risk was deficient; see paragraph 65(4).

(iii) Weaknesses existed in the Firm's Operational Risk Framework ("ORF"): see paragraph 65(5).

(iv) Deficiencies existed in compliance monitoring (from I January 2007 onwards). These are referred to in paragraph 68. The FSA relied on these shortcomings in the standards of compliance by the Business with the relevant requirements of the regulatory system.

Warning signals

44. The Statement of Case in paragraphs 71-80 identifies certain warning signals that should (the FSA says) have prompted Mr Pottage to take steps in discharging his responsibility to assess the design and operational effectiveness of the governance and risk management frameworks in place in the Business. Those warning signals should have alerted him to the risk that there were further deficiencies that had not yet been identified and that the Firm's "governance and risk management frameworks were clearly not designed properly or operating effectively". The summary of the warning signals, which we will set out later (in Part III when addressing the question of whether Mr Pottage had taken reasonable steps) ends with these words in paragraph 80:

> "The serious and widespread deficiencies in systems and controls throughout the period from September 2006 to July 2007 demonstrate that the governance and risk management frameworks in place in the Business failed to operate effectively. This meant that the Business did not comply with regulatory requirements and standards. Given his

controlled functions and, in particular, his role as chairman of the Executive Committees, the Applicant failed to take reasonable steps to satisfy himself that it did."

Skilled Person's Report

45. Paragraphs 81 and 82 of the Statement of Case refer to the Skilled Person's Report (the "SPR") that had been commissioned in pursuance of section 166 FSMA following the discovery in January 2008 of widespread unauthorised trading, concealment of losses and other improper conduct on the Asia II Desk in the LIB (the "Unauthorised Activity"). These issues affected 39 customer accounts in relation to which the Firm has to date paid compensation in excess of $42m. The Report was finalised in August 2008 and (according to the Statement of Case) it concluded among other things that there were significant systems and control failings and that the control environment of the LIB had not been adequate for the period 1 January 2006 until 31 May 2008.

The FSA's assessment of the Business

46. Paragraph 83-91 of the Statement of Case record that the FSA's supervisory visit to the Firm in late 2006 had concluded, in February 2007, that the Business was well-managed and that its systems and controls were appropriate for the scale and nature of the Business at the time. The FSA has emphasised that its review had been "high level" and that it had not had complete information at the time when it issued the related ARROW letter of February 2007. In paragraph 91 the FSA states that "the situation had changed quickly following the Authority's February 2007 ARROW assessment."

The London Operational Risk Review ("LORR")

47. At the end of July 2007 Mr Pottage, having obtained the advice of the new Head of Operations (Mr Reid) and the agreement of Mr Brumsen, decided to initiate a comprehensive review of the effectiveness of the control environment of risk assessment and reporting and of governance across all the parts of the Business. The Final Report of the LORR described the circumstances in which it had been initiated as follows:

> "An escalation [i.e. *an 'increase'*] in the number of recent control-related incidents has occurred in London during the course of the last 18 months [that is, since October 2006]. Included in these incidents was a payment fraud which was not immediately detected internally and other failings resulting in substantial financial impact and increased scrutiny by the UK Regulator, the Financial Services Authority. Specifically in the area of Operations, it had been determined that controls necessary to comply with certain local regulatory requirements have not been carried out appropriately, nor with the required frequency and have not been subject to review and

update on a periodic basis. This has resulted in the FSA questioning the local control environment as well as risk management and governance practices. Accordingly and to review processes for identification and escalation of operational risks, local management initiated a comprehensive review…"

PART II: THE "SERIOUS FLAWS" ISSUE

The expression "serious flaws"

48. This term is a key ingredient in the FSA's particulars of the alleged offence of misconduct. Paragraph 6A(2) of the Statement of Case, for example, noted that, had Mr Pottage performed the continuous process of monitoring that the FSA would have expected as a reasonable step, he would have appreciated sooner than he did that there were "serious flaws" in the design and operational effectiveness of the governance and risk framework. That indicates that the serious flaw is to be of a structural nature rather than a one-off error. Then in paragraph 6A(3) the term "serious flaw" is used to convey a flaw of sufficient seriousness to call for a "Systematic Overhaul". The FSA's particulars of the offence in paragraph 6A(5) use the expression "fundamental deficiencies" with the design and operational effectiveness of the "governance and risk management framework" as being deficiencies that called for the implementation of a "Systematic Overhaul sooner than he did". As we read the Statement of Case, the FSA are using "serious flaws" and "fundamental deficiencies" to have the same meaning and effect. Our function therefore is to examine the features particularised by the FSA in paragraphs 65 and 68 of the Statement of Case with a view to determining whether the FSA has persuaded us on the evidence that they can be properly classed as flaws or deficiencies in the relevant sense. If we are satisfied they can be so classed, we then express a view as to whether they are serious or fundamental.

Weaknesses in the Operational Risk Framework (ORF): alleged serious flaw

49. At paragraph 65(5) of the Statement of Case the FSA alleges that "there were a number of weaknesses in the ORF" which, it says, amounted to serious flaws in the Firm's governance and risk management frameworks and which put the business in regulatory breach not only during the Relevant Period but also before. Those (seven) alleged flaws are taken directly from the Final Report produced in May 2008 at the conclusion of the LORR.

50. Three of those alleged weaknesses derive from the section in the Report headed "Control Documentation and Mappings". These three matters related to gaps in documentation, problems with self-certification and local function heads not having a comprehensive overview of control documentation. Paragraph 65(5) quotes the LORR Report as concluding "that the set up process upon which the biannual self-certification process was based and a key risk identifier was not as robust as it should have been throughout the location". Paragraph 65(5) goes on to state "that local

function heads did not have a comprehensive overview of control documentation to make sure that all relevant control standards were identified."

51. The fourth weakness referred to in the Statement of Case was the "ineffective local implementation of the Operational Risk Assessment Process ("ORAP") accompanied by inadequate communication between Risk Control and the local functions". That is taken from the "Risk Identification and Assessment" section of the LORR Report. That weakness, it was said, had resulted, until the third quarter of 2007, in "only a few items being recorded in the [Operational] Risk Inventory". Further, the Report says, "the traditional risk identifiers" relied upon by each function of the Firm in assessing its own risk had been "largely ineffective or non-existent". There had, for example, been late recordings of transactional losses (which had impeded the identification of recurring items and identifiable patterns); self-certification had been an "imperfect process" (because relatively few, but mostly insignificant, items had been certified as non-compliant and certain items should not have been certified as compliant); and there had been no "established programme of local metrics available".

52. The remaining three "weaknesses" come from the "Local Implementation of the ORF" section of the LORR Report. Local control plans are said in paragraph 65(5) not to have been implemented comprehensively and consistently across all areas: in operations some were too broadly formulated for the staff to carry out the specific controls effectively, or even to understand the underlying risk.

53. The content of the LORR is dealt with in paragraphs 58 and 62 below.

Risk management within the Firm

54. We approach the FSA's observations on the ORF with a brief summary of the manner in which risk is managed within the Firm.

55. UBS operates a "three lines of defence" model for risk management and control. This was explained to us by Mr Bernard Buchs, UBS AG's Global Head of Risk and Compliance, as follows:

> "The first line of defence is the business itself, which has primary responsibility for identifying and managing risks within the business. The second line of defence is the control functions (including Risk and Compliance), who are responsible for risk control – i.e. the development of an overall risk management framework and ensuring that the business adheres to that risk management framework (e.g. through periodic monitoring and assessment). The third line of defence is Group Internal Audit and the external audit function, which conduct independent testing to ensure that the risk management framework and control are operating effectively."

56. UBS's Risk Management and Control Principles that enshrine the ORF draw a distinction between "risk management", which is the responsibility of business management (see Principle 1) and "risk control", which is the responsibility of the control functions (see Principle 2). Within the Firm, the front office was supported in discharging its risk management responsibilities by the front office risk management function led by Mr Bill Weston. Within Operations (which covered the back office function) there was a Chief Operating Officer ("COO") who, together with the Head of Operations and other heads, had teams in place to manage risk. The COO's responsibility was to supervise and oversee. The COO for the Firm for most of the Relevant Period had been Mr Andreas Przewloka: he was engaged on an interim basis from November 2006 until August 2007. He was, at the same time, regional COO for WM&BB in Northern and Eastern Europe. Later on in the Relevant Period there was created what Mr Przewloka described as a "risk and quality management function". That was a "first line of defence" function and the risk managers responsible for the function were within Operations. Mr Przewloka explained in oral evidence that, embedded in the organisation, those risk managers had helped to cover 100% of the risk management tasks. He also emphasised that the second line of defence to control risk was not within Operations or within the area of responsibility of the COO.

57. The risk control function was led by the Firm's Chief Risk Officer, Mr Challis. In conjunction with other control functions (such as Legal, Compliance and GIA) the risk control function's tasks included assisting business management in relation to processes and procedures to identify, assess and mitigate risks, monitoring adherence to the risk appetite set by the business, and providing tools and controls to ensure the adequacy of processing, and risk reporting, including escalating where appropriate.

The ORF

58. We are at present concerned with the particular weakness in the ORF alleged by the FSA, in paragraph 65(5) of the Statement of Case, to have been a serious flaw. The Control Principles referred to above explain how risk management and control apply in the context of operational risk. Operational risk is defined by UBS AG (in line with the Basel Committee definition) as "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external causes (deliberate, accidental or natural). The losses may be direct financial losses, or indirect, in the form of revenue foregone as a result of business suspension. They may also result from damage to our reputation and our franchise, which have longer term financial consequences. Unlike credit and market risks, operational risks are not risks that are actively entered into but, rather, risks that arise as a consequence of our business activity". UBS AG from Zurich defined various categories of operational risks: these were – transaction processing, compliance, legal, liability, security and tax risk. We would add that protection of client money and assets is also an important goal for a wealth management business.

59. Mr Buchs and Mr Pottage gave us detailed explanations of the development, starting from 2004, of the ORF within UBS AG. We were provided, for this purpose,

with the Operational Risk Framework Design Document. It is not disputed that the ORF was designed by risk control specialists with a view to implementing "best practice" in relation to operational risk management and control. Nor is it disputed that the ORF went beyond the minimum standards required by the Sarbanes-Oxley Act 2002 and the Basel II Capital Accord. The ORF comprised, as its key element, a comprehensive process for the identification and assessment of risks. The ORF established control objectives for identified operational risks as well as control standards that needed to be performed to achieve those control objectives without specifying the precise process of how that was to be achieved. Control standards would be designated as either preventing or detecting a risk. Monitoring compliance and the effectiveness of those standards would be by way of a twice yearly process of self-certification (see paragraph 78 below). Independent review and verification were to be provided by risk control and by internal and external audits.

60. The ORF provided for operational risk control documentation "designed to ensure that the Bank's processes operate correctly and effectively". A diagram provided in evidence showed the ORF as a pyramid. The control documentation for the purposes of the ORF covers the roles and responsibilities attributable to each function; the control objectives designed to ensure that operational risks within particular functions are identified and addressed; control standards were specified on a basis that enabled a yes/no answer and "metrics" (being measures used to assess effectiveness of controls) were specified.

61. Below or outside the ORF were found technical standards to be implemented at "ground level" in each geographical location. These standards specified underpinned the control standards and specified how the control tasks were to be performed in any given context (the "control plans"). As already noted, risk management was the responsibility of every employee in the Firm throughout the performance of their day-to-day tasks in accordance with the control plans. "Business management", i.e. those with functional responsibility for the processes of the bank, were responsible for the identification and assessment of risks and the establishment of the policies and standards. Thus, in the case of Operations it was (Mr Przewloka explained) the responsibility of the global, regional and local wealth management Operations function to ensure that the appropriate standards of control were in place within the Operations function in each location, with modifications being made in particular locations to meet local regulatory or legal requirements. In this connection Mr Przewloka explained however that he, as the person ultimately responsible for risk management within Operations, would not have known what monitoring activities the second line of defence would be undertaking in respect of Operations in London.

62. One of the means by which effectiveness of the ORF was periodically assessed by business management was the "self-certification" process. This process was explained to us by Mr Buchs. We will deal with this later. Another of the means through which the risk control function oversaw and reviewed the activities of operational risk management was through the production and consideration of a Quarterly Risk Report (the "QRR").

63. No structure for operational risk management and control can, we acknowledge, eliminate all risk. The ORF, however well designed or implemented it is, cannot be expected to eliminate operational risk throughout the Business of the Firm. But, we comment, we would expect a well-functioning ORF to enable a periodic reassessment of matters such as whether risks have been appropriately identified, whether systems and controls have been appropriately set up and what lessons can be learned from crystallised risk events. The FSA does not, as we understand its position, challenge the ORF as such. The FSA does not suggest that the self-certification process was a "serious flaw" in its own right. Its challenge, as advanced at the hearing, is based on two factors. The first is what the FSA describes as particular "failings in the control plans". The second lies in the assertion of the FSA that the self-certification system failed to make available information and assurance regarding the integrity of the transaction processes and the relevant risk controls.

The FSA's case

64. The FSA's case on failings in risk control plans is based on the expert opinion of Mr Hayward. Mr Hayward's opinion was that the control plans, which formed a key component in the ORF, had been defective and should have raised questions about the effectiveness of the entire structure. The FSA rely in support on the LORR Report which concluded that:

> "Local control plans appear to have been developed with a view to fulfilling the self-certification evidencing requirements rather than addressing all elements necessary to adequately cover the risk."

The LORR

65. The function of the LORR had been to diagnose problems within the ORF. It had been launched because of concerns about the design and effectiveness of ground level controls outside of Operations (where work to remedy weaknesses and failings was already being conducted under the leadership of Mr Donald Reid who had taken over as Head of Operations as from the end of April 2007). In launching the LORR Mr Pottage was taking account of and reacting to representations of Mr Brumsen and Mr Reid. The aim of the LORR had not been to assess or benchmark governance or control arrangements specifically against regulatory requirements. The Report itself was the outcome of 45 (two to four hour) workshops by the Firm's staff whose function had been to review the relevant processes and to identify where the design or operation of individual controls could be improved. This is consistent with the way in which Ms Topley (the then Head of Risk and Compliance) described the LORR to the FSA in January 2008 where she had emphasised that the focus of the LORR had been very much on local implementation of ORF control objectives and standards through local technical standards and control plans in London. Rather than being concerned with the design effectiveness of the overall ORF, the LORR was concerned with the design and operating effectiveness of transaction and business processes and control

plans. We therefore take the LORR as a catalogue of findings of weaknesses in the system for controlling risk, being weaknesses calling for improvements.

66. The LORR Report was, we think, justifiably critical of the risk management and risk control within the Firm. The Report comments, under the heading "Risk Management and Risk Control" that:

> "A number of areas also still do not appear to fully understand the distinction between Risk Management and Risk Control or their respective accountabilities and responsibilities …. This has resulted in a number of examples of undocumented or out of date procedures and local control plan documentation."

Referring to "Risk identification and assessment", the Report observes that prior to the LORR there had been an ineffective local implementation of the "Operational Risk Assessment Process" accompanied by "inadequate communication between Risk Control and the local functions." That, it was said, had resulted "in only a few items being recorded in the ORI" until the third quarter of 2007 "with most of these being situations where risks had already crystallised, rather than items where proactive identification had occurred." Then, it reads, "the traditional risk identifiers, relied upon by the functions and Risk Control to independently challenge the functions' assessments of their own risks, were largely ineffective or non-existent, for example – Transaction Losses … Self Certification … Metrics".

67. Addressing "Local implementation of the ORF", the Report notes that "control plans … are not comprehensively and consistently implemented across all areas". Of Operations, it says, "some of the local control plan items … are so broadly formulated that the persons required to perform the specific controls are not able to do so …. There was also a widespread perception that a number of the staff performing local control plan items did not understand the underlying risk nor reasons for performing the control …"

68. We comment that one of the two compilers of the LORR Report (Mr Challis) had been the Chief Risk Officer throughout the Relevant Period. While the Report contained contributions from other staff responsible for risk, it was a self-assessment and the self-criticisms cannot be overlooked. Particularly relevant is the opening observation of the Management Summary which notes that, in the light of the substantial increase in the volume of the Firm's activities since 1999, "Operations … has been severely stretched with the need to perform multiple and increasingly complex tasks …."

GIA Report on Asia Desks

69. Further weaknesses, both front and back, had previously been disclosed by a GIA Closing Meeting Presentation of 8 May 2007 dealing with the Asia Desks. Those weaknesses had indicated (what Mr Hayward referred to as) "widespread failures to comply with the required procedures".

Evidence of specific weaknesses

70. Before expressing a conclusion on this (the risk frameworks) topic we mention examples of specific occasions where the Firm had fallen down on complying with the requirements to have adequate systems and controls.

71. The "Client Money breach" in October 2006 (see paragraph 95 below for details) resulted in the report from E&Y in March 2007 that disclosed a wider occurrence of the problem. We note that the matter had been raised at a meeting between Mr Arran Salmon (the FSA supervisor covering the Firm) and E&Y to discuss client money controls. The report of that meeting (4 July 2007) referred to lack of knowledge, training and awareness leading to a lack of rigour and inconsistency in performance and system deficiencies. Mr Challis' slide shown at the Risk Committee Meeting of 27 July 2007 showed that there were no specific control standards at the self-certification level and no client money-specific controls in the UBS AG control plan. (For the record we mention a note of a presentation to the FSA dated 26 July 2007 which summarised the actions taken in dealing with the immediate issues around client moneys and reconciliations.)

72. The withholding tax issue, raised by the GIA Report of October 2006, was the subject of an e-mail of 10 July 2007 from the then acting COO (Mr Przewloka). That drew attention to a lack of information about the clients and weak procedures in data management for identifying this. He asks why "this issue was sleeping for such a long time and was never uncovered."

73. The Payments Fraud of January 2007 required immediate and obvious remedies. It disclosed (according to Mr Challis' Report of February 2007) failures to spot forged signatures on the payment instruction and Word/Excel template and no checks on signatures requesting payment being made. It provided evidence that "pp-ing" payment instructions by unauthorised signatories had been considered acceptable. Generally, it showed that the relevant risk controls were not being performed properly.

74. Asset reconciliation failings disclosed in the report from PwC of July 2007 showed significant weaknesses in 2007. In aggregate there had been eight breaches of CASS 2.6 (and one potential breach): these covered both the ex-Laing & Cruickshank and the rest of the Firm's operations. The breaches had not been disclosed by the Operations Control Plan. (The discovery of the problem, following the E&Y report on client money, resulted in the setting up of the Reconciliations Oversight Committee that met weekly at the start.)

75. Unauthorised trades conducted from the Africa Desk, discovered in July 2007, were further evidence of control weaknesses.

76. The unauthorised trades and transactions on the Asia II Desk were not known to management during the Relevant Period; but their covert existence demonstrated widespread weaknesses in risk controls and systems. KPMG's Skilled Person's

Report on the Asia II Desk noted a lack of preventative and detective controls and went on to say that a number of controls considered by UBS AG to be in place were in fact processes and did not function as controls.

Other matters relied upon by the FSA

77. The first of these is Appendix 1 to the GIA Report of October 2006 on Operations and IT. This referred to the generic control plan that was said not fully to reflect all of the key controls in place in Operations as it was not regularly updated. As we understand it, this observation indicates that the relevant controls existed but that there were issues with the control plan documentation; and without their proper documentation there was a risk that the controls would not be performed correctly. We accept Mr Buchs' evidence that the reference in the Report related to failures to document controls that were executed; moreover, he said, the management undertaking to review control plans and linkages had been "satisfactory". The GIA Report itself drew attention to the Firm's non-compliance with withholding tax obligations.

Self-certifications

78. The second of the matters relied upon by the FSA related to the self-certification process. The FSA did not (at least by the conclusion of the present hearing) allege that a self-certification system was necessarily flawed. The actual criticism was that, as it was implemented by the Firm, the information and assurance reasonably available from the system gave little comfort as to the adequacy of internal controls. In this connection Mr Hayward, quoting the words of the LORR, said of self-certification that it was an – "Imperfect process for various reasons … resulting in relatively few items being certified as non-compliant, and those that were being mostly insignificant. Subsequent reviews of issues have demonstrated that certain items should not have been certified as compliant."

79. We have considered Mr Hayward's expert opinion in the light of the facts as explained to us by Mr Buchs and confirmed by Mr Pottage. That evidence shows that self-certification, which was biannual, was an integral part of the design of the ORF. In this connection we accept the evidence that the process was carried out on an electronic system called ORA, the tool used to capture and record whether controls had been complied with. We accept that staff were trained on the self-certification process. Further, we observe, self-certification required multiple sign-offs, with a certifier (typically a reasonably senior employee with supervisory responsibility within the relevant function) and at least one signatory (a senior manager) confirming that the relevant controls had been performed. Typically, as Mr Pottage's unchallenged evidence went, there were multiple levels of increasingly senior "sign-off", each of which would scrutinise the certifications and confirm their accuracy. Moreover, as Mr Kingsley (the expert witness nominated for the Applicant and the Interested Parties (1) and (2)) had observed, evidence had to be maintained and its whereabouts recorded in ORA. Finally in this connection, we note that the results of checks were available to Mr Pottage. They were included as "management

information" in the QRRs presented to the Risk Committee; and the self-certifications were subject to an audit process by E&Y. Those factors do not, we think, displace the criticism set out in our previous paragraph. With that in mind we think that self-certification, as implemented, was deficient in a number of areas relevant, as here, to a wealth management business. We add that Mr Buchs acknowledged (and the LORR Report confirmed) that shortcomings in local implementation had led to certifications not being correct.

80. The third matter relied upon by the FSA, in support of its case that a serious flaw existed in the ORF, is a note by Mr Challis, the Chief Risk Officer, dated 23 March 2007. This draws attention to the absence of independent checking of compliant self-certifications. The purpose of that note had been to invite an increase in resourcing for staff for the risk control function. He had argued that there were certain areas where the risk control function could have been more "value added", in terms of "identifying risk before it crystallised". While the note does not address the level of the seriousness of any weaknesses in the area of verifying and testing compliant self-certificated responses, it is (unlike the LORR Report which was compiled after the event) evidence of concerns within the Relevant Period.

Conclusions on risk framework weaknesses

81. Our overall conclusion is that the ORF, as designed, was not inherently flawed. The problems arose at the ground level of implementation. They arose because appropriate operational controls to ensure correct transaction procedures were not being performed properly or were non-existent. The issue, however, is whether "the design and operational effectiveness of the governance and risk management frameworks in place in the business" were seriously flawed. The ORF and its implementation are at the heart of things. If the risk management framework of an organisation is not operated properly then the information going to management and obtained from processes and controls, from the bottom to the top, will be incorrect at worst and inadequate at best. Here, as we have observed, the ORF's pyramid design is such that the implementation of the "ground level" processes and procedures (i.e. the application of technical control standards, desk level procedures, control plans and operating standards) are below the ORF. If the system, within the location (e.g. within the scope of the firm's operations) and below the ORF is at fault then, no matter how comprehensively the ORF has been designed, at least two consequences will follow. First, management will have no reliable means of determining whether the ground level operatives are performing the right tasks in an expeditious manner, thereby ensuring that assets and moneys entrusted by clients to the Firm are not put at risk. Second, management will not be in a position to obtain assurance by asking the right questions of the checkers (at the first line of defence).

82. The issue is, we think, to be resolved on the basis that the Firm's risk control framework extends to the ground level. We note from the "ORF Design Document" and from a document described as the "Self Certification Presentation" that desk head procedures, technical standards, control plans and operating standards are accepted as important elements within the hierarchy of control.

83 The evidence on this topic starts with the circumstances of the Payments Fraud, the Client Money failings, the shortcomings in the Asset Reconciliations procedures and the non-compliance with withholding tax requirements. That those failings took place was not in dispute. The breaches in the CASS requirements are admitted by UBS AG. The control failings in LIB were the subject of the Final Notice issued to UBS AG in 2009. Those items of factual evidence are in line with self-critical statements found in the LORR Report. They are consistent with the warnings in the 2006 GIA reports on Operations and IT. They are broadly in line with Mr Hayward's opinion; and, although Mr Challis did not attend to give evidence, his concerns expressed in late March 2007 were, we think, borne out.

84. We do not need to exercise hindsight in reaching a conclusion. The evidence satisfied us that there were flaws in the operational effectiveness of the Firm's risk management system. Were they "serious flaws"? We think they were. They were at the centre of the means by which the Firm looked after and managed transactions in clients' assets and money.

Compliance monitoring: Serious flaw allegation

85. In setting out the facts and matters upon which the FSA relied for making the reference decision, the Statement of Case refers to flaws (listed in paragraph 65) in the design and operational effectiveness of the governance and risk management frameworks in place in the business being flaws that had existed since before the Relevant Period began and that had continued throughout the Relevant Period. These included the shortcomings in the structure and operation of the Executive Committees, the inadequacy of Management Information and in the design and implementation of the ORF. We mention those points by way of introduction because paragraph 68 specifies as a further and separate serious flaw "a number of deficiencies in compliance monitoring arrangements in place in" the Firm in 2007. Effective compliance monitoring arrangements, the FSA says, are essential to enable the business to mitigate risk effectively. (Mr Pottage, the FSA says, had failed to appreciate the alleged deficiencies when he initiated the LORR.)

The eight deficiencies

86. The specifications of the alleged deficiencies are contained in paragraph 68 of the Statement of Case which we quote word for word. It starts with these words "There were also a number of deficiencies in the compliance monitoring arrangements in place in UKWM in 2007, including: …" There then follow eight headings which are –

> (1) The workload of the compliance monitoring team, who spent only 25% of their time on compliance monitoring and the balance dealing with queries.
> (2) Insufficient resource. None of the team (four) had specific monitoring risk/audit experience.

(3) Limited monitoring coverage. Only 50% of the core topics contained in the FSA handbook were covered by the 2007 monitoring plan, no functional reviews had been scoped and the monitoring did not extend to cover logical "risk" considerations.

(4) Unclear reporting of findings and lack of identification of issues and trends.

(5) Inadequate risk assessment processes.

(6) Sub-optimal control and sampling tools.

(7) Significant deficiencies in monitoring, methodology and training.

(8) Ineffective issue tracking.

That list of "flaws" is taken from the "Gap Analysis" drawn up by Mr Kevin Daynes. Mr Daynes had been appointed Head of Compliance Monitoring as from September 2007. He was not called to give evidence. The Gap Analysis is the result of a bench-marking exercise of compliance monitoring. This highlighted these as eight areas that could be enhanced. It was included in the Compliance and Risk Plan of January 2008.

The Reports as the basis for the FSA's case

87. The FSA in its Opening and Closing Submissions at the present Hearing summarise the compliance monitoring deficiencies into three categories, namely under-resourcing, an ineffective approach and a failure to monitor across the business. The evidence relied upon by the FSA was based, initially, on three reports.

88. The first of the reports is the LORR Report. The LORR had (as noted) been initiated to "review processes for identification and escalation of operational risks"; it was formally launched in August 2007. This stated that weaknesses in the compliance monitoring function had been identified in mid-2007.

89. Then the FSA presents the SPR produced by KPMG as evidence of deficiencies on the LIB's Asia II Desk. This had stated "that historically compliance monitoring was focussed on desk based, relatively high level reviews and lacked a robust risk assessment process". Third, the FSA relied on Mr Daynes's Gap Analysis which contains the eight items set out in the Statement of Case.

Compliance monitoring: the relevant facts

90. At the relevant time, the FSA's Handbook required a firm carrying on designated investment business with or for customers to allocate to a director or senior manager the function of having responsibility for oversight of the Firm's compliance and reporting to the governing body in respect of that responsibility. That is found in SYSC 3.2.8R (1). By "compliance" was meant (so far as is relevant to the Firm) compliance with the rules in the COB (Conduct of Business) and CASS (Customer Asset) sourcebooks. The senior manager in question had been the Head of Compliance (Mr Richard Wooster) who in turn had reported to the Head of Legal,

Risk and Compliance (Ms Topley); she had sat on both the Risk Committee and the Management Committee and had reported to Mr Pottage as CEO.

91. UBS had, explained Mr Buchs, operated a "three lines of defence" model in relation to the two control functions, namely risk and compliance. They are set out above. We are here concerned with the control function relating to the compliance function.

Weaknesses disclosed in GIA Operations and IT Report

92. We turn now to the further evidence adduced by the FSA in support of the alleged weaknesses in compliance monitoring. We note for this purpose that the FSA confines its attention to the arrangements in place within the Firm in 2007. With that caveat in mind we note that the Operations and IT Audit Report issued on 27 October 2006 expressly confirmed that the organisational set-up of the COO (Chief Operations Officer) function was adequate and that "Nostro and Internal Account reconciliation and payment processes" were well controlled. (We refer to the first and fourth paragraphs of the Executive Summary of that Report.) The Report did, however, identify at least two significant processing and control weaknesses. These were the handling of trade amendments and dealing with local withholding taxes. The GIA Report made recommendations in order to resolve those issues and the management comments on the Report indicate the steps to be taken to address those two weaknesses.

93. The rates of error identified in the number of trade amendments sampled by GIA were considered by Mr Hayward to be significant. The lack of control over trade amendments was acknowledged as a possible cause increasing the risk of fraud or error going undetected. Management agreed that enhancements were to be made to the "Paladign system" and to enforce a "four eye check" over all trade amendments prior to processing. Management undertook to conduct a full and thorough review to identify clients not properly set up in relation to withholding tax and to amend the account-opening process. This process was to be completed by the end of September 2007. It follows that, by the start of 2007, the withholding tax weakness was being addressed and was in the process of being remedied. It will not have been one of the weaknesses that Mr Pottage had failed to appreciate, as alleged in the FSA's Statement of Case, paragraph 70. However the GIA Operations and IT Report is relevant to the extent that it was an early warning signal that there were weaknesses at "ground level".

Breach in Client Money procedures

94. Another weakness that had been exposed in October 2006 and was being addressed and remedied by the Firm had been a breach of the Client Money Rules. We mention this because of its possible relevance to the question of whether, in the year 2007 (as specified by the FSA in paragraph 68 of the Statement of Case); it was a symptom of a wider weakness, namely the failure to have any compliance monitoring system of the activities within Operations.

95. It was found (in October 2006) that client funds in excess of $600,000 had been deposited into a non-permitted bank account. This had resulted in the commissioning of a report by E & Y on 16 November 2006. The preliminary findings of the report had been discussed at the January 2007 Risk Committee chaired by Mr Pottage. A full report had, as already mentioned, been issued on 2 March 2007.

96. Referring to the client money incident in paragraph 63(4) of the Statement of Case, the FSA acknowledges that Mr Pottage had taken steps to "remediate the immediate issue" and had "decided … to carry out a review of UKWM's client money arrangements in order to assess whether there were wider implications." The QRR for the fourth quarter of 2006, discussed at the 22 January 2007 Risk Committee meeting, stated that E&Y "have identified deficiencies in various areas which will need to be addressed". We mention also in this connection that the FSA supervisor, Mr Salmon, who gave evidence, had taken on his role in April 2007 with a generalised understanding that the Firm presented few regulatory problems. However, he indicated that the E&Y report of March 2007 had included a catalogue of failings in the client money area and that it had become evident to him that the problems were more significant than he had first understood them to have been. The E&Y findings had suggested that, rather than being an isolated breach, there had been a deeper, systemic problem with client money processes and controls such that a number of improvements were required to the Firm's procedures in order to meet the CASS client money rules. The Report also recommended a review of the Firm's arrangements for complying with the FSA's custody (CASS) requirements. This recommendation was adopted by the Firm and carried out by PwC who reported in July 2007. PwC found a deteriorating position and breaches of the custody rules at their review date of 30 April 2007. We mention both the Client Money and the Asset Reconciliations issues because of their relevance to the later question of whether the absence, at the start of 2007, of an independent compliance monitoring function contributed to or even established a serious flaw within paragraph 68 of the Statement of Case.

97. On 17 January 2007 the "Payments Fraud" came to light. Compliance had been alerted by a different bank about the payment of £350,000 made by the Firm to an account in the name of a Miss Njoku trading as "Executive Angel". The other bank had rightly suspected that as fraudulent. The payment had been processed on 12 January. The two signatures on the payment instruction had been forged. Upon review of all other payment instructions for the same day, a second instruction for a payment of £250,000, with the same pair of forged signatures, had also been identified (this time to an account at a different bank). Mr Challis, Chief Risk Officer, had notified Mr Pottage immediately. Mr Challis made a detailed report into the payments fraud and this was produced on 16 February 2007. Mr Challis' report identified specific weaknesses in controls. For example, it observed that forged signatures had appeared on the payment instruction; there was no link to any client instruction and no check on the signature requesting payment to be made. An interim process for payments had been immediately introduced on discovery of the fraud; this had involved physical delivery of payment instructions to Operations and call-backs by the processing staff to client advisers. The longer term remedy was to implement

an electronic payments process with a full audit trail. (The FSA took us to a GIA Payment Processing Report on the Firm of June 2008. This rated as "unsatisfactory" the processing systems so far as it was, even at that later time, designed to identify payment fraud risks.)

98. Whether the breach of the rules covering Client Money (discovered in October 2006), Asset Reconciliations and the Payments Fraud revealed, or should have evidenced, wider control failings covering parts of the Business other than Operations is not at this stage in point. Those features are, however, evidence of failings at the ground level of Operations which an effective system of compliance monitoring should have picked up.

99. The withholding tax problem had been foreshadowed by the GIA Operations and IT Report. The main cause of the problem had been the failure of client advisers in the "front office" to provide Operations with correct data, being "static information", about their particular clients' tax status. The Report also says there were no processes in the local control plan or the self-certification framework to identify this particular issue. Although the problem arose before 2007, it is relevant to the continuing issue of whether the absence of compliance monitoring of Operations contributed to a serious flaw within paragraph 68 of the Statement of Case.

100. In late February 2007 a "desk review" of the Asia II Desk had reported. It rated the Asia II Desk as "satisfactory". It identified some control weaknesses and limited failures relating to documentation. It noted that there were "higher risks" associated with the Asia II Desk arising from the fact that it dealt with wealthy families and sophisticated investors seeking aggressive returns. The desk review recommended that the "desk head" should sample the client advisers' monitoring of certain high risk accounts. The evidential significance of the desk review lies in the expressed reaction of Mr Weston (responsible at the time for Front Office Risk Management). He observed in the course of an interview with the FSA in 2009, after the discovery of the Asia II frauds, that the report was "really actually a very good demonstration of how weak the compliance monitoring at desk level was, in the sense that they did not seem to be even able to understand the actual risks involved". (This comment and its significance are also relevant to the position of Mr Pottage dealt with in Part III below.) Mr Pottage stated in evidence that Mr Weston had not referred any of his concerns to him; he suggested that Mr Weston might have been relying on hindsight when speaking some two years after the production of the Asia II desk review. We are inclined to accept Mr Pottage's evidence on this point. More to the point, however, is that the Asia II desk review appears to have been concerned wholly or mainly with the front office function and did not specifically look at the processes within Operations. We observe also that Mr Weston had not been called as a witness and, we were told, had left employment with the Firm.

101. A GIA report on Life and Pensions was issued on 4 May 2007. Its rating of that business area had been "satisfactory" but it identified record keeping and processing documentation as significant issues. The business had been acquired in 2004. The point identified by the audit report was that there had not been a manager

with oversight of the life and pensions part of the business. We understand also that the absence of processing documentation was a temporary problem resulting from archiving difficulties. Mr Hayward accepted that this had not indicated anything with regard to the design and effectiveness of controls in areas of business other than Life and Pensions. We accept this. We therefore base no conclusions on weaknesses relating to Life and Pensions.

102. A GIA Report presentation on 9 May 2007 to Ms Caroline Kuhnert (Head of LIB) on the Asia Desks identified certain audit failings. (Mr Pottage had not seen the presentation but had talked to her about it.) The eventual audit, agreed in November 2007, was qualified. The key matters covered by the report related to the international business; it covered matters such as missing Service Level Agreements between London, Singapore and Hong Kong and deficiencies in client documentation and in internal procedures leading to lack of definition of controls; it also identified weak organisational issues.

103. The real thrust behind the FSA's allegation of deficiencies in compliance monitoring (set out in paragraph 68 of the Statement of Case) lies in the failure on the part of the Firm to have had an effective independent monitoring function in place over the ground level activities of Operations. We are satisfied from the evidence that an independent monitoring function was not in place and (so far as this is relevant to the question of whether Mr Pottage should have instituted a Systematic Overhaul earlier than he did) this fact was probably not known by Mr Pottage until February or March 2007. Moreover, whether there was an inadequacy of resources and personnel to carry out the compliance function, depends upon the required scope of that function. Its sufficiency of resources might have been more significant had the compliance function had the task of monitoring operations. But that was not the case.

104. This brings us to the FSA's allegation that the serious flaw lay in the limited coverage of the compliance monitoring function. We recognise that there is no regulatory requirement in the FSA handbook requiring the entirety of a business to be covered by compliance monitoring. We recognise also that Operations had its own procedures for checking that its staff carried out their day-to-day tasks properly. The inescapable fact however is that the problems referred to above, and particularly those relating to client money, reconciliations and unauthorised transactions and transfers of funds were arising because of non-compliance at ground level. This was acknowledged by Mr Buchs when defending the integrity of the ORF.

105. The point was made by UBS AG that in fact compliance monitoring of Operations was undertaken on an "event driven" basis, with principal responsibility for day-to-day monitoring residing with teams within Operations. UBS AG emphasised that the FSA had been aware of the position and had not regarded it as putting UBS in a state of regulatory breach. They referred, for example, to the FSA's note of its compliance visit on 23 October 2005 which records that – "while we did not cross-refer the control plans to FSA rules, they looked to be reasonably comprehensive." The same note acknowledged that there were areas where "compliance" has no role or oversight; reference was made to activities of Operations

in relation to client money and transaction reporting. The same note did, however, go on to say that – "Compliance should arguably provide some kind of oversight of both processes". It appears from that note and from later correspondence between the FSA and Mr John Saunders, the then Head of Legal and Compliance, that the FSA had not been suggesting that it was essential for the compliance monitoring function to monitor Operations directly. Nonetheless we think that, by the start of 2007, there was evidence, based on the GIA Report on Operations and IT, the Payments fraud and the Client Money issue to the effect that a potentially widespread lack of compliance discipline existed at ground floor level within Operations. At the least there should have been a system of independent compliance monitoring by a special function located within the second line of defence. The FSA have, in our view, made out their case that the absence of such compliance monitoring of operations was a weakness of the sort referred to in paragraph 68 of the Statement of Case.

106. We turn now to item 4 in the list of deficiencies set out in paragraph 68, namely "Unclear reporting of findings and a lack of identification of issues and trends." We observe in relation to the structure and operation of the Executive Committees and to Management Information that there was reporting by compliance, so far as its coverage extended, on a quarterly basis to the Risk Committee through the QRR. We acknowledge that the reports could have been clearer in drawing out key messages and that they could have specified what needed to be done to resolve any issues (as suggested in the risk plan ("the CRP"), produced by Mr Daynes); we are not, however, persuaded that this feature amounts to a serious flaw as that term is used in paragraph 68 of the Statement of Case.

107. We turn finally to the allegation, in paragraph 68, that ineffective issue tracking was one of the deficiencies in the compliance monitoring arrangements in place in 2007. We note that this matter had been considered by the FSA during its visit in October 2004. The FSA had expressed the view that the reporting of issues and deficiencies to the compliance officers and the tracking of the "remediation" was similarly informal. The FSA went on to express the view that increased formalisation was likely to be needed as the business grew. A follow up letter from the FSA observed that "although not material" the processes surrounding the reporting of issues and the tracking of remediation would benefit from greater formalities. It appears to us that there was a weakness in this respect. Little attention was paid to this aspect of the FSA's case in the course of the hearing; we cannot therefore express a firm view on the seriousness of the matter, still less can we say whether the Firm was failing to comply with its regulatory requirements in this respect.

Structure and Operation of the Executive Committees: Serious Flaw alleged in paragraph 65(1) of the Statement of Case.

108. This was advanced as the first "Serious Flaw" relied upon by the FSA. The FSA's case is that there were serious flaws in the design and operational effectiveness of the Executive Committees, i.e. the Management Committee and the Risk Committee. This meant, the FSA alleges in paragraph 65(1) of the Statement of Case, that the ability of the Firm's governance structure to supervise, oversee and control the risks of the business in accordance with local regulatory requirements was compromised. The alleged flaws relied upon by the FSA under this heading are drawn almost entirely from a paragraph taken from the executive summary of the LORR. These are expressed as examples but, as the totality of the FSA's case on this point falls within those examples, we set out the allegations in full:

> "(a) the structure, remit and membership of the various committees were not effectively coordinated;
> (b) it was not clear which committee was responsible for which topic;
> (c) it was not clear to the Business what role the committees played in assessing the operational effectiveness of the governance and risk management frameworks."

The Statement of Case particularises allegation (c) with the following words:

> "(i) The uncertainty was recognised by the LORR (which the FSA relies upon) as follows: 'Although formal committees have been established to oversee the location's activities, these have not always been effectively coordinated nor have the terms of reference been reviewed and adapted to ensure an integrated and robust governance structure with predefined escalation routes. In addition, the composition of some of the top-level committees, namely the Management Committee and the Operating Committee are almost identical, sometimes making it unclear as to which committee or forum is responsible for covering certain topics. Furthermore, the functional model and lack of local coordination in the governance model has resulted, on occasion in new business decisions being taken in isolation of, and without the necessary escalation to the executive committees or cross-functional or consultation to ensure all aspects of a new introduction, including control aspects are reviewed and agreed in advance.'
> (ii) On 14 September 2007, the Risk Committee was re-launched as 'a steering committee for addressing risks'. It is clear that this was not the role it had previously been performing. It was clear that effective oversight of risk could not be achieved via the quarterly meeting of a committee whose purpose was to approve the contents of a historic report to be sent to Zurich and which was dependent on incomplete and inadequate information."

109. Three further allegations follow:

> "(d) There was limited discussion of risk related issues by the Management Committee and no evidence that risk related issues were escalated, where appropriate, by the Risk Committee;
>
> (e) the Risk Committee met only quarterly and its main function was to discuss and approve the Quarterly Risk Review (for the benefit of management in Zurich) and to review the Risk Inventory …. The agenda for the quarterly meetings was largely unchanging and the Risk Committee was not capable of providing effective oversight and challenge;
>
> (f) there was no process to consider and identify, on a front to back basis, the key risks arising from [the Firm's] business model and to assess the design and operational effectiveness of the governance and risk management frameworks."

Mr Hayward's expert opinion

110. In support of its allegation the FSA relies on the expert opinion of Mr Hayward who, in his report, concluded that the Risk Committee had been ill-equipped to carry out effective oversight. The FSA relies also on criticisms by Mr Hayward of the absence of summary reports and issue-tracking reports from compliance monitoring and other internal monitoring functions. In particular reliance is placed on Mr Hayward's conclusion that specific changes should have been made. The frequency of meetings should, in his expert opinion, have been increased so that they were not dominated by the QRR. The terms of reference of the Executive Committees should have been revised to ensure that the distinct role of each such committee was clearly defined, understood and effectively performed. Mr Hayward's opinion was that there should have been better discipline over the tracking and follow-up of issues. The committee in question should have ensured that it received information about compliance and control monitoring sufficient to enable it to exercise effective oversight of those functions. There should have been more discussion of the root causes of operational failure. Emphasis was placed by Mr Hayward on the statement of Mr Pottage that it had not been until the end of August 2007 that he proposed to start chairing the meetings "properly" and get more involved in agenda setting. As we understood Mr Hayward's evidence on this topic the terms of reference for the Risk Committee were not a "serious flaw" as such. It was, in his opinion, the behaviour of those involved that had failed to demonstrate to him the discipline, rigour and challenge necessary for effective governance.

The facts relating to the Executive Committees

111. It was common ground that the Executive Committees referred to in the Statement of Case were the Management Committee and the Risk Committee. Those

two committees were central components of the Firm's governance and risk management frameworks. Mr Pottage had been chairman of both committees.

112. The Management Committee had met monthly and was the senior body responsible for running all business originating from the UK. Its overall responsibility was the strategic management of the UK "location" and it was supported by other committees that made up the governance structure, including the Risk Committee.

113. The Risk Committee was responsible for monitoring the status of the risk of the UK location and reviewing significant changes. Where appropriate, risk issues should have been referred from the Risk Committee to the Management Committee. (The FSA uses the word "escalation" to connote that reference process.)

114. The risk control function was, throughout the Relevant Period, led by the Firm's Chief Risk Officer, Mr Challis. (He was not called to give evidence.) He was responsible for servicing the Risk Committee. In conjunction with other control functions, such as legal, compliance and GIA, the risk control function's tasks (we accept) included assisting business management in relation to processes and procedures to identify, assess and mitigate risks, monitoring adherence to the risk appetite set by the business, and providing tools and controls to ensure the adequacy of processes, and risk reporting, including escalation where appropriate.

115. The evidence of Mr Buchs (then Global Head of Risk and Compliance in UBS) and of Mr Pottage, which we accept, was that the structure and approach of those two committees had been centrally designed from Zurich and mandated as part of UBS's global risk management framework. The QRRs and the Operational Risk Inventory had been two of the principal means by which UBS identified, reported on and assessed risk issues. The QRRs, the format and frequency of which were determined by UBS Global Wealth Management Risk and Compliance, "captured" information regarding both primary risks and operational risks, as well as other additional risk indicators, such as audit results, complaints, new business developments and the results of the ORF's six monthly self-certifications. The inclusion on the Risk Committee agenda of standing items to cover each of the key risk areas was done so as to ensure that each of the key risk areas was properly discussed. We note that Mr Challis had said, in the course of an interview with Enforcement that by reviewing and approving the QRRs – "… the Risk Committee [was] signing that off that they are saying yes we believe that to be a true and accurate record if you like of the risks that were in the location and, in our assessment of it".

116. The Risk Committee met quarterly until September 2007. The formal quarterly meetings were required to enable it to consider and, if appropriate, to sign off the then current QRR soon after the quarter-end. The FSA Rules, we note, do not prescribe the frequency with which a risk committee is to meet. MiFID, which took effect in November 2007, indicates that such a committee should meet at least annually. The launch of the LORR in July 2007 resulted in an increase in the volume of risk issues that needed to be addressed and Mr Pottage increased the frequency of

meetings to monthly. We accept that the consideration of the implications of those issues to the Firm called for the direct and active involvement of Mr Pottage as chairman of the Risk Committee.

QRRs considered by the Executive Committees

117. We have examined the QRRs considered at the four Risk Committee meetings in the relevant Period and have read the minutes of those meetings. We note that at the third quarter meeting on 18 October 2006, Mr Pottage had focussed his attention on risk relating to credit and the processing of transactions; he had installed an amber rating and he had asked for an inventory of risks that the Firm wanted to run. The meeting for the fourth quarter, on 17 January 2007, had been immediately concerned with the "client money" issue and the commissioning of a report from E&Y. The report by Mr Challis on the "payments fraud" that had been exposed in January 2007 had been discussed in detail at the next risk committee meeting of that year.

Minutes of meetings as evidence of discussions at meetings

118. In paragraph 109 above we record that the FSA seeks to establish that there had been "limited discussion of risk related issues". We have examined the minutes of the quarterly Risk Committee meetings during the Relevant Period. We were not, however, provided with a comprehensive set of the pre-reading material provided to Management Committee members, agenda or minutes each month for all of the Relevant Period. Our examination of the minutes of the Management Committee meeting of 19 December 2006 shows that "standing items" included an update by the COO, a presentation by the consultants on the 2010 Plan and an update on the Firm's financial performance. At the meeting of 1 February 2007 Mr Pottage asked that risk also become a standing item. The minutes were quite short. It was not possible to discern precisely how much discussion had actually taken place on risk and operational items at the each Management Committee meeting. The FSA has not satisfied us, on the strength of the limited evidence of minuted discussions at meetings and other pre-reading materials, that the extent and content of the discussions at both Executive Committees was so limited as to constitute a "serious flaw" within paragraph 65(1) in the sense of being "incomplete and inadequate", to use the words of the LORR.

Further discussion outside meetings

119. We accept Mr Pottage's evidence that on many occasions it had been necessary to deal, on an informal basis and outside the formal meetings of the Risk Committee and the Management Committee, with risk and compliance-related issues.

Internal audit issues

120. As regards internal audit issues we are satisfied that the appropriate committee addressed all significant items and all overdue items (whether significant or not) through the QRR. We understand that all significant and non-significant items had

also been tracked in "audit track" (a computerised tool) and a failure to implement an action plan in line with an agreed deadline would (Mr Hayward accepted) have prompted questions from Zurich.

Involvement of Mr Pottage

121. Regarding Mr Pottage's role as committee chairman we are not persuaded by the FSA's assertion that he had not taken his responsibility seriously until July 2007 when the LORR was under way. Our reading of the minutes of the meetings of the Risk Committee and the Management Committee shows that he had been taking an active role. His greater involvement once the LORR had started, i.e. through the monthly meetings of the Risk Committee had, we think, been the inevitable result of the production of a higher volume of issues generated by the "workshops" carried out in the course of the LORR. We mention also that Mr Przewloka had personally rated Mr Pottage as a very organised and structured person, especially in relation to meetings.

Overlapping membership of Executive Committees

122. We now address the alleged "serious flaw" caused by the overlapping membership of the risk committee and the management committee. We mention in this connection Mr Pottage's explanation in evidence that it had been a deliberate decision by him to have common membership of the committees. We note that in the follow-up Report by KPMG (following the SPR) there is a comment that "there is considerable overlap between the membership of the Management Committee and the Risk Committee, ensuring that the majority of the Management Committee are involved in detailed discussions regarding risk issues." We note also that Mr Hayward's expert opinion was that the overlap was capable of being a source of strength, as it had the potential to be (to use his words in oral evidence) "a substantial mitigation of the risk that uncertainty over their roles would lead to important matters being covered by neither committee".

Alleged failures to "escalate"

123. In the Statement of Case paragraph 65(1)(d) the FSA alleged that there had been, during the Relevant Period, limited discussion of risk-related issues by the Management Committee and no evidence that risk-related issues were "escalated", where appropriate, by the Risk Committee. We are not persuaded of this. We have already observed that risk issues had indeed been considered by the Management Committee. Moreover, the significant overlap of personnel between the Risk Committee and the Management Committee must have enabled the Risk Committee to address risk issues without necessarily needing to "escalate" them formally to the Management Committee.

Conclusions on alleged flaws in operation of Executive Committees

124. The FSA has not established its case as regards its allegation in paragraph 65(1) of the Statement of Case. The evidence does not satisfy us that the structure and operation of the Executive Committees is properly to be regarded as a serious flaw.

125. The FSA states that a matrix management structure presented challenges to Mr Pottages's ability to discharge his regulatory obligations. It will be recalled from paragraphs 22 to 24 above that the FSA had taken these challenges into account when reaching the referred decision. They were matters, it was said in the Statement of Case, that should have increased Mr Pottage's awareness of the need to spend "sufficient and substantial time" to ensure that governance and risk management frameworks were in place. Mr Pottage explained that his authority within the Firm, as a local component of a multi-national organisation, was limited. We accept that. He was in a position of influence, but did not have the authority to make changes to the governance and risk management frameworks. We did not understand the FSA's case at the hearing to place any real emphasis on those factors. We do not find them to be factors of weight, one way or the other, to the present issue which is whether Mr Pottage breached the standards required of him by SP7.

Insufficiency of Management Information ("MI"): Serious Flaw

126. Paragraph 65(4) of the Statement of Case states that there had been "serious deficiencies in the management information available to [Mr Pottage] and other members of the senior management team which meant that the supervision of the Business and the management of risk was necessarily deficient". The MI made available to him had been "primarily concerned with financial performance with insufficient focus on the strength of controls and the status of net risks". The term "management information", explained the FSA in its opening submissions, was used to refer to routine, documentary reports providing information which enables managers to judge performance of the Business and compliance with the regulatory requirements. We refer to SYSC 3.2.11G which 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 regulatory concern. Three factors will be the relevance, reliability and timeliness of that information.
>
> (2) Risks of regulatory concern are those risks which relate to the "fair treatment of the firm's customers to the protection of consumers, the confidence in the financial system, and to the use of that system in connection with financial crime".

SYSC 3.2.12G states that:

> "It is the responsibility of the firm to decide what information is required, when, and for whom, so that it can organise and control its activities and can

comply with its regulatory obligations. The detail and extent of information required will depend on the nature, scale and complexity of the business."

The FSA's contentions

127. The FSA relies on a number of findings in the SPR. The SPR observes that the predominant focus of front office MI had been on financial performance rather than on risk management and compliance. To a large extent the SPR had been concentrating on MI as regards the activities of the LIB and on the MI used within the LIB. It does however make the point that prior to July 2007 there had been no consolidated back office MI reporting on operating performance. Specifically, it comments that the MI had not been "granular" enough to have picked up the issues occurring on the Asia II desk such as the high volumes of FX activity and intra-client account movements. The SPA gives the MI available for the period 2001 and 2007 a rating of "ineffective". The FSA goes on to place reliance on Mr Daynes' Compliance and Risk Plan which described a number "areas for enhancement" in compliance monitoring arrangements. These, referred to by the FSA as "flaws", included unclear findings of monitoring reports and ineffective issue tracking. Then the FSA refers to the Firm's own acknowledgement of deficiencies in MI. This is found in the Final Report of the LORR. This concludes that "the use of local metrics to monitor both quality and risk" had not been adequate; and "reporting by certain functions (e.g. operations, origination, accounting" had not provided "the specific and granular information required locally to monitor operational risk".

128. The expert opinion of Mr Hayward was relied on in support of the allegation that the MI available in 2007 failed to cover risk, compliance and operational issues in sufficient detail to enable it to be used in a meaningful way by senior management.

129. The FSA further relies on Mr Hayward's expert opinion that the GIA Reports were too limited. This was because, first, those reports had not covered the International desks (other than the Asia desks) or the functions such as HR, legal risk, compliance, accounting and marketing. Second, on the strength of his expert opinion, Mr Hayward said that the GIA reports had not been sufficiently respected by management; he based this on the management responses to the GIA Report on Operations and IT of October 2006.

130 The FSA contends in essence that such MI as Mr Pottage obtained, including verbal updates from risk and compliance officers, had been "plainly inadequate". The FSA relies on Mr Callum Licence, who had become COO in August 2007. When interviewed by the FSA he had said, as regards MI, "we didn't have a dashboard here at the time. The management information wasn't very good". Explaining this in cross-examination he said "… for me this was some information but it was not enough information for me to get to the bottom of the issues that we had in Operations at the time".

The evidence

131. We turn now to the evidence. We have read through the quarterly QRRs and supporting documentation and the minutes of the Risk Committee meetings. We note Mr Hayward's expert opinion that the information in those showed "some value in

reporting what had gone wrong in the past and, to some extent, enabling consideration of future issues". Mr Hayward qualifies that by observing: "their usefulness is greatly limited by the absence of significant consideration of the root causes of operational risk issues. Without this, they are of limited value as a basis for considering what might go wrong in the future." It was not clear to us whether Mr Hayward had been shown the full QRRs and supporting papers (that we saw) for the four periods.

The QRRs

132. The QRRs, we note, use a risk reporting template provided by Zurich to enable consideration in due course at the "global level". The template for the QRR requires the local risk officer to address, in some cases with a "yes/no", a multitude of risk issues. The information to be included is drawn from, among other sources, the Risk Inventories which cover (we were told by Mr Buchs) operational risk issues and action plans. The QRR, when compiled, brings together information concerning "primary risks" (i.e. market and credit risks) as well as "operational" risks. The Firm as a local business unit is required to provide, under the heading "Additional Risk Indicators", information covering audit results, complaints, new business development and, to quote from Mr Buchs' evidence, "SOX 404/ORF Risk Assessments".

133. The Risk Committee was required by Zurich to address each QRR at its quarterly meeting. The Chief Risk Officer was required to update the Key Risk Inventories. In compiling the quarterly QRR the Risk Committee was, Mr Buchs said (and we accept this), required to make a risk assessment as regards each risk category on a red-amber-green rating basis. Mr Buchs explained that the Central Risk Reporting Team within Operational Risk Control (in Zurich) reviewed the information contained in the locations' QRRs, spoke to the local risk officer if appropriate and produced a consolidated global QRR which was considered during meetings of the Global Risk Committee.

134. In relation to management information regarding compliance monitoring, we observe that the QRRs document a number of "Desk Reviews" including whether any issues have been identified and what had been done about them. Those Desk Reviews covered areas such as "Know Your Customer", Client Reviews, Client Suitability Assessment and timely execution. Mr Kingsley expressed the expert opinion that this suggested that Mr Pottage had indeed received what he (Mr Kingsley) regarded as summary information on compliance monitoring as part of the QRR.

Conclusion

135. MI will, in principle, be deficient if it is incorrect or if it is insufficient. It will be incorrect where the sources from which it is captured are inaccurate or misleading. It will be insufficient if the system fails to provide access to the required data. It is not in dispute that three events happened during the relevant period that caused errors and insufficiencies in the quality and quantity of MI relating to the Firm's core activities. First, as acknowledged by UBS AG, the Firm had failed to comply with the regulatory requirements relating to client money; that had been the subject of the E&Y report produced early in 2007. Among the required changes referred to by E&Y was a list of

compliance improvements and this included record keeping. Second, again as acknowledged by UBS AG, there had been failures by the Firm to comply with the CASS rules relating to asset reconciliations. Those failures had been investigated by PwC and we were provided with the PwC report on the status of reconciliations undertaken in accordance with the CASS custody rules. The information that should have been available, had there been proper compliance with the CASS rules, should have been an ingredient in the MI available to senior management. Its absence must, we think, have been a deficiency in both the quality and the quantity of the MI.

136. Then, as recorded in paragraph 14 above, the Firm had been in regulatory default as a result of weaknesses in the systems and controls in place within the LIB business. These had not been properly implemented. The result had been for transactions and intra-client account transfers to have gone unobserved and unrecorded or improperly recorded. That too resulted in a deficiency in the MI. The regulatory defaults have been acknowledged by UBS AG which has agreed to pay a penalty. But that does not stop those circumstances from being taken into account when determining whether, as an objective fact, the omissions from the records of those transactions and transfers were deficiencies in the MI available to Mr Pottage for the purposes of the allegation in paragraph 65(4) of the Statement of Case.

137. We mention in this context an admission made by Mr Pottage in evidence that, while the template for recording open trades positions was itself suitable for its purpose, the information contained within it had been deficient. The information actually provided had failed to include a number of open trades. The consequence was that the record showed an inaccurate and more favourable picture of the true position. That example showed further evidence of a deficiency in the content of the MI.

138. The question of whether there is a serious deficiency in MI cannot be determined without examining the integrity of the risk management framework adopted by the firm in question and the standard of its compliance monitoring. Here, as we have concluded, there were deficiencies in both those areas. It must almost inevitably follow that those deficiencies will cause knock-on deficiencies in the quality and quantity of the MI. Thus, whatever view we may hold of the content and usefulness of the QRRs and of the value to be attributed to the GIA Reports, the inaccuracies and omissions resulting from, e.g., failures to comply with the CASS rules are bound to come into the reckoning when deciding whether the MI is flawed. For the reasons we have given, we think that there were flaws. They were, seen in the context of a wealth management business such as that of the Firm, flaws of a sufficiently serious nature to be classed as serious flaws. That is the position quite irrespective of whether they should have been perceived by the reasonable CEO postulated by the wording of SP7.

139. We have reached our conclusion on the deficiency or otherwise of MI on the basis of what we saw as the content of the MI as well as the form in which it was presented. We accept that the structure of the QRRs is formulaic and that it was not designed to address the root causes of any material weaknesses. In that connection we record a remark of Mr Pottage, in evidence, that the Operational Risk Inventory “did not create any material value for us locally”. But, as noted, we have seen some of the pre-reading material for Risk Committee meetings. We accept that Mr Pottage had

been receiving information verbally from his senior staff, e.g. from Ms Topley, the Head of Legal, Risk and Compliance. We also accept that information was provided to members of the Risk Committee and Management Committees so that risk matters were addressed at these meetings.

PART III (THE "REASONABLE STEPS" ISSUE)

The Charge of Misconduct against Mr Pottage

140. We have concluded that the FSA has established serious flaws within paragraph 65 of the Statement of Case ("a number of weaknesses in the ORF" and "serious deficiencies in management information" during the Relevant Period) and within paragraphs 68-70 ("a number of deficiencies in the compliance monitoring arrangements in place in the Firm in 2007"). With those conclusions in place we now turn to the question of whether the FSA has made out its case of misconduct against Mr Pottage.

141. We start by recording the particulars of misconduct. The FSA's case in paragraph 6A(1) of the Statement of Case is that Mr Pottage was guilty of misconduct on account of his failure "to take reasonable steps to satisfy himself by way of an initial assessment at the outset of his appointment as to the design and operational effectiveness of the governance and risk management frameworks in place". "An initial assessment", the Statement of Case specifies in paragraph 48, should have allowed [Mr Pottage] to obtain an accurate and thorough understanding of:

> "(a) the state of the Business, including the design, operational effectiveness and strengths and weaknesses of the governance and risk management frameworks;
>
> (b) the operational risks of the Business and the current systems of control so as to determine the extent to which the Business was controlled effectively on a day-to-day basis;
>
> (c) the quality of management information available to assist in his assessment of whether the governance and risk management frameworks of the Business were operating effectively;
>
> (d) any significant risk or compliance issues during his predecessor's tenure and manner in which they had been resolved, or not resolved;
>
> (e) the practical implications of the global matrix management structure and the extent to which its implementation in the UK location had a material bearing on the ability of the business to ensure it complied fully with its local regulatory obligations;
>
> (f) the strengths and weaknesses of the key individuals who reported to him."

142. In paragraph 6A(3) the FSA states that –

> "If Mr Pottage had performed an Initial Assessment or Continuous Monitoring adequately during the Relevant Period he would have identified that there were serious flaws in the design and operational effectiveness of the governance and risk management frameworks such that it was necessary to carry out the Systematic Overhaul of those frameworks which would identify and remediate those serious flaws ("the Systematic Overhaul")"

In paragraph 6A(4) the FSA particularises its allegations as follows:

> "Mr Pottage was unaware of the need to spend, and therefore did not spend, sufficient time with regard to the operation of the governance and risk management frameworks of the Business. He did not perform an Initial Assessment or Continuous Monitoring adequately and therefore failed to appreciate the need for the Systematic Overhaul."

> "In particular … Mr Pottage was too accepting of the assurances he received that there were no fundamental deficiencies with the design and operational effectiveness of the governance and risk management frameworks."

Further particulars are given in paragraph 6A(5). These are set out at the start of this Decision.

The regulatory background

143. Section 66(1) of the FSMA states that the FSA may impose a financial penalty of such amount as it considers appropriate on a person if it appears to the FSA that he is guilty of misconduct and the FSA are satisfied that it is appropriate in all circumstances to take action against him. Section 66(3) specifies that if the FSA is entitled to take action under that section of the Act, it may impose a penalty on him as such amount as it considers appropriate. Under Section 66(2) a person is guilty of misconduct if, while an approved person, he has failed to comply with a statement of principle issued under section 64 or he has been knowingly concerned in a contravention by the relevant authorised person of a requirement imposed on that authorised person by or under the Act.

144. Section 64(1) states that the Authority may issue statements of principle with respect to the conduct expected of approved persons. These statements, and guidance upon the application and purpose of the statements, are contained in the parts of the FSA's Handbook known as APER. APER Principle 7 states, in Chapter 2.1.2P of APER, that:

> "An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is

responsible in his controlled function complies with the relevant requirements and standards of the regulatory system."

145. Chapter 4.7.2 of APER contains the following examples of conduct which, in the opinion of the FSA, do not comply with Principle 7. The most relevant examples of conduct which do not comply with Principle 7 include:

(1) failing to take reasonable steps to implement (as personally or through a compliance department or other department) adequate and appropriate systems of control to comply with the relevant requirements and standards of the regulatory system (APER 4.7.3E);

(2) failing to take reasonable steps to oversee the establishment and maintenance of the systems and controls appropriate to the business (APER 4.7.3E);

(3) failing to take reasonable care to monitor (either personally or through a compliance department or other departments) compliance with the relevant requirements and standards (APER 4.7.4);

(4) failing "to take reasonable steps to adequately inform himself" about the reason why significant breaches (whether suspected or actual) of the relevant requirements and standards of the regulatory system may have arisen (APER 4.7.5E) and

(5) failing to take reasonable steps to ensure that procedures and systems of control are reviewed and, if appropriate, improved, following the identification of significant breaches (whether suspected or actual) of the relevant requirements and standards of the regulatory system may have arisen (APER 4.7.7E).

146. APER 3.1.4G deals with the personal culpability of the approved person in question. It provides that an approved person will only be in breach of a Statement of Principle where he is personally culpable. Personal culpability, it provides, arises "where an approved person's conduct was deliberate or where the approved person's standard of conduct was below that which would be reasonable in all the circumstances".

147. APER 4.7.12G provides –

> "An approved person performing a significant influence function need not himself put in place the systems of control in his Business… Whether he does this depends on his role and responsibilities. He should, however, take reasonable steps to ensure that the business for which he is responsible has operating procedures and systems which include well-defined steps for complying with the detail of relevant requirements and standards of the regulatory system and for ensuring that the business is run prudently. The nature and extent of the systems of control that are required will depend upon the relevant requirements

and standards of the regulatory system, and the nature, scale and complexity of the business…".

148. As noted, an approved person will only be in breach of a Statement of Principle where he is personally culpable, and not simply because a regulatory failure has occurred in an area of business for which he is responsible. It is not alleged that Mr Pottage's conduct was deliberate. Nor it is alleged that, simply because matters went wrong while Mr Pottage held office as CEO, there had been a failure to take "reasonable care". This follows from the fact that the burden of proof lies with the FSA.

149. ENF 11.5.6G provides in sub-paragraph (2) that the FSA will not discipline approved persons on the basis of vicarious liability, providing appropriate delegation has taken place. It goes on to provide that the FSA will consider that an approved person performing a significant influence function may have breached Principles 5-7 only if his conduct was below the standard which would be reasonable in all the circumstances. In sub-paragraph (3) it is provided that – "An approved person will not be in breach if he has exercised due and reasonable care when assessing information, had reached a reasonable conclusion and has acted on it."

150. From the provisions in the Handbook set above and with the evidence of Ms Megan Butler (the Head of Department, Supervision, Investment Banks 1, within the FSA) in mind, we make the following observations:

(1) Where a control failure in a business becomes apparent, the CEO from his unique position of oversight can be expected to assess the wider implications of that failure to the business as a whole.

(2) The CEO as an approved person will be the subject of disciplinary action on account of a breach of a Statement of Principle where he is personally culpable, but not otherwise.

(3) A CEO is not required to design, create or implement controls personally: his is a role of oversight.

(4) There is not an obligation on the CEO to do the job of an appropriately appointed delegate of his of hers.

(5) An approved person is not required "to ensure" that the business has compliant systems and controls. The obligation on him is to "take reasonable steps to ensure" that the business has compliant systems and controls. What is required to be done by way of "reasonable steps" depends on all the circumstances.

151. The critical question for us, when determining whether the FSA has made out its case for misconduct on the part of Mr Pottage is, reverting to the words of APER 7, to decide whether he failed to take reasonable steps in the circumstances relied on

in paragraph 6A of the Statement of Case. The failure alleged against Mr Pottage is that of not initiating a Systematic Overhaul as a result of either or both of an adequate Initial Assessment or an adequate Continuous Monitoring at the appropriate time. The test to be adopted is whether Mr Pottage's failure to institute a Systematic Overhaul at the appropriate time fell outside the bounds of reasonableness. It is not alleged by the FSA that Mr Pottage's initiation of the LORR fell short of an acceptable Systematic Overhaul. It is implicit therefore that the FSA has to satisfy us that, in the circumstances, the appropriate time for instituting the LORR was before the time when Mr Pottage initiated the LORR, which was late July 2007..

How Mr Pottage should have carried out his regulatory responsibilities: The FSA's general case

152. Mr Pottage's responsibility as CEO (CF3) holding a position of significant influence was his alone. To be in a position to take the "reasonable steps" called for by APER 7 Mr Pottage, as CEO, should (so the case for the FSA goes) have taken positive steps to satisfy himself as to the effectiveness of the governance and risk management frameworks: to do so, he should not simply accept what he is told but should, as appropriate, corroborate, challenge and consider the wider implications. While he had a compliance officer (with CF10 function) and a risk officer (CF14) as part of the management structure of the Business, Mr Pottage was the "only individual with full regulatory responsibility for all aspects of compliance with the regulatory regime". To quote from the FSA's Closing Statement produced for the present hearing:

> "In any event, as a matter of fact, neither the Compliance nor Risk functions were monitoring all areas of the business, and this was or should have been apparent to Mr Pottage. As a result it should have put him on notice that: (i) he was personally obliged by reason of his CF1 and CF8 controlled functions to ensure that proper monitoring was in place, particular given the issues in the Operations function of which he was aware on appointment and the matters which Ms Topley brought to his attention shortly after: (ii) until this occurred, the degree of reliance that Mr Pottage could reasonably place on these functions was significantly limited and (iii) Mr Pottage's wide perspective as CEO was of particular importance in achieving effective oversight, given this limited degree of reasonable reliance."

The FSA goes on to say that "in practical terms, one of the important obligations on a CEO is to obtain and understand the sources of information and assurance available to him. This involves the taking of reasonable steps to "trust but verify" sources of information and assurance: i.e. where possible, to corroborate generally confirmations of the absence of problems or concerns." The FSA commented on Mr Pottage's statement that he had carried out such a process of corroboration. This reads:

> "… I explain how my first seven years at WMUK gave me, from before September 2006, what seemed then and still seems to me today

> a reasonable view that the governance and risk management frameworks of WMUK were fit for purpose. This view was not founded on assumptions or merely on assurances provided to me in the course of the initial assessment, but was in fact grounded in numerous, diverse pieces of corroborating and reinforcing evidence deriving from my own experience as well as from formal, documented expert opinions and a wide variety of management information."

The FSA says that it does not accept Mr Pottage's evidence in that regard. It considers that he had entirely failed to carry out the necessary process of corroboration. In the circumstances the FSA contended "that Mr Pottage had failed to take reasonable steps to identify and remediate the serious flaws. Mr Pottage only began to take reasonable steps to address the serious flaws in [the Firm's] governance and risk management frameworks at the end of July 2007 when the LORR, a wholesale review of the overall governance, adequacy of the control environment and risk assessment and reporting process across all of the Business's functions, was initiated". This was not, alleged the FSA, Mr Pottage's initiative. It was the response on the part of senior managers, who reported to Mr Pottage, to an accumulation of warning signals.

The Initial Assessment

Mr Pottage's Background

153. We have already noted that Mr Pottage's career with UBS started in 1999 when he joined to set up wealth planning in Products and Services. Previous to that he had practised as a Chartered Accountant and Chartered Tax Adviser. He had held positions in the front office (during the period 2000-2005). He had been Deputy Head of UK Domestic and in 2001/2 he had been Acting Head of "UK Domestic", (a CF8 function) and later he had been Head of Products and Services. He had (and this was not challenged) acquired a practical knowledge of many aspects of compliance regulations, how the back office worked and as to the "UBS" approach to approval of new business. He had been a member of the Risk Committee; in that capacity he had had experience of QRRs. He had often chaired the Management Committee through which he had seen the introduction of certification measures to comply with the Sarbanes-Oxley Legislation, the introduction of ORF and the Risk Inventory and the creation of the GIA (Internal Audit Track) System together with steps to monitor GIA Reports. He had become acquainted with the worldwide structure of UBS AG and its risk and compliance departments; he was acquainted with the people in senior positions throughout the worldwide activities of UBS AG. During the Relevant Period Mr Pottage reported directly to Mr Brumsen, the Business Unit Head in London. We understand that Mr Pottage did not directly report to anyone in Zurich.

154. In 2006 and prior to taking up his role as CEO, Mr Pottage had, as already mentioned, been involved in the preparation of a Business Strategy Plan for the Firm, "the 2010 Plan". A significant part of the 2010 Plan was to improve the "front to back" operational processes to support the planned trebling of transactions by 2010.

16 "priority gaps" were specifically identified as part of the "Change Programme". The objective was to improve volume and data integrity issues and to mitigate operational risk starting with the "back end transaction processing applications". Work was planned for throughout 2007 and was assisted by external consultants. Another objective had been to address what was perceived to have been the "silo mentality" within the front office.

The 2010 Plan

155. That the 2010 Plan and its Change Programme were directed at managing the expected growth in the Firm's Business was not in dispute. The FSA did not, however, accept that the Plan's aim was to remedy or enhance the governance and risk management frameworks of the Firm's Business. The FSA drew support from a Report of the FSA Supervisors following the ARROW meeting of November 2006 which observed of the purpose of the Plan that it had been to focus on "bottlenecks in the front-to-back operational process" to which Mr Pottage and Mr Brumsen were "busy making a series of individually minor enhancements".

156. To judge from the content of the Plan itself and from Mr Pottage's evidence, we conclude that risk and compliance matters were relevant to the creation and implementation of the Plan and were taken into account by those (including Mr Pottage) who were responsible for framing it and putting it into operation. Thus, when Mr Pottage took up the CEO role, he must have been alive to the regulatory framework and had a working knowledge of its demands on the Business.

The steps taken as part of the Initial Assessment: as acknowledged by the FSA

157. The facts and matters on which the FSA has relied in deciding that Mr Pottage was guilty of misconduct included an explicit recognition of the eight steps that he had taken and which had "resulted in him being provided with assurance that there were no issues in the Business that he needed to be particularly concerned about". Those are set out in paragraph 59 of the Statement of Case (from which that quotation comes) and are summarised in paragraph 38 above. Those positive features are, we think, to be taken in conjunction with Mr Pottage's existing familiarity, referred to above, in the workings not just of the Firm and its Business but in the worldwide operations of UBS as well. The FSA has not specified what it regards as an appropriate period within which an Initial Assessment should be made. Everything depends on the scale and nature of the business in question. We regard two months as appropriate with the possibility, if circumstances demand this, of stretching to three months.

Mr Pottage's role and remit

158. There is an issue here. The FSA said that when Mr Pottage was appointed he had been given a particular remit "to strengthen our internal processes, our controls, the way in which the front office interacted with all the partners we have in the bank, so it's all internal focussed activities". Those words quoted from an interview of Mr

Brumsen by Enforcement were presented by the FSA (in its written submissions) as evidence that Mr Pottage's "specific remit was to strengthen the Business' internal controls, and focus on the back office and on the way in which the front office in the UK interacted with all the partners within the Bank. As such, Mr Pottage's role was narrower than that of a typical CEO and had a particular emphasis on strengthening controls. As set out below, his initial assessment did not reflect this state of affairs." Mr Brumsen was not called to give evidence. He was, as already mentioned, the Business Unit Head of the Firm at the time of Mr Pottage's appointment; he was Mr Pottage's local line manager. When the words of Mr Brumsen's interview were put to Mr Pottage in cross examination, Mr Pottage had answered, "the remit I got was very specific, to implement the Change Programme… I wasn't given a vague open ended remit to strengthen internal controls whereby I would have to have done something more in the nature of an investigation and, you know, design a way of approaching a new problem. I was simply asked to implement the Change Programme." Mr Pottage also added that his remit included finding "a solution" to what he described as the Laing & Cruickshank problem and breaking down the silo mentality culture.

159. We are not persuaded that Mr Pottage had such a specific remit as the FSA has sought to draw from the words used by Mr Brumsen in the course of the interview. The inference that the FSA invited us to draw from Mr Brumsen's words was that, because of the control-driven remit, Mr Pottage should have questioned the information he had received when he had conducted his Initial Assessment. More to the point, we cannot see why that remit should have caused him to question the information he received in the course of his Initial Assessment, unless of course he had specific grounds to question such information or decide that it required corroboration. We mention in this context that, among Mr Pottage's earlier steps, were replacing the then COO and setting up a search to recruit a new Head of Operations, because he had insufficient confidence in the abilities of both incumbents in their abilities to carry out the 2010 Plan; and, as we have noted, risk and compliance matters were relevant to the creation and implementation of the Plan.

160. We have examined the evidence with particular reference to an email of 20 December 2006 from Mr Pottage to Mr Brumsen. This is headed "Draft Objectives 2007". It sets out a contemporary summary of what Mr Pottage understood to have been the scope of his role. It specifies eight topics relating to the handling and management of client affairs and eight that relate to the team working within the Firm. Those topics include the improvement of functions across the Business and "from the front to the back". He sees his task as including the recruitment of a high quality COO and to ensure that strategic initiatives identified for 2007 are executed and communicated with special reference to front to back aspects. He sees his CEO function as acting as "a role model for UBS vision, values and culture". The contents of that email reinforce the evidence of Mr Pottage that his objectives and his role went significantly wider that those contained in Mr Brumsen's account relied on by the FSA. In particular, we do not accept that Mr Pottage's remit was confined to improving internal systems and controls.

161. The relevance of our finding as to the scope and remit of Mr Pottage's role goes to the FSA's assertion that, because he had been given the specific responsibility for strengthening controls, there must have been a pre-existing concern within UBS AG that insufficient attention had been paid to those matters prior to his appointment. Consequently, it was claimed for the FSA, Mr Pottage should have directed his attention at seeking corroboration of and challenging positive assurances given by former CEO's team. However, because we do not accept that Mr Pottage's role was as narrowly drawn as Mr Brumsen's statement suggests, we do not find the FSA's claim to be persuasive.

The particulars of misconduct regarding Mr Pottage's alleged failure to conduct an adequate Initial Assessment

162. The first particular is in paragraph 56 of the FSA's Statement of Case. This, as already observed, alleged that Mr Pottage had taken up "his appointment as CEO at a time when there were serious flaws in the design and operational effectiveness of the governance and risk management frameworks in place in the Business throughout the Relevant Period…"

163. The Initial Assessment allegations are particularised in paragraph 57 of the Statement of Case which we have summarised in paragraph 36 above. That paragraph, as noted, includes a series of specified matters that should have increased Mr Pottage's awareness. We will deal with these later. In failing to perform an adequate Initial Assessment, as the FSA alleged, it followed that he had failed to identify the need for the Systematic Overhaul. See paragraph 61 of the Statement of Case. Finally in paragraph 62 is the assertion that Mr Pottage had been too accepting of the assurances he had received that there were no fundamental deficiencies in the design and operational effectiveness of the governance and risk management frameworks.

Mr Hayward's evidence

164. The FSA relied on the evidence of Mr Hayward in support of their allegations concerning Mr Pottage's failure to carry out an adequate Initial Assessment. Mr Hayward introduced his expert evidence with a statement of his expectation that:

> "Any newly-appointed CEO [would] make a start by seeking to gain an understanding of, in particular, his objectives; his authority; the quality and character of the senior executives on whom he depends; and the nature and condition of the organisation over which he now presides, including the adequacy of its control". That, his expert opinion continued, "should be sufficient to give the incoming CEO an accurate and thorough understanding of the six matters listed in paragraph 6A(1)(a-f) of the Statement of Case".

Mr Hayward agreed with most of the points particularised by the FSA in paragraph 57. We turn now to look at the particulars.

The alleged shortcomings as particularised by the FSA in paragraph 57 of the Statement of Case

165. Particular 1 was that there were a number of inherent risks in the Business, heightened in relation to the LIB, which required a higher degree of supervision, oversight and control. This was not in dispute.

166. Particular 2 related to the absence of a middle office. Mr Hayward did not endorse this.

167. Particular 3 refers to the operation of the global matrix management structure as raising "challenges particularly in relation to the LIB". It is not clear what the FSA means by this, but in the course of the hearing of the reference no reliance was placed on it.

168. Particular 4 is in issue. Mr Hayward's expert opinion was to agree that Mr Pottage had been specifically charged with strengthening internal processes and controls. We have already stated that we are not satisfied on the evidence the FSA has adduced that Mr Pottage had been so "specifically charged". In this respect we think that Mr Hayward might have stepped beyond his role as an expert witness.

169. In Particular 5 the FSA states that Mr Pottage "was aware of cultural issues in the Business concerning responsibility for risk management". This is not disputed.

170. In Particular 6 the FSA says that, because Mr Pottage had been given such a wide span of responsibility, including specific responsibility for the full range of front office issues and regulatory responsibilities across the whole of the Business, he should have made particular efforts at the start of his appointment to establish authority over governance and risk management issues relating particularly to the front office. Mr Hayward accepts this as his expert opinion. To us it is a self-evidently obvious point to take; but we recognise that Mr Pottage had had substantial experience of the Business before taking up his role as CEO.

171. Particular 7 is that Mr Pottage had approved a significant expansion of the Business at a time when there were known operational issues. As we have already observed, Mr Pottage's awareness of the regulatory and risk requirements must have been heightened by his admitted involvement in the drawing up and implementation of the 2010 Plan.

172. Particular 7(a) referred to problems relating to the former Laing and Cruickshank business. These had included a lack of independence of the back office: no back office independent verification of client instructions: the lack of dual control over amendment of client data and making of payments as well as the lack of oversight over front office. These had been identified by a GIA Report of 2004. Mr Hayward's expert opinion was that a reasonable CEO would be reminded by those issues that control could not be taken for granted; if left to their own devices, things

had a tendency sooner or later to go wrong and constant management attention was needed to maintain control. We did not understand Mr Pottage to dissent from that.

173. In particular 7(b) the FSA asserted that Mr Pottage should have been aware of weaknesses in the control framework recognised by the 2010 Plan. Those weaknesses are not specified although the FSA does refer to the 2010 Plan being "a long term Change Programme designed to address a number of weaknesses in the operating platform, the infrastructure and the IT system." Here again, bearing in mind Mr Pottage's direct responsibility for the 2010 Plan (admitted by the FSA in paragraph 46 of the Statement of Case), we infer that Mr Pottage must have been well aware of those factors.

174. In Particular 7(c) the FSA refers to two incidents of unauthorised trading in September 2005 and in September 2006, being matters of which Mr Pottage "should have been aware". Mr Pottage stated that he had been aware of them. This was not challenged. Mr Pottage observed in evidence that employees do from time to time behave inappropriately and that it is difficult entirely to prevent a client adviser and a client from acting in such a way. Mr Hayward acknowledged this.

175 Particular 7(d) referred to a qualified audit of the "Financial Intermediary Business" published in April 2005 which had raised issues around, among others things, "suitability documentation". No further explanation was advanced as to why this was relevant. Mr Pottage explained the circumstances. He said he had been aware of the "issues" and of the way they had been dealt with in October 2005. We do not see that Particular 7(d) assists the FSA to prove its case on the Initial Assessment allegation.

176. In Particular 7(e) the FSA refers to "the known operational issues of which Mr Pottage was aware or should have been aware" including the fact that "senior management in Zurich had made it clear they had had concerns" as to the "high level approach" of his predecessor. We heard no details of those concerns. If Mr Pottage's predecessor had had a different approach to managing the Business, Mr Pottage must have been aware of that. In evidence, Mr Pottage explained how his predecessor's role had been split into two and that he had been appointed CEO by Mr Brumsen, the Business Unit Head, because of his awareness of the need to integrate the Laing and Cruickshank activities into the Business and because of his involvement in the Change Plan.

177. So far we are unpersuaded by the FSA's evidence as to the alleged shortcomings. Mr Pottage's Initial Assessment had been conducted with the importance of spending appropriate time on governance and risk management matters in mind.

The FSA's wider allegations

178. The other ground for the FSA's Initial Assessment allegation was based on the expert evidence they obtained from Mr Hayward. Mr Hayward had expressed the

opinion that a reasonable CEO in Mr Pottage's position would have made an extensive and rigorous enquiry to find out exactly what he was taking on in his new role; and he would do this with especial diligence and rigour in view of the Firm's circumstances. Mr Hayward's expert opinion was that while Mr Pottage had undertaken the principal elements of such an Initial Assessment, he had not performed them with enough rigour. Mr Hayward's expert opinion was that, had the Initial Assessment been made "with an open mind and due rigour", Mr Pottage should have realised that the information and assurance available to him was not enough for him to be confident that he knew what was going on in the organisation. He had, in Mr Hayward's expert opinion, been "too accepting of the assurances he had received that there were no fundamental deficiencies with the design and operational effectiveness of the governance and risk management frameworks". In this respect Mr Hayward was exactly reproducing the reasons given, in paragraph 6A of the Statement of Case, for the FSA's decision to penalise Mr Pottage in the first place. Those conclusions, helpful to the FSA though they are, are largely outside the role of expert evidence. They are trespassing on the position of the Tribunal set out in section 133 FSMA.

179. However we need to address the circumstances underlying Mr Hayward's judgmental conclusions. Take the issue of whether Mr Pottage knew or should have known that there was, as a matter of UBS policy, no or insufficient independent monitoring of the effectiveness of the risk control framework by the second line of defence. It was Mr Hayward's opinion that if Mr Pottage had conducted with sufficient rigour his initial meetings with Risk Control (Mr Challis and, as from October 2006, Ms Topley), with Compliance (Mr Wooster and Ms Topley), with Front Office Risk Management (Mr Weston) and with GIA, both in London and Zurich, then he would have appreciated that there were deficiencies.

180. As it happened Mr Pottage did conduct those meetings not long after he had been appointed CEO. He had relevant discussions with those individuals, each of whom was an expert in his or her specialist role which was that of a CF and in most cases a "SIF". None of those individuals expressed any concern as to the effectiveness of the Risk Control Framework. There is no evidence that any of them raised any of the matters relied upon by the FSA in paragraph 57 of the Statement of Case. The inevitable inference is that none of the specialists had identified those matters as weaknesses. The point can be illustrated by reference to the absence of independent monitoring by a second line of defence of "compliant self-certification". Mr Hayward had expressed the expert opinion that the self-certification process within the ORF, which had been designed and globally implemented by UBS was "a high risk model", because the processes had only recently been designed and implemented and that the independent monitoring of compliant self-certifications should have been a "kindergarten level internal control". The reason it had not been drawn to Mr Pottage's attention, however searching his questioning might have been, was, we have to infer, because no one within the Firm or even in UBS AG regarded the absence of independent monitoring in those circumstances as inadequate.

181. We now turn to another aspect of Mr Hayward's expert opinion. This was that Mr Pottage was unable to place any reliance on the critical potential sources of

information and assurance available to him, namely the GIA reports, compliance monitoring, operational risk monitoring, management information, and conversations with management and staff. Those topics were highlighted in the FSA's written submissions.

182. Regarding the GIA reports, Mr Hayward's expert evidence was that they had failed to cover a wide enough section of the Business, and they were not sufficiently respected by management in that either recommendations were rejected or responses to correct weaknesses were slow. We have already referred to the (Laing and Cruickshank) GIA Report of September 2005 which had, Mr Pottage told us, disclosed specific weaknesses that had been put right. The GIA Report on Operations and IT of October 2006 had been discussed at the October 2006 Risk Committee meeting and with the FSA at the ARROW meeting the same month. (The Report of the ARROW meeting observed that "The Operations and IT environment… is felt to be fit for purpose with one key exception". That exception was the withholding tax arrangements (to which we will return later)). We accept that management may have legitimate business reasons for rejecting some internal audit recommendations and that responses may take time if there need to be significant changes made to the IT systems.

183. Mr Hayward's expert opinion with regards to compliance monitoring was that a reasonable CEO should, in the absence of a substantial amount of assurance from internal audit, turn to compliance monitoring as a source of information and assurance. His expert opinion was that he "would have expected Mr Pottage, as part of his Initial Assessment, to review the outputs of compliance's recent work as well as its plan for the year". Mr Hayward accepted that there was some reporting around compliance activity in the QRRs which he said was related to anti-money laundering, trades and Know Your Customer information. We have read the QRR for the fourth quarter of 2006 and the supporting material. We are not persuaded that Mr Pottage, with his pre-existing experience of the regulatory obligations relating to the Firm, had insufficient compliance monitoring material available to him to enable him to carry out an adequate Initial Assessment. Nor did the FSA draw our attention to any matter in the material that Mr Pottage saw or should have seen that ought to have caused him to challenge the assurances he was getting from the risk and compliance specialists, such as Mr Challis (the Chief Risk Officer).

184. While, for reasons given above, we have concluded that there were deficiencies in the MI available to Mr Pottage, we have nonetheless read through the QRR for the fourth quarter of 2006 (covering the Initial Assessment period) and the pre-reading material for the Risk Committee meeting. We are not persuaded that Mr Pottage, with his prior experience of regulatory obligations applicable to the Firm, had insufficient compliance material available to him to enable him to carry out an adequate Initial Assessment. Nor did the FSA draw our attention to any matter that Mr Pottage saw or should have seen that ought to have caused him to challenge the assurances he was getting from the compliance specialists, such as Mr Challis (the Chief Risk Officer).

185. "Operational risk monitors" should, said Mr Hayward, have been a source of information and assurance to Mr Pottage. Of course, as Ms Butler said, a CEO should trust but verify. But if people who are specialists in compliance and risk control do not have material concerns about compliance monitoring and operational risk management, a CEO in Mr Pottage's position and with his experience will more likely have no or insufficient information on which to base his own challenge or with which to make his own corroborative tests.

186. Before concluding on this point, we draw attention to the steps that the FSA recognise Mr Pottage as having taken at the start of his time as CEO. He commissioned a peer review of the Operations function of the Business in September 2006. That was followed by the replacement in October 2006 of the COO and the recruitment in January 2007 of a new Head of Operations (Mr Reid who took office in March but came to work at the Firm in late April). The restructuring of Operations included the integration of the operations function of the former Laing and Cruikshank Business into the operations function of the rest of the Business. Mr Pottage authorised the engagement of E&Y to conduct an external review of the client money arrangements. This had followed shortly after the discovery of an isolated breach of the client money rules. Not long after that Ms Topley had been appointed as Head of Legal Risk and Compliance. Mr Pottage had agreed with her that it was appropriate to extend the range of activity of the monitoring team in the compliance function. We have already summarised the eight steps listed in paragraph 59 of the Statement of Case that Mr Pottage had taken and which he had regarded as providing him with assurance that there were no issues in the Business about which he needed to be particularly concerned.

Conclusion on Initial Assessment

187. To conclude on this point we are not satisfied from the evidence adduced by the FSA that Mr Pottage failed to take reasonable steps to satisfy himself by way of an Initial Assessment at the outset of his appointment. In this connection we are not satisfied that he failed to question effectively the assurances he received that there were no fundamental deficiencies in the design and operational effectiveness of the governance and risk management frameworks. The evidence does not satisfy us that Mr Pottage had been too accepting of the assurances that he had received that there were no such fundamental deficiencies with the design and operational effectiveness of the governance and risk management frameworks. Mr Pottage had not consequently failed to take the step of instituting a Systematic Overhaul during or shortly following the Initial Period of his tenure of office as CEO. In summary, our view is that there was insufficient evidence apparent to Mr Pottage during the period of the Initial Assessment that there were flaws such that he needed to "dig deeper" in challenging his team. Nor was there sufficient evidence apparent to him that should have called for the initiation of a major systematic overhaul of the scale eventually demanded by the LORR.

Continuous Monitoring: the relevant particulars of the alleged offence

188. The FSA has particularised the alleged misconduct in both or either of two ways. First (as noted) Mr Pottage has failed to take reasonable steps to satisfy himself

by way of an Initial Assessment as to the design and operational effectiveness of the governance and risk management frameworks in place and consequently to initiate a Systematic Overhaul early enough. That is paragraph 6A(1) in association with sub-paragraphs (3) and (4); we have just dealt with that. Second, it is alleged that Mr Pottage failed to perform a continuous process of monitoring that would have allowed him to appreciate, sooner than he did, that there were such serious flaws calling for a Systematic Overhaul: that is sub-paragraphs (2), (3), (4) of paragraph 6A of the Statement of Case. The FSA contend that Mr Pottage should have appreciated the significance of certain "warning signals"; these are listed in paragraph 71 of the Statement of Case. In the light of our conclusion that the FSA has not satisfied us that Mr Pottage failed to carry out an adequate Initial Assessment, the FSA has now to satisfy us that Mr Pottage failed, through the inadequacies of his continuous monitoring and of his consequent oversight, to perceive the implications of the warning signals; if we are so satisfied we will then be in a position to decide whether to direct the FSA that a penalty for misconduct is to be imposed on Mr Pottage.

189. Following its criticism of Mr Pottage in respect of the Initial Assessment the FSA's written submissions go on to say:

> "In any event, the FSA additionally relies upon the serious failures that arose over the remainder of the Relevant Period, which are considered under the heading of Continuous Monitoring. The further failures that arose in the context of the Continuous Monitoring add compelling weight to the finding of regulatory breach which the Tribunal is asked to make."

190. As with Initial Assessment, the term "Continuous Monitoring" is not a term of art, and is not in widespread use in the financial services sector. It is used here in the context of paragraph 6A (2) of the Statement of Case, namely that the FSA's view is that Mr Pottage should have performed a "continuous process of monitoring that would have allowed him to appreciate sooner than he did, in the face of a series of warning signals…, that there were serious flaws in the design and operational effectiveness of the governance and risk frameworks". The parties are at one in accepting that the carrying out of adequate Continuous Monitoring is a reasonable step for a CEO in Mr Pottage's position to take for purposes of APER 7.

191. The FSA's submissions go on to state what the FSA means by an adequate Continuous Monitoring. First, relying on Mr Hayward's expert evidence, it submits that it describes an activity that is integral to the CEO's management of any organisation. It requires information and assurance (which were inadequate) together with formal arrangements to ensure effective communication. The FSA accepts that Mr Pottage did indeed take "some steps by way of Continuous Monitoring over the Relevant Period" and "took some steps to remediate the various control failures that arose". However, the FSA submits, these were not sufficient to constitute adequate Continuous Monitoring as is required by the relevant regulatory standard. The FSA's submissions put its position as follows:

"In particular when the control failures occurred, Mr Pottage did not appreciate the wider implications such as:

(i) the deficiencies in the ORF evidenced by the failures, including the fact that self-certification could not be relied upon;

(ii) the deficiencies in all three lines of defence that allowed the various incidents to occur and (in respect of the client money, payment fraud and asset reconciliation incidents) failed to identify them after they had occurred; and

(iii) the fact that, pending long-term solutions such as recruitment of senior individuals and the introduction of system upgrades (such as the e-payment system envisaged as part of the 2010 Plan), Mr Pottage needed to take immediate action in order to strengthen the oversight of the Business."

192. The thrust of the FSA's case, so far as Continuous Monitoring is concerned, comes to this. Mr Pottage failed to take the required "reasonable steps" because he relied on a system that failed to provide him with an adequate level of assurance and which (to use Mr Hayward's words) lacked formal arrangements to ensure effective communication. While he addressed the control failures that he became aware of, being those evidenced by the warning signals, his responses were inadequate and moreover he failed to appreciate the wider implications of the warning signals. Specifically, says the FSA, Mr Pottage's inadequate chairing of the Executive Committees and his inadequate responses to the warning signals had led to his falling short of the standards required by APER 7 in that he failed to take the requisite steps. Put positively, the FSA states that "a reasonable CEO" would have investigated the control failures, asked why they had not been detected and corrected by supervisory oversight, reinforced the system of monitoring, attacked the silo culture and recognised the weaknesses of the Risk Committee in exercising oversight and following issues up.

193. We have already stated that we are not satisfied that there was any serious flaw in the structure and operation of the Executive Committees. Mr Hayward had commented that it had not been until the end of August 2007, when Mr Pottage is recorded as having said that he did start chairing the Risk Committee meetings "properly" and setting the agenda, that necessary changes to the conduct of such meetings had been made. Until then, in Mr Hayward's expert opinion, meetings had been too infrequent, without appropriate terms of reference, with indeterminate roles being played by the members, with inadequate tracking of issues, with insufficient information about compliance and control monitoring and without adequate discussion about the root causes of operational failures.

194. We have looked at all those points, made by Mr Hayward, in the light of the evidence that was before us and we are not persuaded of their force. The word "properly" was, obviously (we think), used in the context of the much more intensive activity created by the emerging findings of the LORR. The Committees, we record, duly considered and actioned the GIA Report on Operations and IT of October 2006.

The Committees considered Mr Challis' report on the Payments Fraud (released in February 2007) which, among other things, referred to the need to have more effective supervisory oversight over the payments processes. And the Committees discussed the key points in the E&Y Report of client money arrangements which had identified failures and operational weaknesses and also recommended a review of custody arrangements. Regarding Mr Hayward's criticism that the overlap between the membership of the two Committees, that had not been shared by the Skilled Person (KPMG) when making a follow-up report in 2009 which observed that that feature ensured that the majority of the Management Committee had been involved in detailed discussions regarding key risk areas. Finally, regarding Mr Hayward's criticisms of Mr Pottage's chairing of the Committees, namely his failure to see that issues arising were effectively tracked and followed up, we note that all significant and non-significant audit items were tracked in the "audit track" system; moreover, as regards compliance issues, Mr Hayward accepted that the only significant compliance issues of which he had been aware, i.e. client money arrangements and weaknesses in asset reconciliations, had been tracked "extensively". Mr Pottage had added risk as a standing item to the agenda of the Management Committee in February 2007. With those observations in mind, we are not persuaded that Mr Pottage's chairing of Committees had been inadequate.

The "warning signals" and their relevance to the FSA's allegation of misconduct

195. The FSA refers, in paragraph 71 of the Statement of Case, to specific detailed control failings identified in the Relevant Period as "warning signals" which should have indicated to Mr Pottage the need to undertake a "Systematic Overhaul". The term "Systematic Overhaul" has no established meaning. It could, the FSA acknowledged in the course of argument, cover an overhaul of part of a business. We have taken the expression to connote a review the nature and scope of which is similar to that of the LORR.

196. The relevant control failings are then listed in the Statement of Case. These are the specific and detailed control failings identified in –

- The GIA Report of October 2006 on Operations and IT;
- Mr Challis' February 2007 draft report into the payment fraud which took place in January of that year;
- The report of a compliance monitoring desk review of the Asia II Desk dated 23 February 2007;
- E&Y's Report into client money arrangements (dated 2 March, although the four main areas on which their findings were based were reported to the Risk Committee on 22 January 2007);

- Control failings were then identified in customer asset reconciliations, as Mr Reid informed the Management Committee in his update of 31 May 2007;

- The Life and Pensions GIA Report dated 4 May 2007.

The FSA acknowledged in paragraph 74 of the Statement of Case (and this is borne out by the evidence) that each of those specific failings and weaknesses had been remedied. The case advanced is that Mr Pottage should have been prompted by those matters to institute an investigation into whether there were other control failures in other areas of the Business. Referring to those weaknesses Mr Hayward confirmed that this was his position and gave as his reason that their occurrence created "the background conditions in which any process is more likely to fail".

197. The FSA's line of argument is that Mr Pottage, instead of treating the warning signals as they became apparent as demanding a Systematic Overhaul, had not shown such resolution. As the FSA saw it, Mr Pottage (to use his words in evidence when asked about remarks he had made about the Payments Fraud and Client Money issue in the course of an earlier interview conducted by the FSA) –

> "…was trying to work out how in my mind it was consistent that we had a framework which I knew at high level, I knew on paper, I knew in, you know, in some theoretical level, how was that consistent with a couple of incidents occurring, where I as CEO seemed to have had no warning of them, and indeed nobody else in the organisation seemed to have any warning of them coming. So I was starting to wonder how that might happen: were these events on their own that happened from time to time, or was it indicative of something more serious? But I am summarising here several months of evolution of thought, in terms of how I approached that".

Mr Hayward expressed the expert opinion that on receipt of the preliminary summary of the E&Y findings into the Client Money issue (at or about the time of the January 2007 Risk Committee meeting) "combined with other matters", the reasonable step required of a CEO by APER 7 would have been to initiate a Systematic Overhaul. (Mr Pottage did not institute the LORR until late July 2007.) However in cross-examination Mr Hayward accepted that a reasonable CEO would have waited for the consultants' final report dated 2 March 2007. As Mr Hayward's expert opinion went, the warning signals should have made the reasonable CEO (assumed by APER 7) recognise that the design and operational effectiveness of governance and/or risk management frameworks were seriously flawed.

198. Mr Pottage's evidence to the Tribunal was that he had not reached the "tipping point" at which a Systematic Overhaul on the lines of the LORR became an imperative until 11 July 2007 when an incident of unauthorised trading on the Africa Desk had demonstrated front office failings. Until then he had taken the failings to having been confined to the back office (i.e. Operations): and therefore, he believed,

were covered by the 2010 Change Programme. The FSA challenged the evidential value of what Mr Pottage claimed. In 2009 when he was being interviewed by the Enforcement Division of FSA, he had given a different account of the development of his thinking and his decision making. He had expressed a vaguer response to the matters now referred to as the warning signals; he had seen them as "unknown unknowns" to which the Business had adopted a fire-fighting and reactive approach. The FSA contended that we should not therefore accept Mr Pottage's current explanation that he had knowingly addressed the build-up of signs of control failings and initiated the LORR in July 2007 when it had appeared to him that there was no other reasonable expedient.

199. Dealing with that last point now, we are not persuaded by the FSA's contention. At the time of the 2009 interview, Enforcement's line of enquiry had been into the circumstances leading to the Asia II Desk fraud, a front office situation, and the outcome of KPMG's SPR coupled with a report by Deloitte. The identification and implications of the "warning signals" were not part of the enquiry, nor indeed the subject of the interviews of Mr Pottage in 2008 and 2009. The FSA's approach altered its direction by the time the Regulatory Decisions Committee hearing took place; and by the time the Statement of Case was produced the FSA's case concentrated on the Relevant Period which did not cover the disclosure of the Asia II Desk fraud. In 2008 and 2009 Mr Pottage had been seeking to emphasise his lack of actual management responsibility for the front office, despite his regulatory status as CEO for the whole of the Business. Direct responsibility for the front office activities lay with the Head of Origination whose line manager was Mr Brumsen and not Mr Pottage.

Mr Pottage's account of the circumstances during the Relevant Period

200. Before examining the warning signals we set out Mr Pottage's account of events during the Relevant Period. The primary facts of this are not disputed. The FSA says that, despite what Mr Pottage has asserted, he should have initiated a Systematic Overhaul much earlier than he did. We now quote from Mr Pottage's own witness statement. (The reference in the quotation to "UK Limited" is to the "Laing & Cruickshank" part of the Firm's business.)

> "In October 2006 an issue arose with a client money implication and in January 2007 there was a paym ents fraud. Both the client money issues and the payments fraud were rather specific issues (the former being necessarily limited to UK Ltd and the latter being always possible regardless of the quality of systems and controls), but I was nevertheless concerned that such incidents could occur in an unanticipated manner. Careful investigations of those incidents (including with the help of external consultants and internal experts from Zurich) took place and were substantially complete by March 2007.

I was already considering whether there were possible wider implications for our overall risk management approach … At the end of March I initiated a risk brainstorming session with the Head of Legal, Risk and Compliance and the Origination Risk Manager which proved to be the start of an uninterrupted assessment of our risk management approach that culminated in the LORR and the subsequent remediation programmes. The LORR was of course an enormous undertaking both in terms of resources and what it signalled to the organisation. Naturally such a step was not a "first response" but followed the active pursuit of various alternative approaches which in practice ran between March and July.

I gathered my key risk specialists [Topley, Challis and Weston] at a brainstorming meeting [on 19 April 2007], outlined my concerns – chiefly, whether there were unknown unknowns by which I meant other unanticipated risk incidents likely to occur – and sought to test again my understanding of the robustness of our frameworks.

We had a second brainstorming within a few days (on 2 May) and I had numerous bilateral discussions with Abi [Topley], with Bill Weston (the Origination Risk Manager), with Shaun Challis (the Chief Risk Officer) and with Matthew Brumsen on the topic. The conclusion of those discussions was that the overarching Operational Risk Framework was indeed sound and thus each risk had been considered. (I still believe that is correct and that as the LORR unearthed, what was wrong was not the governance and risk management framework, but problems in the control plans at the bottom of the pyramid). … Nevertheless, it did not slow down my quest for seeking out unknown unknowns and I invited the same key risk team to brainstorm among themselves to see if they could identify risk areas where those unknown unknowns might lurk.

They were unable to do so in their early attempts and they committed to try again using a more structured approach. In the event, they were not able to specify any particular concern although they shared my concerns that we were perhaps not good at risk identification and that unknown unknowns could still be out there.

At the same time (around the end of May) it was already evident that Operations would require a complete overhaul and that process was already well under way (the overhaul included a new Head, new direct reports for Donald Reid who would sit on his Operations Management Committee, a new structure, the setting up of a Reconciliations Oversight Committee, the launch of an "amnesty", the reopening of all audit points closed by the previous Head of Operations and a review of control plans).

> Shaun Challis, as Chief Risk Officer, shared with me (in his email of 1 June 2007) the considered view of the risk group that the issues in Operations did not read across into Origination, where he said we had a good handle. There were clear indicators from multiple sources to support that conclusion (including the conclusions of GIA, Compliance Monitoring results and SOX/ORF results on which Ernst & Young had reported). Nevertheless, I asked the team to continue looking for unidentified risks.
>
> During July, a number of incidents or issues came to my attention which caused me to question again the conclusion about Origination."

201. Regarding the "brainstorming meeting" of 19 April referred to in the extract from Mr Pottage's statement in the last paragraph, we saw an email of the same day from Mr Pottage to all those who had attended that meeting. In that message Mr Pottage refers to a variety of risks and admits to a feeling that "we are fire fighting rather than proactively preventing" and to a fear that "there may be material unknown unknowns". He then sets out various possible actions which include further analysis and the extension of the scope of desk reviews. The email shows clear evidence of the state of Mr Pottage's concerns and of his attempts to get to the heart of the problems. But, as we have observed, he was not a risk specialist. He would, no doubt, have had a clearer focus on the "unknowns" if he had been. However, the fact that he had summoned to that and subsequent meetings his Head of Legal, Risk and Compliance, his Chief Risk Officer and his Front Officer Risk Manager indicates that the objective he was pursuing with his specialists was to achieve an appropriate standard of compliance systems and controls within the Business.

202. We note that it was not just Mr Challis, the Chief Risk Officer, who had expressed the view that problems were confined to Operations (at least until July 2007) but did not extend to the front office. The UBS AG officials responsible for the GIA Asia Desk Report had made a presentation to Mr Pottage at which they had stated that their concerns about the front office had been restricted to two particular aspects of new business regarding, first, intermediary clients and, second, on-balance sheet residential mortgages. They had not expressed other concerns about the front office (aside from the issue that the Laing and Cruickshank business had remained separate from the main Business). The general view of the GIA officers about the front office seemed to Mr Pottage to have aligned closely with the one expressed by Mr Challis at the end of May that we had "a reasonable handle on the issues there".

The warning signals

203. The series of circumstances and events that should have been construed as warning signals, taken cumulatively, are listed in paragraph 199 above. At the hearing of the reference the case for the FSA focused on the ones with which we now deal.

The GIA Report on Operations and IT: Warning Signal

204. The qualified GIA audit of Operations and IT was published on 26 October 2006. We have already examined this in Part II dealing with "serious flaws". Mr

Hayward had drawn attention to the qualifications in the Report relating to error prone manual processes and automated processes lacking basic control: these he described as "out of touch with reality". Mr Hayward's expert opinion was that Mr Pottage should have been "extremely sensitive to anything which suggested that the ORF might not be working as it should"; the GIA Report should, in his view, have raised awareness of the weaknesses of the entire structure and should have been properly addressed by management.

205. For Mr Pottage it is emphasised that the Report had confirmed that the organisational setup of the COO function had been adequate and that Nostro and Internal Account Reconciliation and Payment Processes were well-controlled. The Report, had, as we have observed, been discussed at the Risk Committee meeting in October 2006 at which Mr Pottage had evidentially played an active role. Mr Pottage was in the process, in October 2006, of moving the then COO because of his (Mr Pottage's) misgivings as to that COO's suitability. Mr Przewloka was to be engaged to take on the COO role as interim COO. (At the same time Mr Przewloka retained his responsibilities as the "regional" COO.) Moreover, deadlines were agreed with GIA to remedy the two significant control weaknesses, i.e. the handling of trade amendments and local withholding taxes.

206. We are not satisfied that Mr Pottage should, in the light of that Report have considered it necessary to investigate whether there were control failures in other parts of the Business. Steps had been taken to address the issues raised by the GIA and, as observed, the issues and the problems were confined to Operations. We are reinforced in this conclusion by the opinion of Mr Kingsley who was asked for his expert evidence as to whether the totality of the GIA Report should have caused a reasonable CEO to question whether management oversight in other areas was deficient. His opinion was that he could not see what would prompt such a thought; he expressed the view that he would not have expected the Report to cause much concern to a reasonable CEO.

207. The Report had referred to a "withholding tax" issue. This matter had first been identified in October 2006. Interest had been paid without deduction of withholding tax at a time when the Business did not have up to date records and other documentation necessary to justify gross payment. The October 2006 Risk Committee had discussed the matter and agreement had been reached with the GIA to put things right by a particular date. The amount of tax for which the Firm appeared to be accountable, because of its failure to deduct, appears to have increased by the time of the Risk Committee meeting of 22 January 2007. By June 2007 the estimated loss was thought to have arisen further and management in Zurich were involved. A detailed review was undertaken by Mr Challis in association with risk control in Zurich. The problem is evidence of weaknesses in both Risk Control within the Firm as well as in Compliance Monitoring. We do not find that the withholding tax issue, which disclosed a relatively small loss to the Firm at the earlier stages of Mr Pottage's tenure as CEO (and only assumed its full financial significance in mid-2007 when the scale of the problem was fully revealed) should have been a factor that prompted him to introduce a Systematic Overhaul earlier than he did.

The Client Money and Asset Reconciliations issues: warning signals

208. The compliance function detected a breach of the client money rules by a client adviser at the end of October 2006. It appears that an investment director had arranged the placement in the sum of dollars directly with another institution without following the correct procedures. This had been an isolated incident (which could only have occurred in the former Laing & Cruickshank Business). In paragraph 63(2) of the Statement of Case the FSA acknowledges that Mr Pottage "took steps to remediate the immediate issue and initiated an investigation of the incident by … risk control. Although this incident did not appear to Mr Pottage to be indicative of wider failings, and did not occur in the LIB, Mr Pottage also decided to carry out a review of UKWM's client money arrangements in order to assess whether there were wider implications". That review had been undertaken by E&Y. The QRR relating to the former Laing and Cruickshank Business (for the fourth quarter of 2006) stated that E&Y "have identified deficiencies in various areas which will need to be addressed". These included the lack of any review process to monitor compliance. The Executive Committees also adopted E&Y's recommendation that a review of customer asset reconciliations be undertaken.

209. It was Mr Hayward's expert opinion that Mr Pottage should have initiated a review of the whole business in February 2007, i.e. before receiving the full Report from E&Y. Mr Pottage described the idea as "fanciful". Moreover, as Mr Hayward himself acknowledged, until management had received the detailed Report, they could not know precisely what improvements were going to be needed nor how those improvements should be implemented.

The Payments Fraud: warning signal

210. The Payment Fraud came to light on 17 January 2007. It involved payments being identified as based on forged internal instructions. Mr Pottage had described it and the findings of Mr Challis, when reporting on it, as "alarming". In particular the fraud and the underlying control issues had not apparently been picked up by any "line of defence" but by the Firm being put on notice by one of the receiving banks. Mr Kingsley's evidence was that the Report on this incident should indeed have featured on Mr Pottage's "wall of worry".

211. The FSA argued that the payments fraud revealed several control failures in the payments processes. Mr Hayward's expert opinion had been that the failure of such basic controls should have rung warning bells. His opinion was that, following the Report on the fraud from Mr Challis, dated 16 February 2007, Mr Pottage should have taken the only response open to a reasonable CEO and initiated a Systematic Overhaul. This was because the fraud identified a weakness in the quality of management information and it should, Mr Hayward said, have been apparent to Mr Pottage by this time that the Business needed a much stronger grip on it. The FSA's case is that by then it was "absolutely clear that there were a range of problems across the entirety of the Business". The incidents had occurred across the Operations function in short succession at a time when Mr Pottage had not hired replacements for

the COO and Head of Operations roles following his concerns about the ability of the incumbents to deliver the Change Programme. None of these problems had been identified by the apparently wide-ranging review of Operations carried out for the purpose of the 2010 Plan. The incidents, contends the FSA, "demonstrated the failures of the three lines of defence, which applied across the Business, and Mr Pottage could not therefore reasonably have had confidence that other problems did not exist (such as the client asset reconciliation breakdown which then came to light)".

212. We are not persuaded that the discovery of the payments fraud in January 2007 even taken together with the client money issue, should have prompted, as a reasonable response, the initiation of a Systematic Overhaul. A Systematic Overhaul like the LORR requires significant resource and planning and (as Mr Kingsley mentioned) serious disturbance and dislocation of staff. The Firm took steps to remedy the particular failings in the payments processes. The control failure was put right and a new system (albeit imperfect as mentioned in Part II above) was introduced. Moreover Mr Pottage, who was admittedly not a risk expert, did seek to question whether the fact that incidents were occurring without warning might indicate that there were gaps in the ORF. What Mr Pottage did, having heard that a new call-back checking system was in place, was, we think, within the range of reasonable responses. Mr Pottage also recognised that he needed to strengthen the management of Operations. Mr Przewloka had taken over as COO at the turn of the year and the two Heads of Operations were to be removed; their roles combined as soon as their replacement (Mr Reid) became available.

Desk Review of Asia 2 Desk – warning signal

213. This Compliance Desk Review dated 23 February 2007 was the first of the Enhanced Desk Reviews. Those had been a new project introduced by Mr Pottage in conjunction with Ms Topley in October 2006. The outcome of the review was a rating of "Satisfactory (some weaknesses/limited failures found)".

214. Mr Hayward's expert opinion was that that Desk Review Report contained directions for "remedial action" but "no root cause analysis". His opinion was that the risk assessment was "questionable". In his view the content of the Report should have "raised further doubt in the mind of a reasonable CEO concerning the sufficiency of information and assurance available to him". At an interview in 2009 with the FSA Mr Weston (who had been Head of Front Office Risk Management during the Relevant Period but had left the Firm in 2008) had said that the Report "was really actually a very good demonstration of how weak the compliance monitoring desk level was, in the sense that they didn't seem to be able to understand the actual risks involved".

215. The FSA relied on those statements as evidence that Mr Pottage's awareness of the deficient quality of information and assurance should have been aroused and that a major overhaul was then needed.

216. Mr Pottage did not accept that Mr Weston had ever drawn to his attention the concerns referred to in the extract set out above. Mr Pottage's recollection was that Mr Weston, as Front Office Risk Manager, had actually expressed some confidence to him about the front office and that he (Mr Weston) had derived some comfort from the Desk Review. Mr Pottage observed that, while he had had concerns that the Desk Head of the Asia II Desk had been active with his own clients (a large number of trades were being effected) as well as managing the Desk, he (Mr Pottage) understood that the volume of such trades was reducing and in the process of going direct to (what he referred to as) the "investment bank". Mr Kingsley saw the contents of the Report as "a small element" which would have not featured on what he again described as the CEO's "wall of worry". Mr Weston gave no written or oral evidence.

217. We note that the Desk Review had been carried out by the then Head of Compliance Monitoring and signed off by the Head of Compliance. There had been monthly LIB risk and compliance meetings between the Head of LIB (Ms Kuhnert) and her business manager, the Head of Compliance (Mr Wooster) and the Front Office Risk Manager (Mr Weston) at which, said Mr Pottage, he would have expected the matters raised in the Desk Review Report to have been addressed. The outcome of the Review, Mr Pottage said, had given him no cause for concern and he had regarded the Review as a positive step.

218. We are not satisfied that the Asia II Desk Review should have been taken by Mr Pottage as a warning signal prompting a decision to initiate a Systematic Overhaul earlier than Mr Pottage actually did so. It is significant that when the later Asia Desk GIA Report was released in July 2007, it revealed further compliance weaknesses and raised doubts as to the findings of the Asia II Desk Review.

GIA Report on Life and Pensions: warning signal

219. This was identified by Mr Hayward as a warning signal. It had been issued on 4 May 2007 and gave a "satisfactory" rating but raised as a significant issue shortcomings with pre-completion documentation controls.

220. The Life and Pensions side of the Firm's Business had been acquired as a going concern from Scott Goodman & Harris in 2004 and had not by 2007 been incorporated into the ORF. Mr Salmon, the FSA supervisor responsible for the Firm, stated that the Report "highlighted the failure of a basic control to ensure suitability of advice, which is also fundamentally important for a wealth management firm".

221. Mr Pottage acknowledged that the Firm had indeed had difficulties with missing documents. He saw the problem as arising from the volume of documentation being produced. That was characteristic of the industry and had resulted from the switch from paper files to electronic files. He said that the Firm had built a "Client Relationship Management Tool" which had not been perfect. In his view the Firm had addressed the problems but "they were never going to go away completely".

222. We consider the Life and Pensions GIA Report to have raised awareness of serious compliance and risk issues. The value of customer assets in the Life and Pensions section of the Firm was in the region of £1bn. The problems were not, we think, so serious in themselves as to have demanded a Systematic Overhaul. They were, as we have explained, being addressed by the adoption of electronic processes. Further, we accept Mr Pottage's explanation that documents that had apparently gone missing were being found in different archives. However, this Report together with the other warning signals above should have alerted Mr Pottage to the failings in the Firm's systems and controls in a number of operational areas and of the need to consider these in a more systematic way. Mr Pottage's email dated 19 April 2007 to Mr Challis, Ms Topley and Mr Weston marked "high importance" showed that he was trying to get them to prioritise the Firm's approach to risk but that the focus was wider than the front to back problems that should have been becoming evident to him.

Mr Pottage's reasons for launching the LORR

223. In determining whether Mr Pottage failed to take the reasonable step by not initiating the LORR sooner than he did, we now consider the evidence as to why he did in fact initiate it. Mr Pottage's reasons for launching the LORR were explained to us in his evidence. In assessing these, we take into account the fact that he was admittedly not a risk expert; nor was it his job to carry out the function of a risk expert. His reasons for launching the LORR, we note, were not that he thought there might be something wrong with aspects of the overarching frameworks such as the committee structure or the membership and remit of the Risk Committee or the work of compliance monitoring. He had already considered some of those matters and did not expect to find significant failings there. We note in this connection that compliance monitoring had been outside the scope of the LORR. The particular prompts for the LORR, which had generated a growing concern on the part of Mr Pottage, were that he had been troubled by the re-opening of three audit actions, by an episode of intra-day trading which had indicated to him a lack of precision in the detailed processes to be followed and by the discovery in July 2007 of the Africa Desk unauthorised trades.

224. We recognise that had Mr Pottage been a risk expert with a greater experience of Operations, his perception of the weaknesses relating to the ORF, Compliance Monitoring and to Management Information might have been better focussed before July 2007. Nonetheless we are satisfied that by the end of July 2007 he had sufficiently substantial concerns that there might be flaws in the design and effectiveness of controls in areas other than Operations to justify embarking on the resource intensive task that was then initiated. An overhaul was already underway within Operations under the direction of Mr Reid and key decisions had already been taken to employ a head of compliance monitoring; but Mr Pottage had been concerned that the problems might go wider. Consequently he designed the LORR correctly as a "drains-up review" of operational risks and controls across the Business. We are mindful of the fact that it was only a matter of three months from the date that Mr Pottage initiated his 'brainstorming' meetings with his senior

management team and the July 2007 Risk Committee when the LORR was first proposed.

225. It was suggested to Mr Pottage in cross-examination that he had only implemented the LORR because the newly-arrived Mr Reid had proposed a governance review in the Risk Committee on 22 July 2007. The fact is, however that the LORR was not primarily a governance review; it was, to use Mr Pottage's expression again a "drains-up review". Of course he considered and adopted the advice of Mr Reid. But that does not in our view demonstrate that it was an unreasonable step to have failed to institute the LORR as a Systematic Overhaul at an earlier stage than July 2007.

Conclusions

226. In Paragraph 200 above we have set out Mr Pottage's own statement that gives an overview of his reactions to the risk-related events that occurred during the Relevant Period. We are aware that the explanation that he has given in the course of interviews with the FSA was less focussed and indicate a level of awareness on his part of the Firm's actual exposure to risk that does not emerge from the measured account in his statement. The fact remains, however, that every specific control failure identified in the Business had been fully investigated and had been remedied or was being dealt with in accordance with a defined plan. The great majority of those controlled failures had arisen in Operations, where, in addition to the implementation of measures designed to remedy them in the specific areas of client money and client assets, steps were being taken under the new management of Mr Reid. Steps had been taken to strengthen the compliance monitoring team; these had been underway since early 2007 and a suitable candidate (Mr Daynes) had been found and started in office in September 2007. It is also, we note, a fact that no one, whether in the GIA function, the Risk Control or the Compliance functions (in Zurich or London) or indeed the FSA, had suggested, prior to the initiation of the LORR, that it was necessary or appropriate to carry out a wider review of systems and controls than had in fact been put in place. Finally, it is relevant to mention that Mr Pottage himself took a number of steps throughout the Relevant Period to discharge his CF3 and CF8 control function responsibilities, not least in initiating the LORR itself.

227. Our views of the evidence as a whole and of those points in particular have led us to the conclusion that the FSA has not established its case that Mr Pottage had committed misconduct. There were, as we have found in Part II of this Decision, and as UBS AG have in some respects admitted, failings in the Firm's compliance with relevant standards of the regulatory system (see APER 4.7.3E). The FSA has not satisfied us however from the evidence as a whole that Mr Pottage's standard of conduct was "below that which would be reasonable in all the circumstances" (see APER 3.1.4G). In particular we are not satisfied that his failure to institute a Systematic Overhaul at an earlier date (than when the LORR was initiated) was beyond the bounds of reasonableness. Put positively, we think that the actions that Mr Pottage in fact took prior to July 2007 to deal with the operational and compliance issues as they arose were reasonable steps.

228. For those reasons we have concluded that the appropriate Direction for the FSA is to take no action against Mr Pottage. Our decision is unanimous.

SIR STEPHEN OLIVER QC
JUDGE OF THE UPPER TRIBUNAL
RELEASE DATE: 20 April 2012

APPENDIX

WITNESSES

Expert Witnesses

Jonathan Hayward: Director of Independent Audit Limited (a consultancy specialising in corporate governance): nominated by the FSA.

Stephen Kingsley: Senior Managing Director in FTI Consulting's Economic and Financial Consulting practice: nominated by the Applicant.

Witnesses of Fact

Mr John Pottage: the Applicant

Mr Bernard Buchs: Global Head of Wealth Planning in UBS Wealth Management & Swiss Bank: called for the Applicant.

Ms Megan Butler: Head of Department, Supervision, Investment Banks 1 within the FSA: called for the FSA.

Mr Callum Licence: Chief Operating Officer for UBS Wealth Management in the UK and in Jersey: called for the Applicant.

Mr Andreas Przewloka: Chief Executive Officer for UBS Wealth Management in Luxembourg: called for the Applicant.

Mr Arran Salmon: Supervisor within the FSA: called for the FSA.

Mr Neil Stocks: Advisor to members of the Legal and Compliance function of UBS AG: called for the Applicant.