

SEE FINAL NOTICE ISSUED ON 27 MARCH 2015

DECISION NOTICE

To: Arch Financial Products LLP
Address: 16 Berkeley Street
Mayfair
London
W1J 8DZ
Date: 14 September 2012

1. ACTION

- 1.1. For the reasons given in this Decision Notice, and pursuant to section 205 of the Financial Services and Markets Act 2000 (the “Act”), the FSA has decided to publish a statement to the effect that Arch Financial Products LLP (“AFP” or the “Firm”) has contravened regulatory requirements. This action is in respect of breaches of Principles 1, 2, 3 and 8 of the FSA’s Principles for Businesses (“the Principles”) and breaches of rules contained in the part of the FSA Handbook relating to Senior Management Arrangements, Systems and Controls (“SYSC”) and Conduct of Business (“COB”) which occurred between July 2006 and March 2009 (the “Relevant Period”).
- 1.2. Were it not for AFP’s financial position, the FSA would have decided to impose on AFP a financial penalty of £9 million.

2. SUMMARY OF REASONS

- 2.1. During the Relevant Period AFP breached Principles 1, 2, 3 and 8 in the conduct of its business as investment manager of two UK funds, the CF Arch cru Investment Funds (the “Investment Funds”) and the CF Arch cru Diversified Funds (the “Diversified Funds”) (together the “UK Funds”) and as investment manager of 22 incorporated cell companies of Arch Guernsey ICC Limited (the “Guernsey cells”) into which the UK Funds invested. The UK Funds are FSA authorised OEICs and NURSs. The Guernsey cell companies had three directors, two non-AFP directors and Mr Addison of AFP was the third director.
- 2.2. AFP adopted an investment allocation strategy whereby the majority of the UK Funds’ scheme property was invested in the Guernsey cells. This strategy was adopted to provide investors in the UK Funds with exposure to private market assets.
- 2.3. AFP, as manager of the UK Funds, was required to ensure that the UK Funds’ scheme property aimed to provide a prudent spread of risk. However, the investment strategy of allocating the majority of the UK Funds’ investments to buy shares in the Guernsey cells had obvious inbuilt liquidity risks which AFP failed properly to manage. The setting up of this structure displayed a lack of due care, skill and diligence particularly in respect of the requirement for a Non-UCITS Retail Scheme (“NURS”) to be managed in accordance with the appropriate requirements, notably the requirement for the scheme property of a NURS to aim to provide a prudent spread of risk.
- 2.4. The structure set up by AFP gave rise to inherent conflicts of interests and therefore the clear risk of poor and/or unsuitable investment decisions. In particular there was a risk of conflict between the interests of the UK Funds and the Guernsey cells, between the interests of the sub-funds of the UK Funds and between the interests of the Guernsey cells. There was also a significant risk of conflict of interest between AFP and the UK Funds on the one hand, and between AFP and the Guernsey cells on the other.
- 2.5. AFP earned structuring and transaction fees for arranging some transactions for the Guernsey cells; it also had its own investments in, or commercial arrangements with, some of the parties involved in the transactions. This created a risk that AFP would structure transactions for the Guernsey cells in such a way as to maximise its own

benefit. The risk of such transactions being carried out was exacerbated by the fact that AFP had considerable discretion in its investment management role for both the Guernsey cells and the UK Funds.

2.6. However, in spite of the significant and apparent conflict risks, AFP did not maintain or operate effective operational, organisational and administrative arrangements to prevent conflicts of interests arising and failed to take reasonable steps to prevent such conflicts giving rise to material risks of damage. AFP had no consistent procedure for conflict management or recording of conflict management.

2.7. Furthermore, AFP caused the Guernsey cells to enter into four transactions in which AFP and related persons or entities stood to make gains at the expense of the Guernsey cells. AFP recklessly failed to manage the conflicts:

(1) AFP caused the Guernsey cells to purchase shares in AFP's parent company, Arch Group (UK) Limited ("AGL"), at a price determined by one of its directors with no independent verification of the price and inadequate contemporaneous recording of the conflict of interest. While Mr Farrell and Mr Addison of AFP disclosed to the non-AFP directors of the Guernsey cells that AFP was going to direct the Guernsey cells to purchase newly issued shares in AGL to raise new capital for AGL, the non-AFP directors of the Guernsey cells were not informed that Mr Farrell was also going to be selling his personal shares in AGL to the Guernsey cells for a personal capital gain of £492,359. Nor were the non-AFP directors of the Guernsey cells informed as to the price per share at which the Guernsey cells were to be purchasing the shares.

(2) In another transaction AFP caused the Guernsey cells to invest £20.2 million into a company ("Company A") from which Company A paid AFP and a business associate a fee of £3 million each for undefined services. This represented 16% of AFP's total income for the year ending 29 February 2008. The fee of £3 million was not disclosed to the non-AFP Guernsey directors. Further, no conflict documentation was prepared in respect of this transaction despite the clear and obvious conflict and despite AFP receiving external contemporaneous advice telling AFP that clear

documentation for conflicts of interest was required. The only document which recognised any conflict of interest in the transaction was prepared in January 2010 for the FSA by AFP and was misleading in that it did not mention the most important conflict, being the size of the fee paid to AFP in relation to the transaction.

- (3) AFP caused the Guernsey cells to invest in the UK Funds' distributor, Cru Investment Management Limited ("Cru"), which was a major business partner of AFP. Investing the Guernsey cells' funds in Cru improved AFP's ability to negotiate favourable distribution terms with Cru and enabled AFP to benefit from increased funds under management as Cru performed its duties under the distribution agreement. AFP recklessly failed to manage the conflicts of interests arising from this transaction, in particular, by failing to disclose to the non-AFP Guernsey cell directors material factors in respect of the clear benefits obtained by AFP and AFP's business partner from the Guernsey cells' investments and in failing contemporaneously to record conflicts and conflict management.
- (4) AFP caused the Guernsey cells to invest in a company ("Company B") associated with AFP, which investment disproportionately benefited AFP's parent company compared to the Guernsey cells. In particular AFP also directed the Guernsey cells to purchase certain share warrants from its parent company's nominee on the basis of a valuation prepared by Mr Farrell, who was also the majority shareholder and director of the parent company, which led to a profit of £49,999 for AGL. AFP continued to direct the Guernsey cells to invest in Company B at a time when there was a clear and obvious risk that further investment was likely primarily to benefit AFP's associates rather than the Guernsey cells providing the funds to Company B. AFP recklessly failed to manage these conflicts of interest, and there is no evidence that AFP disclosed the conflicts to the non-AFP directors of the Guernsey cells, or that the conflicts were contemporaneously recorded.

2.8. Accordingly, AFP was aware of the risk that it would cause the Guernsey cells to enter into transactions which would benefit AFP and its associates, to the detriment of

the Guernsey cells. Notwithstanding that risk, AFP failed to manage effectively or at all these significant and serious conflicts of interest in breach of Principle 1.

- 2.9. AFP's investment decision-making structure was also flawed. Before December 2008, when AFP put Chinese walls in place, the same committee was making decisions regarding the management of the UK Funds and the Guernsey cells and the Guernsey cells' underlying investments. Therefore, there was a risk that individuals making decisions at UK Fund level had knowledge of confidential information about the Guernsey cells which other external investors in the Guernsey cells and the market in general did not possess. This was particularly serious given that the Guernsey cells were publicly listed.
- 2.10. The compliance monitoring undertaken by AFP during the Relevant Period was also inadequate. There was no documented monitoring programme in place and put into practice until November 2008. Compliance monitoring results were not sufficiently recorded and AFP's records did not demonstrate that adequate reporting of such monitoring to senior management took place.
- 2.11. Accordingly, AFP failed to:
- (1) conduct its business with integrity in breach of Principle 1, in that in respect of four transactions in which AFP put its or its associates' interests before the interests of the Guernsey cells, AFP recklessly failed to manage these conflicts of interest;
 - (2) conduct its business with due skill, care and diligence, in breach of Principle 2, by adopting an investment allocation strategy which failed to aim to provide a prudent spread of risk;
 - (3) implement appropriate control structures and compliance arrangements to manage the risks associated with both the structure of the investments made by the UK Funds and individual transactions undertaken by AFP in breach of Principle 3; and
 - (4) generally to manage conflicts of interest fairly, both between itself and its customers and between its customers and its other clients in breach of

Principle 8 and relevant conflict rules set out in COB 7.1 (pre-November 2007) and SYSC 10 (from November 2007 onwards).

2.12. The FSA views AFP's failings as serious because:

- (1) AFP's failings had a significant impact on AFP discharging its obligations as investment manager;
- (2) there are (and were during the Relevant Period) over 6000 investors in the UK Funds (many of these are nominee holders for underlying beneficial investors, so the number of individual investors is much higher);
- (3) AFP was the investment manager for assets under management in the UK Funds and the Guernsey cells totalling approximately £645 million at their peak in September 2008. The UK Funds have now been suspended; and
- (4) the failings were repeated and prolonged.

2.13. AFP's actions would therefore merit the imposition of a significant financial penalty but for its financial position.

3. DEFINITIONS

3.1. The definitions used in this Decision Notice are listed in Appendix 3.

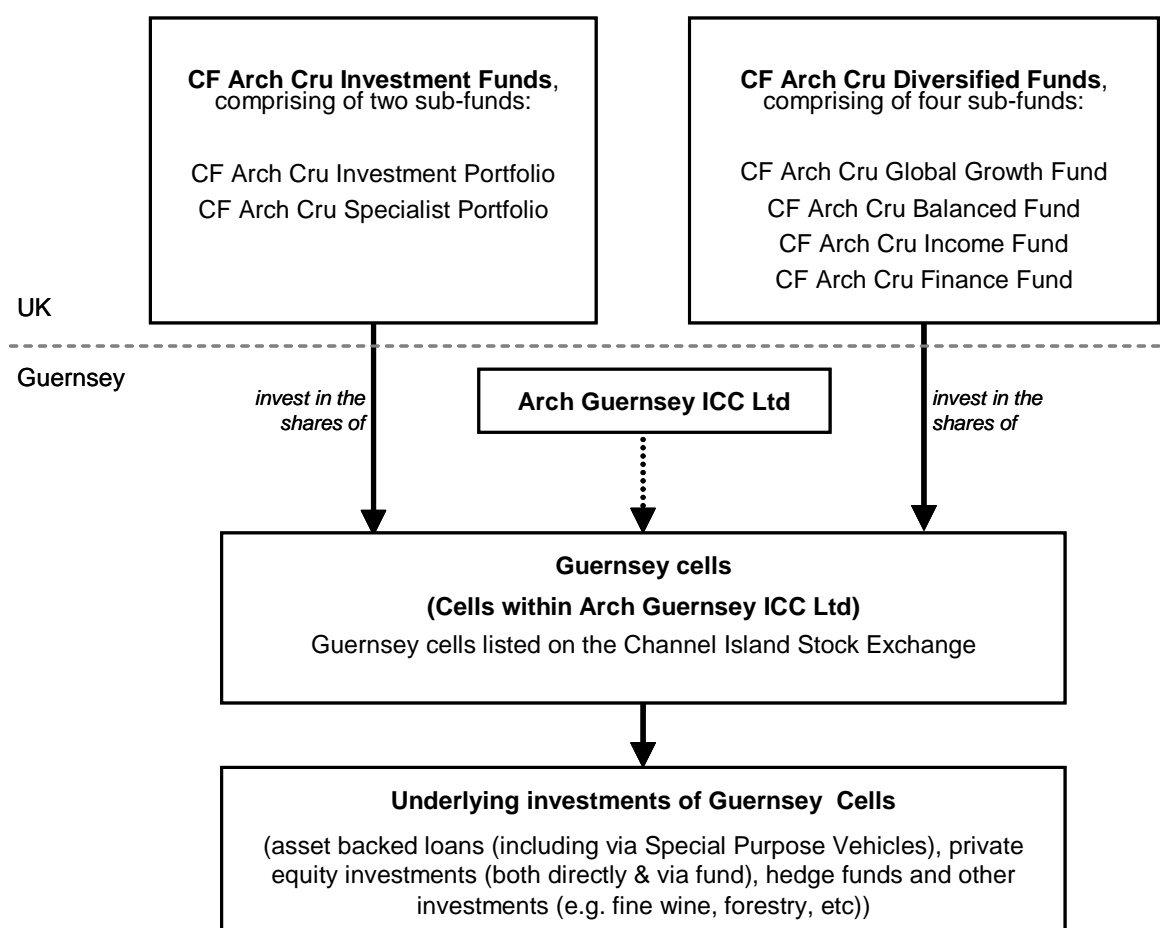
4. FACTS AND MATTERS

Background

4.1. AFP was incorporated on 24 November 2004 as a limited liability partnership. It has been authorised and regulated by the FSA since 14 March 2005 and is majority owned by AGL. The number of people working at AFP grew substantially from 11 individuals (staff and partners) in July 2006 to 61 individuals at its peak in November 2008. Two of the key individuals at AFP during the Relevant Period were Mr Farrell who was the Chief Executive Officer (CEO), and Mr Addison who was the Chief Operating Officer (COO), Chief Financial Officer (CFO) and, until 10 November 2008, the Compliance Officer.

- 4.2. In January 2006, AFP approached an ACD to act in relation to an OEIC, the Investment Funds, which was a NURS. The Investment Funds were set up in January 2006 and was authorised by the FSA.
- 4.3. The Investment Funds were launched by AFP on 29 June 2006. These were the first UK OEICs investment managed by AFP. When the ACD had been appointed, it delegated the role of investment management of the Investment Funds to AFP pursuant to an agreement dated 5 July 2006.
- 4.4. As investment manager, AFP adopted an investment allocation strategy whereby the Investment Funds, comprising two sub-funds - the CF Arch cru Investment Portfolio (the “Investment Portfolio”) and the CF Arch cru Specialist Portfolio (the “Specialist Portfolio”) – primarily invested in shares of the Guernsey cells. These Guernsey cells were established by AFP and incorporated in Guernsey. The Guernsey cells were subsequently listed on the CISX from January 2007; they were the first incorporated cell companies listed on the CISX. AFP was also appointed as investment manager of each of the Guernsey cells by the Guernsey cells’ directors, one of whom was also a partner in AFP. AFP began investing the scheme property of the Investment Funds in the Guernsey cells from January 2007.
- 4.5. In September 2007, AFP took on the investment management responsibilities for a second OEIC, the Diversified Funds, and appointed the same ACD, which delegated the role of investment management of the Diversified Funds to AFP pursuant to an agreement dated 26 September 2007.
- 4.6. The Diversified Funds had three sub-funds as at 26 September 2007: CF Arch cru Balanced Fund (the “Balanced Fund”); CF Arch cru Global Growth Fund (the “Global Growth Fund”); and CF Arch cru Income Fund (the “Income Fund”).
- 4.7. Having been appointed as investment manager to the Diversified Funds, from September 2007 AFP began to invest the assets of the three sub-funds of the Diversified Funds in the Guernsey cells. These had previously been invested in corporate bonds, investment trusts and other OEICs. A further sub-fund of the Diversified Funds – the CF Arch cru Finance Fund (the “Finance Fund”) – was launched in October 2008 and, from its launch, AFP invested all of its non-cash scheme property in the Guernsey cells.

- 4.8. Under the investment management agreements, in its role as discretionary investment manager of the property of both the UK Funds and the Guernsey cells, AFP had discretion to deal in investments, effect transactions and take all day-to-day decisions as AFP considered appropriate in relation to the property of both the UK Funds and the Guernsey cells. However, under the investment management agreements relating to the management of the UK Funds (the “UK Funds IMAs”) AFP also had to conduct its investment management role within the investment objectives and restrictions set out in the prospectuses for the UK Funds and in accordance with the provisions of COLL which related to, amongst other matters, the requirement for prudent spread of risk.
- 4.9. As at March 2009, there were 22 Guernsey cells listed on the CISX into which the UK Funds had invested in the Relevant Period. A simplified structure of the UK Funds is shown in the following diagram:



- 4.10. The Rules in COLL 5.6 prevented the UK Funds' scheme property being invested in significant concentrations of private market assets. However, subject to certain concentration restrictions, it was permitted for the scheme property of the UK Funds to be invested in transferable securities admitted to an eligible market, which could include the shares of the Guernsey cells. The UK Funds were invested in the shares of the Guernsey cells, and the underlying investments of the Guernsey cells were predominantly comprised of assets such as long-term asset-backed loans, private finance and private equity, which would not fall to be characterised as transferable securities admitted to eligible markets.
- 4.11. Trading in the UK Funds was suspended on 13 March 2009, because of the ACD's concerns that there was insufficient liquidity in the sub-funds of the Investment Funds to meet anticipated redemptions. Dealings in the other sub-funds of the UK Funds were suspended at the same time because of concerns that the suspension of one sub-fund might trigger an unsustainable run of redemptions on the other sub-funds, and due to the illiquidity of the sub-funds' broadly similar underlying investments.

Liquidity and spread of risk

- 4.12. As well as investing in eligible securities and investing in accordance with the quantitative investment limits set out above, under the terms of its investment management agreement with the ACD, AFP was also obliged to ensure that, taking account of the investment objectives and policy of the UK Funds, the scheme property of each of the UK Funds aimed to provide a prudent spread of risk. AFP failed to do this.
- 4.13. The UK Funds invested primarily in the Guernsey cells' shares. For example, the Investment Portfolio, which was the largest of the sub-funds of the UK Funds, at 2 April 2007, had 81% exposure to the Guernsey cells. This exposure dropped to 64% in July 2007, but then went back up to 85% on 1 October 2007. At 31 June 2008, the percentage was 90% and after this the percentage remained at over 90% until the UK Funds' suspension on 13 March 2009, when the percentage was 97%. After March 2008, no purchases of non-Guernsey cell assets occurred by the UK Funds.
- 4.14. Not only were the UK Funds predominantly invested in the Guernsey cells, the UK Funds and other Guernsey cells were majority owners of most of the Guernsey cells.

However, trading in the shares of the Guernsey cells occurred through the Guernsey cells' market maker. These trades included trades by the UK Funds and the Guernsey cells between themselves. Secondary market transactions involving non-AFP related parties were limited. For example, of the total number of trades in the Guernsey cells' shares during the trading period of 12 February 2007 and 29 April 2009, buy trades and sell trades involving an external (i.e. non AFP related counterparty) totalled around £19 million and £25 million respectively. Buy trades and sell trades with AFP-related counterparties were around £161 million and £155 million respectively.

- 4.15. AFP's allocation strategy for the UK Funds resulted in a concentration of the UK Funds' scheme property in the Guernsey cells' shares and the UK Funds' majority or complete ownership of many of the Guernsey cells. UK Fund investors were exposed to the risk that the UK Funds would not be able to liquidate their holdings in the Guernsey cells in the secondary market to meet redemption requests at times of net outflows from the UK Funds in the four-day settlement period which would be required. This risk crystallised and resulted in the suspension of the UK Funds in March 2009.
- 4.16. AFP did not take sufficient action to maintain or increase the UK Funds' liquidity (for example, the Investment Portfolio (the largest of the sub-funds) held less than 10% of its scheme property as cash between 30 June 2008 and suspension) and instead continued to invest in the Guernsey cells. At 1 October 2008 the UK Funds collectively held £34.2 million in cash, which equated to approximately 8% of their scheme property. Between 1 October 2008 and 31 December 2008, £8.8 million of net inflows were invested in the UK Funds. However, AFP did not keep this cash within the UK Funds to bolster their cash balances, but instead continued to invest in the shares of the Guernsey cells, eroding the cash buffer still further, such that by 1 January 2009, the UK Funds held just £22.8 million (approximately 6%) of their scheme property as cash.
- 4.17. AFP could have tried to obtain additional cash reserves from its investments in the Guernsey cells through, for example, requesting that these Guernsey cells conducted share buy-backs or other corporate actions. However, this would have depended on such action being taken by the directors of the Guernsey cells, an independent body,

when it may not have been in the best interests of the Guernsey cells and, in any event, the Guernsey cells may not have had sufficient liquidity.

Management of conflicts of interest

- 4.18. AFP did not have in place sufficient organisational and administrative arrangements to prevent conflicts of interest or to prevent the material risk of damage to the interests of its clients.
- 4.19. The fact that AFP was investment manager of both the UK Funds and the Guernsey cells gave rise to inherent conflicts of interest and therefore the risk of poor and/or unsuitable investment decisions. There was a clear and obvious risk of conflict between the interests of the UK Funds and the Guernsey cells, between the interests of the sub-funds of the UK Funds and between the interests of the Guernsey cells. There was also a risk of conflict of interest between AFP and the UK Funds on the one hand, and between AFP and the Guernsey cells on the other, in particular:
- (1) AFP was investment manager for both the UK Funds and the Guernsey cells and earned fees in relation to the value and performance of the investments which AFP made. AFP's fees as investment manager at Guernsey cell level were higher and AFP earned more than at UK Fund level. There was therefore a risk that AFP would put its own interests above the interests of investors and invest the UK Funds in the Guernsey cells when this may not have been appropriate;
 - (2) AFP received fees in transactions in which the Guernsey cells were involved. This created an incentive for AFP to undertake potentially inappropriate transactions for the Guernsey cells in order to gain transaction fees, or structure transactions in such a way as to maximise transaction fees; and
 - (3) AFP directed the Guernsey cells to invest capital in entities in which AFP or associated entities had an interest.
- 4.20. Principle 8 and the relevant rules (COB 7.1 until 31 October 2007, then SYSC 10 from 1 November 2007) required that AFP managed conflicts of interest fairly.

However, throughout the Relevant Period AFP did not have effective operational and administrative arrangements in place to manage the serious potential and actual conflicts in its business. AFP did not consistently record the conflicts arising nor did AFP record the steps taken to manage these conflicts.

- 4.21. AFP had high-level conflict of interest policies in place which set out general principles of conflict management, but AFP did not follow these policies. Further, AFP received advice from external consultants as to the procedures it should follow to comply with the FSA's rules, but AFP did not follow this advice. AFP was also required by SYSC 10.1.10 to have an appropriate written conflicts of interest policy in place by 1 November 2007. However, a written policy was not implemented until August 2008, by which time the UK Funds' money had been invested in the Guernsey cells.
- 4.22. Up to 31 October 2007, under COB 7.1, in a situation of conflict, AFP was required to take reasonable steps to ensure fair treatment for a customer and if relying on disclosure of an interest to a customer to manage the conflict, be able to demonstrate that it had taken reasonable steps to ensure that the customer did not object to AFP's interest or conflict, before the transaction was undertaken. AFP could only demonstrate that it had taken such steps through maintaining conflicts records.
- 4.23. From 1 November 2007, SYSC 10.1.6 required that AFP kept and regularly updated a record of the kinds of activity carried out by AFP in which a conflict of interest entailing a material risk of damage to one or more clients may arise or had arisen.
- 4.24. AFP only rarely recorded conflicts management analysis carried out in respect of transactions entered into by the Guernsey cells. AFP recorded some, but not all, conflicts on a variety of internal documents, including deal tickets, records of proposals to its internal investment committee (Investment Committee Proposals ("ICPs")) or conflict file notes, or a combination of those documents. Further, many of these documents were created a number of months after the event. There was no clear or consistent procedure implemented for conflict recording and no centralised single record of conflicts and their mitigation until after the Relevant Period.
- 4.25. In certain cases, material details of the conflicts arising from transactions were omitted from the conflicts notes or other documents it did create (created either

contemporaneously or after the event), the effect of which was to obscure the full extent of the conflicts. In other cases, AFP considered that certain conflicts were not significant or did not need to be recorded contemporaneously (either at all or to a degree which the FSA considers adequate) or which AFP's senior management considered they had managed through structuring. This is despite an email sent on 15 September 2007 by Mr Addison to most of AFP's staff which advised that AFP had to ensure, for the purposes of any possible FSA visit to AFP, that there was a paper trail showing that AFP had identified and managed conflicts in a reasonable manner and that the onus was on AFP to demonstrate to the FSA that it had managed conflicts in a reasonable manner.

- 4.26. For AFP to comply with both COB 7.1 and SYSC 10 (and its own internal guidance) AFP had to record conflicts and their management so that it could demonstrate that it had managed conflicts fairly. AFP's conflict management processes were not sufficient to comply with these requirements. AFP's record of conflicts was set out on various documents which were accessible by relevant AFP staff on what AFP described as a "need to know basis". However, it was not clear, when looking for a conflict record of a particular transaction, where to look, as it could be recorded on an ICP, a deal ticket or a specific conflict file note. Further, it was not always the case that a conflict and its management would be recorded in a note. AFP's conflict recording was said in some cases to be "*inherent*" in transaction structuring or transaction rationale, or "*obvious and well understood internally*", so did not need to be written down.
- 4.27. Further, from 1 November 2007 SYSC 9.1.3 required the storage of information in a way accessible for future reference by the FSA in particular in relation to each key stage of the processing of each transaction. AFP did not comply with this. Comprehensive centralised conflicts logs were not created until 2009.
- 4.28. Before the creation of the centralised conflicts logs, AFP created various "conflicts of interest file notes", in which some, but not all, conflicts were recorded and some explanation was provided as to how these conflicts had been mitigated. However, nine of these conflict file notes were created after the relevant transactions. These conflict file notes were created in February 2009, following a request on 30 January

2009 from the ACD of the UK Funds for provision of AFP's conflicts of interest policy and register.

- 4.29. The time lag in some cases between the transaction and the creation of the file note created the risk that any potential damage arising from the conflict may have already occurred and the opportunity to effectively mitigate such conflicts would have passed. Other potential conflicts, which should have had a clear explanation of their identification and mitigation, had no such notes.
- 4.30. One of the other potential mechanisms open to AFP for managing its conflicts was through disclosure, for instance to the non-AFP directors of the Guernsey cells. However there is no record of prior disclosure to the Guernsey cell directors in every case where there was a conflict in AFP's conflicts records. In certain cases where disclosure was recorded as being made, the disclosure was not sufficiently detailed to enable the directors to reach an informed decision as to the conflict. Alternatively the relevant disclosure was made after the transaction had already taken place by which time the opportunity to manage the conflict and to avoid the risk of detriment had passed.
- 4.31. AFP caused the Guernsey cells to enter into a number of significant transactions in which AFP or associated entities made gains at the expense of the Guernsey cells and where these conflicts arising were recklessly not recorded, managed and/or disclosed as set out below:

AGL Shares

- 4.32. The Guernsey cells made debt and equity investments in AGL, AFP's parent company, in four transactions between February 2007 and February 2008. The investment in AGL in February 2007 was one of the first transactions AFP directed the Guernsey cells to make after the Guernsey cells were launched. Two serious and obvious conflicts arose from these transactions:
- (a) AFP, as investment manager to the Guernsey cells, arranged for the Guernsey cells to invest in equity and loan notes in AGL; (which owned 97% of AFP throughout the Relevant Period); and

- (b) a large proportion of the AGL shares purchased by the Guernsey cells were purchased from Mr Farrell, the CEO of AFP, and majority owner of AGL, who made a capital gain of £492,359 on the sale of these shares to the Guernsey cells. Mr Farrell prepared the valuation which set the price at which the Guernsey cells purchased his shares and the new shares issued by AGL.

Details of the transaction

- 4.33. On 23 January 2007 AFP's internal Investment Committee approved the allocation of an investment in AGL equity and loan notes by the Guernsey cells. The Guernsey cells were then launched on the CISX.
- 4.34. On 15 February 2007, a business plan was presented to the non-AFP directors of the Guernsey cells by Mr Farrell and Mr Addison. In this business plan AFP proposed that the Guernsey cells invest £1 million in loan notes of AGL and £500,000 by way of new equity of AGL. Although it did not state the proposed price per share, the financial projections which accompanied the business plan indicated a conservative value of AGL for 2007/2008 as being between £15.375 million and £15.522 million.
- 4.35. Two weeks later on 27 February 2007 AFP directed the Guernsey cells to enter into a revolving discounted note facility with AGL of up to £660,000. On 28 February 2007, AFP directed the Guernsey cells to invest £510,000 in AGL comprising 5,268 newly issued AGL shares and then on 15 March 2007, AFP directed the Guernsey cells to purchase 5,166 shares from Mr Farrell at a cost of £500,121. It was not stated in the business plan presented to the non-AFP Guernsey cell directors by Mr Farrell and Mr Addison that Mr Farrell would be making a personal gain from the transactions and that the Guernsey cells' investment funds would not be going into AGL, but directly to Mr Farrell. This serious conflict was further not disclosed to the non-AFP Guernsey cell directors, before Mr Farrell sold his shares to the Guernsey cells.
- 4.36. The shares were sold at £96.81 per share valuing AGL at approximately £17.4 million. This valuation was recommended by Mr Farrell. No independent valuation was sought by AFP despite the clear conflict of interest between the interests of AFP, Mr Farrell and the Guernsey cells. Mr Farrell signed the revolving discounted note

facility on behalf of the Guernsey cells. The Guernsey cells were also liable for stamp duty at 0.5% on the transfer from Mr Farrell to the Guernsey cells for which they would not otherwise have been liable to pay if, for instance, new shares in AGL had been issued. There is only documentary evidence of the Guernsey cells' directors approving the issuing of loan notes and not the equity transactions.

4.37. It was not until April 2007, nearly two months after the transaction, that a valuation file note was prepared by Mr Farrell which set out the rationale for the valuation of AGL at £17.45 million on which the share price of £96.81 was based and at which price the Guernsey cells had purchased his shares and the newly issued AGL shares. The valuation file note does not refer to the earlier projections and valuations presented to the Guernsey cell directors.

4.38. Despite the serious potential conflicts and the clear risk that Mr Farrell, through his valuation of the AGL shares and his own sale of these shares, could influence his own gain, AFP did not manage the conflict by obtaining an independent valuation of AGL.

Management of the conflict of interest: Documentation and disclosure

4.39. In this transaction, there was a clear and obvious risk that AFP could put its own and its associates' interests ahead of the Guernsey cells. However, AFP recklessly failed to manage the conflict. AFP omitted to inform the non-AFP Guernsey cell directors that Mr Farrell would be selling his shares to the Guernsey cells. Further, AFP did not seek an independent valuation, allowing reliance to be placed on Mr Farrell's valuation when this was clearly inappropriate, and did not record the relevant conflicts of interest in relation to the transaction.

4.40. One document identified that the transaction "*may be seen externally as conflict of interest*" and explained that this was mitigated by the "*Management of Conflict of Interest process*". However, the document was silent as to what this process involved and how it would mitigate the conflict. Furthermore this document was created in April 2007, after the initial transactions had taken place in February 2007.

4.41. Another document, a "*Note for the Investment Committee and Senior Management*" created in March 2007, after the transactions had taken place, recognised the conflict presented by the Guernsey cells purchasing shares in AGL. This note recorded that Mr

Farrell would be selling his shares to the Guernsey cells (at a price of £96.81) as well as the Guernsey cells purchasing newly issued shares. The note gives the impression that the conflict of interest was managed by stating that on 15 February 2007, the directors of the Guernsey cells were informed of the investment and raised no objections to the investment or its rationale. However, the note is misleading as it does not make it clear that the business plan presented to the directors of the Guernsey cells on 15 February 2007 did not include the following material factors:

- (1) that the rationale and associated benefits of the Guernsey cells investing into AGL, as set out in the business plan and as approved by the Guernsey cells' directors, was not relevant because the Guernsey cells bought shares from Mr Farrell personally rather than subscribing for new shares in AGL. As a result, the purchase monies did not go into AGL (which may have benefited the Guernsey cells as AGL shareholders) but instead to Mr Farrell which provided no benefit to the Guernsey cells;
- (2) that the Guernsey cells were to be purchasing £500,121 worth of Mr Farrell's shares in addition to the £510,000 equity investment in new shares and that Mr Farrell stood to gain personally from the transaction;
- (3) the share price to be paid by the Guernsey cells; and
- (4) that stamp duty at 0.5% would need to be paid by the Guernsey cells on the transfer.

4.42. Another conflict of interest file note documented the "*potential conflict of interest*" arising from members of the "*Guernsey Investment Management team owning AGL shares*", or holding AGL share options at the same time as the Guernsey cells' investment in AGL. However, this was not created until February 2009.

4.43. No disclosure of any of the Guernsey cells' investments in AGL was made to the ACD or the depositaries of the UK Funds at the time. When the ACD was made aware of the Guernsey cells' investments in AGL, it instructed AFP to unwind the trades, which AFP did.

Investments in Company A

- 4.44. AFP received a significant fee from a transaction in which the Guernsey cells, through a linked transaction with an unlisted cell company, also managed by AFP, loaned £20.2 million to a third party holding company, Company A, of which Mr Farrell, along with a business associate of his (the “Business Associate”), was a director. A third party also loaned £0.8 million to Company A.
- 4.45. On 29 October 2007, Company A purchased the shares of a group of companies for an agreed price of £15 million (the “Company A Acquisition”) using funds from the £21 million indirectly invested by the Guernsey cells and the third party company.
- 4.46. The Board of Company A at the time of the Company A Acquisition comprised Mr Farrell and the Business Associate. On 29 October 2007 (the date of the Company A Acquisition), Mr Farrell and the Business Associate as the Board of Company A resolved to pay £6 million in “structuring fees”, being £3 million each to AFP and the Business Associate. Consequently, at the time of the acquisition, the Guernsey cells’ indirect investment into Company A was, in effect, being used to pay a significant fee to AFP.

Management of the conflict of interest: documentation and disclosure

- 4.47. AFP’s £3 million fee was not contemporaneously disclosed to the non-AFP directors of the Guernsey cells.
- 4.48. There is no evidence of the rationale for the Company A Acquisition being recorded or discussed in any Investment Committee meetings, ICPs or conflicts notes, nor any justification for the size of the fee. There is also no documentation recording how the conflict arising from Mr Farrell’s position as a director of Company A from August 2007 was monitored and managed.
- 4.49. In August 2007, prior to the introduction of new FSA rules on conflicts of interest introduced in November 2007, AFP instructed external compliance consultants to assist in relation to the management of conflicts of interest. The consultants advised AFP to document the reasons for undertaking a transaction through the unlisted cell company so that there was a clear paper trail for dealing with the conflict in a fair

manner. In spite of the clear specific advice, this was not done. Funding was provided for the Company A Acquisition from the Guernsey cells through the unlisted cell company in August and October 2007.

- 4.50. No mention is made of the size of the fee paid to AFP in relation to the Company A Acquisition, even in a conflicts file note created by AFP, after the commencement of the FSA's investigation, to explain to the FSA conflicts management at AFP during the Relevant Period (the "January 2010 Conflicts File Note"). There is no mention in the section entitled "Specific Examples of Conflicts Management", in which the Company A Acquisition is referred to. This material fee being paid to AFP indirectly from the Guernsey cells is a significant and obvious conflict. A fair explanation would highlight the fee paid to the investment manager as one of the conflicts to be managed and would set out the amount of the fee. The January 2010 Conflicts File Note also down-plays Mr Farrell's role in the transaction; it states that Mr Farrell was appointed as a non-executive, unpaid director of Company A after the Company A Acquisition to represent the interests of the Arch investors but omits to mention that Mr Farrell was one of the original directors of Company A, and was one of the directors who approved the £3 million payment to AFP.
- 4.51. The fee of £6 million for a transaction valued at £15 million equates to an effective commission rate of 40%. Furthermore, the fee received by AFP represented 16% of AFP's total income for the year ending 29 February 2008.
- 4.52. Given the significant experience of AFP's managers and the clear and obvious conflict, AFP recognised that there were significant conflict problems arising out of the transaction, but AFP recklessly failed to take appropriate steps to manage the conflict.

Investments in Cru Investment Management Limited ("Cru")

- 4.53. Around the time of the transaction in which the Guernsey cells invested into AFP's parent company AGL, just after the Guernsey cells were incorporated, the Guernsey cells also made debt and equity investments in AFP's major business associate, Cru, which exclusively marketed and distributed the UK Funds and some of the Guernsey cells. Over time, these investments amounted to £3.38 million. Cru's income (which materially affected the value of Cru) came from a series of distribution agreements

with AFP under which Cru's income was determined by the volume of investment brought into the UK Funds and into certain Guernsey cells. Cru's directors were also members of an AFP committee which discussed investments to be made by the UK Funds and at Guernsey cell level.

- 4.54. Fees earned by AFP as investment manager were based on the value of AFP's funds under management. By Cru performing its obligations under the distribution agreements, encouraging investment into the UK Funds and certain Guernsey cells and thereby increasing the funds under AFP's management, AFP stood to gain from increased management fees and the opportunity to earn greater fees for structuring transactions with those funds. Additionally agreeing to invest the Guernsey cells' funds in Cru improved AFP's ability to negotiate favourable distribution terms with Cru.
- 4.55. In January 2007 the Guernsey cells were launched. On 13 February 2007 (the date on which the distribution agreement between AFP and Cru was entered into) the Guernsey cells provided finance to Cru for £480,000 worth of A shares in Cru at £1 per share (equating to a 6.78% stake of the voting shares). On this basis, Cru would have been effectively valued at around £7 million at this time. As at 30 April 2007, the £480,000 invested by the Guernsey cells represented 99.8% of the share capital and share premium of Cru, yet the Guernsey cells held just 6.78% of the voting shares (and the associated rights to dividends). The Guernsey cells also provided the first tranche of debt funding of £780,000 on 14 February 2007.
- 4.56. This transaction meant that although the Guernsey cells had contributed the substantial majority of the actual share capital of Cru, they only had a small minority of the voting, ownership and dividend rights.
- 4.57. Further, following the first tranche of debt funding (in the amount of £780,000), which the non-AFP Guernsey cell directors were made aware of, the loan facility increased to over £3.5 million through the Relevant Period, but the non-AFP Guernsey cell directors were not informed of this increase.

Management of the conflict of interest: Documentation and disclosure

- 4.58. AFP recognised that there was a conflict in the Guernsey cells investing in Cru, given the commercial relationship between AFP and Cru. On 14 February 2007 (the day after the equity investment had taken place) AFP sent the Cru deal documentation to the Guernsey cell directors but omitted to inform the AFP Guernsey cell directors of the full picture as there is no record of the Guernsey cell directors being informed of the fact that the Guernsey cells were effectively providing all the finance for Cru.
- 4.59. With regard to the debt investments, the non-AFP Guernsey cell directors were not informed of the substantial increases in debt funding provided by the Guernsey cells to Cru, until after the Guernsey cells had provided that funding.
- 4.60. Information in respect of the Guernsey cells' initial debt investments in Cru was provided to the directors of the Guernsey cells (again, after the event). However there is no evidence that the directors were consulted on the subsequent material loan notes. This was despite the facility significantly increasing from £780,000 in February 2007 to over £3.5 million in February 2009.
- 4.61. Although AFP prepared a note for its senior management, recording that there could be the "*perception*" of a conflict of interest, this note was not actually created until March 2007, after the transaction was completed. The ICP for AFP's Investment Committee in respect of the Cru transaction included some considerations of conflicts but was not prepared until 26 July 2008.
- 4.62. The January 2010 Conflicts File Note which was prepared for the FSA after the commencement of the FSA investigation in January 2010 in respect of this transaction states "*The percentage of Cru acquired was small (~6%) and achieved at a cheap price at the time*".
- 4.63. AFP caused the Guernsey cells to invest in Cru, which transaction benefited AFP's business partner. This would also have had the effect of improving AFP's ability to negotiate favourable terms with Cru in the distribution agreement. However, AFP recklessly failed effectively to manage the conflicts arising out of this transaction.

Investments in Company B

- 4.64. The Guernsey cells made debt and equity investments to the value of £6.4 million to a third party company, Company B, in which AFP's parent company and associates had shareholdings and other interests (for instance Mr Farrell was the non-executive chairman of the board of Company B).

Equity Investments

- 4.65. Certain Arch entities, the Guernsey cells and the directors of Company B entered into a Property Advisory Agreement dated 21 September 2007 whereby AGL and the Guernsey cells invested in the equity of Company B. Under this Property Advisory Agreement:

- (1) certain Guernsey cells would purchase 15% of Company B from Company B's directors at a cost of £3.75 million;
- (2) AGL shareholders would obtain 5% of Company B by swapping this with 2% of AGL's shares;
- (3) An affiliate of AGL, which acted as nominee holder for AGL, paid £1 for equity warrants in Company B; and
- (4) AGL would share property management fees with Company B, arising from properties owned directly or indirectly by those Guernsey cells investing into Company B.

- 4.66. There were a number of obvious conflicts of interest arising from the transactions with Company B:

- (1) The Guernsey cells paid £237.49 per share (£3.75 million) to acquire an equity stake in Company B. The Company B valuation which set this price was based on Company B's own profit forecasts, which were not independently verified;
- (2) AGL obtained its shareholding in Company B through a share swap. In order to obtain 5% of Company B, AGL's shareholders swapped 2% of AGL's equity. The AGL valuation was prepared by AFP and was not

independently verified. Therefore the share swap was carried out on the basis of two non-independent valuations. While the price per share paid by AGL to Company B was the same as that paid by the Guernsey cells, the Guernsey cells paid cash for their shareholding and therefore provided capital to Company B, whereas AGL on the other hand paid in illiquid shares in itself, a private company which had not been independently valued.

- (3) As noted above, under the Property Advisory Agreement, an affiliate company of AGL obtained equity warrants in Company B for £1, which it held as nominee for AGL. However, this affiliate subsequently sold these warrants to the Guernsey cells for £50,000. The ICP prepared in respect of the Guernsey cells' purchase of these warrants identified a conflict of interest arising as a result of AGL being the seller, but it did not mention the amount that AGL was set to gain from the Guernsey cells from this transaction. The ICP stated that the price of the warrants was "*clearly favourable*" to the Guernsey cells, despite the lack of independent valuation for these warrants as it was Mr Farrell, the majority shareholder in AGL, who recommended the price at which the warrants should be sold to the portfolio managers. The price led to a profit, in cash, of £49,999 for AGL/its affiliate.
- (4) Under the Property Advisory Agreement, AGL was entitled to receive 50% of the management fees of properties that were purchased by the Guernsey cells (through various special purpose vehicles) and subsequently managed by Company B. AGL would benefit from the management fees if the Guernsey cells' adviser, an affiliate of AFP, advised the Guernsey cells to purchase properties recommended by Company B rather than by third parties who made recommendations to the Guernsey cells.

Debt

- 4.67. By March 2008, Mr Farrell had been appointed as a board member of Company B. Despite receiving warnings from this date onwards about Company B's financial difficulties, AFP continued to arrange for one of the Guernsey cells to make further loans to Company B.

- 4.68. In November and December 2008, debt investments were made by a different Guernsey cell. This potentially benefited AGL, as a shareholder in Company B, as well as the other two Guernsey cells, who were also shareholders in Company B, but there is no evidence that this course of action benefited the Guernsey cell making the debt investment. This conflict was not considered or documented by AFP.

Management of the conflict of interest: documentation and disclosure

- 4.69. No steps were taken by AFP to prevent the conflict of interest between its parent's interests and those of the Guernsey cells (for example, in earning the management fees under the Property Advisory Agreement) giving rise to damage to the interests of the Guernsey cells. Although a conflict of interest was acknowledged in one of the later ICPs there is no evidence that the conflicts were properly managed at the time.
- 4.70. With the exception of a loan facility agreement of £850,000 approved in November 2008, none of these investments were disclosed to and approved by the non-AFP directors of the Guernsey cells, despite the significant and obvious conflicts arising out of the investments in Company B.
- 4.71. The Guernsey cells' investments in Company B were not recorded in AFP's Investment Committee minutes until 2009, although elements of the transactions were recorded in a note setting out AFP's review in September 2008 of potential conflicts arising from Guernsey cell investments where it also held a stake. In respect of the equity investment the mitigation set out in this document is that "*AGL and Fund dealt on same terms. No cherry picking or optionality in favour of either party*". While it is the case that both the Guernsey cells and AGL paid the same price per share, the Guernsey cells paid £3.75 million cash for their investment, whereas AGL provided equity in itself (being unlisted shares in a private company) based on a non-independent valuation. This was not highlighted in the conflict record, particularly in the section dealing with mitigation or management of conflicts.
- 4.72. A "*Conflicts of Interest File Note*" was produced in respect of the initial transaction in Company B. This identified a conflict of interest arising as a result of the Guernsey cells and AGL co-investing in Company B and listed a number of mitigating factors. However, this note was not created until 23 February 2009.

- 4.73. In these transactions, AFP put its own interests ahead of the Guernsey cells' interests and AFP, being aware of the risk, recklessly failed effectively to manage the many conflicts arising out of the transactions.

Separation of decision making between the UK Funds and Guernsey cells

- 4.74. Prior to December 2008, when separate Investment Committees were formed to manage the UK Funds and Guernsey cells, the same individuals were involved in making investment decisions at both UK Funds level and at Guernsey cell level. This meant that there was no effective safeguard against the risk of sharing of confidential information and knowledge between those involved in making investment decisions for one set of AFP's clients at UK Funds level and those involved in making investment decisions for another set of AFP's clients at Guernsey cell level. There was a risk that individuals who were involved in making decisions at both levels, when making decisions at UK Funds level, had knowledge of non-public information about the Guernsey cells which other external investors in the Guernsey cells, and the market in general, did not possess. In addition, AFP provided the Guernsey cells' market maker with indicative prices at which it would be prepared to buy and sell shares in the Guernsey cells.
- 4.75. While external investors would only have known the net asset value ("NAV") of the Guernsey cells as published on the CISX, AFP individuals had access to more up to date information in respect of the detail which supported the NAV. There was a risk that this additional information would enable AFP to make more informed decisions on behalf of the UK Funds. AFP placed those individuals responsible for making investment decisions for the UK Funds and providing indicative prices to the market maker of the Guernsey cells in the position of having to disregard the non-public information about the Guernsey cells in carrying out their duties for the UK Funds. This was not appropriately controlled.
- 4.76. The Guernsey cells were set up as independent closed-end investment companies, listed on the CISX, which were intended to be marketed to external investors from at least 13 February 2007. The external investors' interests were not necessarily the same as the UK Funds' interests. AFP should have recognised and managed the conflict between the interests of the Guernsey cells (and their shareholders) and the

UK Funds from the outset, by having appropriate procedures in place to ensure that the investment decision making for both sets of funds was entirely separate.

Compliance Management

- 4.77. During the course of the Relevant Period, the UK Funds grew from two sub-funds to six sub-funds, staff numbers increased from 11 in July 2006 to 61 in November 2008 and the total value of funds under management reached £645 million in September 2008, increasing the potential for conflicts and increasing the complexity and volume of potential regulatory and compliance risks. This generated significant risks to AFP's business and to the UK Funds in terms of ensuring that adequate compliance procedures and conflicts controls were in place.
- 4.78. Compliance monitoring at AFP was generally informal and lacked a documented structure throughout most of the Relevant Period. There was no comprehensively documented monitoring programme in place until November 2008. Instead, between 2006 and November 2008, Mr Addison as the compliance officer conducted informal monitoring when he thought this was necessary. Although these informal steps may have been a useful component of a monitoring plan, they should have been conducted alongside more formal and procedural monitoring with a clear audit trail of work carried out and the results of that monitoring. This is particularly important given the compliance risks and the nature, scale and complexity of AFP's business, in order to ensure that the procedures were adequate to detect any risk of failure by the Firm.
- 4.79. Compliance monitoring results were not properly recorded and AFP's records do not demonstrate that adequate reporting of such monitoring to senior management took place. If such monitoring had been effectively carried out, it may have identified deficiencies in AFP's management of conflicts of interest.
- 4.80. Further, prior to August 2008 there is insufficient evidence to demonstrate that AFP effectively and regularly discussed the compliance issues that affected the Firm and/or the funds at senior boards or committees. This was particularly important given the increasing complexity of potential regulatory and compliance risks over time.

5. FAILINGS

- 5.1. The regulatory provisions relevant to this Decision Notice are referred to in Appendix 2.
- 5.2. By reason of the facts and matters set out above, AFP's conduct demonstrated a lack of integrity contrary to Principle 1. AFP recklessly failed to manage conflicts of interests between itself and associated entities and its clients. AFP directed the Guernsey cells to enter into four transactions in respect of which it was aware that there was a risk that AFP or its associates would benefit, to the detriment of the Guernsey cells, and AFP recklessly failed to manage and adequately record the conflicts arising from these transactions.
- 5.3. AFP should have ensured that it was fully transparent about the extent and nature of AFP and its associates' interests in the transactions, for example by disclosing to the Guernsey cells' non-AFP directors sufficient information, prior to the transactions taking place, to enable them to give informed consent to the transaction taking place. AFP should have sought independent valuations in respect of the four transactions. The management of the conflicts of interests in these transactions should have been adequately documented, with transparency on the nature of the risks and a record of how the Firm reached a decision on the transaction.
- 5.4. By reason of the facts and matters set out above, AFP breached Principle 2 by failing to conduct its business with due skill, care and diligence. In particular, AFP failed to ensure that the UK Funds' scheme property aimed to provide a prudent spread of risk, because AFP adopted an allocation strategy of investing a majority of the UK Funds' assets into the Guernsey cells for which there was a limited secondary market. AFP did not properly manage the inherent liquidity risks arising from this strategy, for example by investing in readily realisable cash or cash equivalent investments. Investors were therefore exposed to the risk that the UK Funds would not be able to liquidate their holdings in the secondary market to meet redemption requests, a risk which crystallised in March 2009 resulting in the suspension of the UK Funds.
- 5.5. By reason of the facts and matters set out above, AFP breached Principle 3 by failing to implement appropriate control structures and compliance arrangements as were appropriate to its business and by failing to have adequate risk management systems

in place in relation both to its role as investment manager to the UK Funds and its role as investment manager to the Guernsey cells. In particular:

- (1) AFP failed to ensure that it had adequate systems for segregating and controlling the Firm's access to and use of non-public information about the Guernsey cells. Prior to December 2008, the same individuals were in charge of making investment decisions at both UK Funds level and at Guernsey cell level. This meant that there was no effective safeguard against the risk of information being shared between those involved in making investment decisions at UK Funds level and those involved in making investment decisions at Guernsey cells level. Given that AFP was marketing the Guernsey cells to external investors from at least February 2007, AFP should have had Chinese wall segregation in place from the outset to manage the risk of non-public information being used by decision makers for the UK Funds; and
- (2) AFP failed to have effective compliance monitoring procedures in place and failed to ensure that the results of compliance monitoring were adequately recorded and reported to senior management. AFP should have had a formal compliance monitoring programme, given the complexity of AFP's business and the risks it faced.

5.6. By reason of the facts and matters set out above, AFP breached Principle 8 by failing to manage conflicts of interest in that its general conflict management procedures were deficient and led to the risk of inappropriate transactions taking place. In particular AFP failed to have a formal conflict procedure which provided for adequate review of the documented conflicts within the Firm. Given the potential conflicts inherent to the structure and the complexity of AFP's business:

- (1) there should have been a formal conflict framework which provided for independent review of documented conflicts within the Firm, especially given the extent of senior management's personal involvement in the conflicted transactions;
- (2) AFP should have ensured that there was explicitly and contemporaneously recorded consideration of conflict risk within the decision-making structure

at a transactional level, particularly given that specific advice was provided to AFP on these terms in August 2007. The management of the conflict of interest in transactions needed to be adequately documented, with transparency as to the nature of the risks being run, with a record of how the Firm reached a decision on the transaction;

- (3) in the event that conflicts were being managed by disclosure to relevant parties, AFP should have ensured that these parties were provided with full and sufficient information, prior to the transaction taking place, to enable them to give informed consent to the transaction taking place, and maintained a record of such disclosures; and
- (4) from 1 November 2007, AFP should have ensured that there was an adequate written conflicts policy in place (as required by SYSC 10) and that records kept in accordance with this policy were accessible (as required by SYSC 9.1.3).

5.7. During the Relevant Period AFP also breached certain COB and SYSC rules, set out in Appendix 1, in particular in relation to conflicts of interest and compliance procedures.

6. SANCTION

6.1. The FSA's policy on the imposition of financial penalties and public censures is set out in Chapter 6 of the FSA's Decision Procedure & Penalties Manual ("DEPP"), which forms part of the FSA Handbook and came into force on 28 August 2007. It was previously set out in Chapter 13 of the Enforcement Manual ("ENF"). The FSA has had regard to both DEPP and ENF as both manuals applied at separate times during the Relevant Period. Both manuals set out the factors that may be of particular relevance in determining whether it is appropriate to impose a financial penalty. The criteria are not exhaustive and all relevant circumstances of the case will be taken into consideration.

6.2. For the reasons set out above, the FSA considers that AFP breached Principles 1, 2, 3 and 8 and several COB and SYSC rules. In determining that a public censure is

appropriate and proportionate in this case, the FSA has considered all the relevant circumstances. The FSA considers the following factors to be particularly important:

Deterrence

- 6.3. The principal purpose of a public censure is to promote high standards of regulatory conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches and demonstrating generally the benefits of compliant behaviour.

The nature, seriousness and impact of the breach

- 6.4. In determining the appropriate sanction, the FSA has had regard to the seriousness of the contraventions, including the nature of the breaches, the number and duration of the breaches, and the number of customers who were exposed to the risk of loss and the funds under management by AFP. The FSA considers that the breaches identified in this case are of a serious nature.
- 6.5. In particular, it is noted that AFP was the investment manager for assets under management in the UK Funds and the Guernsey cells totalling approximately £645 million at their peak. The FSA is also mindful of the fact that AFP earned approximately £42 million in the financial years covering the Relevant Period.

The extent to which the breach was deliberate or reckless

- 6.6. In relation to AFP's behaviour in breach of Principle 1, the FSA considers that AFP recklessly contravened regulatory requirements.

The size, financial resources and other circumstances of the person on whom the penalty is to be imposed

- 6.7. The FSA has taken into account the financial resources of AFP.
- 6.8. Although AFP was a relatively small firm, the size of the assets it managed meant that its failings had an extensive impact. It is noted that AFP does not have sufficient resources to pay a financial penalty and may in any event be subject to claims from potential future creditors. It is also noted that AFP does not have sufficient resources

to contribute to a redress package for investors who have suffered losses from their investments in the UK Funds.

Conduct following the breach

- 6.9. Pursuant to a voluntary variation of its FSA permissions in April 2009, AFP has agreed not to perform regulated activities without the FSA's prior written approval.

Disciplinary record and compliance history

- 6.10. AFP has not previously been the subject of disciplinary action by the FSA.

Other action taken by the FSA

- 6.11. In determining the level of financial penalty which would have been imposed on the Firm, but for its financial condition, the FSA has taken into account penalties imposed by the FSA on other authorised persons for similar behaviour. However, the FSA has also had regard to the principal purpose for which it imposes sanctions, namely, to promote high standards of regulatory conduct.

Conclusion

- 6.12. Taking into account the seriousness of the breaches and the risks they posed to the FSA's statutory objectives of market confidence and the protection of consumers, but for the financial condition of AFP, the FSA would otherwise have decided to impose a financial penalty of £9 million. Taking into account the financial condition of AFP, the FSA has decided to publish a statement that AFP has contravened regulatory requirements.

7. REPRESENTATIONS AND FINDINGS

- 7.1. Below is a brief summary of the key written and oral representations made by AFP and how they have been dealt with. In making the decision which gave rise to the obligation to give this Decision Notice, the FSA has taken into account all of AFP's representations, whether or not set out below.

Breaches

- 7.2. AFP made representations that it had not breached any of the FSA's rules or principles. In particular, AFP denied breaching Principle 1, and stated that neither Mr Farrell nor Mr Addison had acted with a lack of integrity.
- 7.3. The FSA has found that AFP did breach the FSA's rules and principles, as set out in this Decision Notice, including breaching Principle 1 by acting with a lack of integrity.

Liquidity and spread of risk

- 7.4. AFP made representations that:

- (1) the investment strategy of allocating the majority of the UK Funds' investment to the Guernsey cells did not have 'inbuilt liquidity risks'. Any strategy would have liquidity considerations, but AFP recognised the need to provide adequate liquidity, and did so. AFP reasonably considered that it was in the best interests of the UK Funds to allocate significant scheme property into the transferrable securities of the Guernsey cells which were set up for that purpose and provided diversified and differentiated exposure to a broad spectrum of assets. The UK Funds and Guernsey cells also had investment limits which ensured that risk was spread. The setting up of the structure did not display a lack of due skill, care and diligence. It was adopted and implemented following careful planning and consideration, including professional advice given to AFP. The structure was made known to the ACD and the FSA, who raised no objections. It fully complied with the requirements of COLL and all other relevant rules;
- (2) the secondary market trading of the Guernsey cells was not limited. The CISX is a recognised market, there was material trading of the Guernsey cells by third parties, and it was growing over time. Besides the secondary market, the Guernsey cells also increased liquidity by issuing new shares from time to time. Only the inappropriate use of hindsight in the wake of the global financial crisis supports an allegation of failing to

aim to provide a prudent spread of risk. The severity of the crisis was not a known risk in advance, even if the crisis itself was. Any issues were exaggerated by the advent and impact of the global financial crisis and by a massive reduction in the availability of generally available external investment and a connected contraction in liquidity;

- (3) the risk that the UK Funds may not be able to liquidate their holdings in the Guernsey cells in the secondary market to meet potential redemption requests had been considered, and was prudently managed, by AFP. The risk never crystallised and was still capable of proper and effective management at the time immediately prior to suspension. That would have remained the case had the UK Funds not been suspended. There was sufficient liquidity to allow the funds to continue trading and plans to manage liquidity proactively were being formulated and reviewed on a constant basis from late August 2008, following the extreme currency movements at that time. The suspension was not supported by AFP and was not warranted as other avenues were available to generate sufficient cash within the UK Funds to meet any potential redemption requests. These included the sale of assets at the UK Fund or Guernsey cell level as well as injections of new capital at both levels; and
- (4) at all times AFP aimed to provide a prudent spread of risk and, as far as it was able to, it achieved this aim.

7.5. The FSA has found that:

- (1) Although the broad nature of the investment objectives and prospectuses of the UK Funds allowed direct investment in transferable securities such as those of the Guernsey cells, the investment strategy adopted by AFP plainly did have inbuilt liquidity risks, as it involved concentration of funds in the Guernsey cells. The fact that the structure was known to the ACD and the FSA did not absolve AFP of its responsibility to aim to provide a prudent spread of risk. The substantial and continuing investment of the UK Funds in the Guernsey cells indicates that AFP did

not seek to ensure that the UK Funds held diversified assets with varying exposures to liquidity risk;

- (2) the Guernsey cells' shares had few other investors and a limited and, for some Guernsey cells, completely untested secondary market and a primary market that did not demonstrate sufficient additional demand related to the liquidity needs of the UK Funds. Although the severity of the financial crisis may not have been anticipated, this did not affect the fact that the strategy adopted by AFP did not aim to provide a prudent spread of risk;
- (3) AFP did not take reasonable steps to manage liquidity and cash levels in the UK Funds, and its response to falling cash balances and market instability did not display due skill, care and diligence. There was an insufficient cash buffer and the potential sources of additional liquidity were insufficiently certain and/or sizeable to generate sufficient liquidity as and when required. The liquidity risk did crystallise – the FSA has seen no evidence that the suspension of the UK Funds was unwarranted; and
- (4) in all the circumstances AFP failed to aim to provide a prudent spread of risk.

Management of conflicts of interest

7.6. AFP made representations that:

- (1) AFP was always conscious of conflicts of interest issues and maintained effective oversight and management of the risk of conflicts of interest in accordance with the applicable rules and principles. AFP always endeavoured to deal with conflicts appropriately and fairly. AFP maintained written records of conflict management appropriately, and had compliance manuals and arrangements in place throughout the Relevant Period. These were adhered to;

- (2) no poor or unsuitable investment decisions had been made as a result of conflicts of interest (or at all). No causal link had been (or could be) established between AFP's alleged failings and the losses suffered by investors. Therefore the risk alleged had to be regarded as effectively managed;
- (3) AFP never put its interests above the interests of investors. It only took investment decisions where the investment objectives and policies of the UK Funds and sub-funds warranted it, and in accordance with AFP's contractual and regulatory obligations. Any potential benefit received by AFP or its associates was incidental to the proposed benefit to the Guernsey cells and any risk of a conflict was carefully considered before any investment decision was actioned. AFP would not have given the substantial rebates to clients that it did, if it had been motivated to act in its own interests at the expense of its clients;
- (4) where AFP directed the Guernsey cells to invest in entities in which AFP or its associated entities had an interest, AFP carefully considered its obligations and ensured that any conflict was effectively managed, for instance by ensuring valuations were prudently calculated, disclosures of interests were made, and/or Mr Farrell and Mr Addison did not take part in the investment decisions concerned;
- (5) there was a clear alignment of interests or 'community of interest' from the outset between the Guernsey cells and the UK Funds, since the Guernsey cells were set up specifically to implement the UK Funds' strategic asset allocation and investment strategy. The Guernsey cells were essentially just an investment wrapper - any benefit to the Guernsey cells was a benefit to the UK Funds;
- (6) although for much of the Relevant Period there was no single document or table labelled as a centralised conflicts register, conflicts were properly and appropriately recorded and recognised in a variety of documents, and the relevant information could always be found as needed. Taken as a whole this system was sufficient for AFP to meet its

regulatory obligations. Further, in mid-2008 AFP introduced a firm-wide risk matrix;

- (7) not all conflicts were required to be recorded. Potential conflicts were always taken into account, even if not explicitly documented – for instance, where they were a recurring feature of transactions. Disclosure where warranted was made appropriately, even if the records only summarised it. Further, where any documents were created after the event, this was only done based on existing sources of prior or contemporaneous information and the recollection of those involved and/or confirmation by them. Conflicts were always managed at the time - a delay in the recording of a conflict did not affect the management of that conflict; and
- (8) AFP's discretion under the investment management agreements meant that it was not required to, for instance, disclose information to the Guernsey cell directors even where a conflict existed. Where it did so this was because it chose to, not because it was required to.

7.7. The FSA has found that:

- (1) as set out in this Decision Notice, AFP did not manage conflicts of interest fairly. Its records and arrangements with regard to conflicts of interest were inadequate;
- (2) irrespective of whether poor or unsuitable investment decisions were made, or losses caused, as a result, AFP's failure to manage conflicts of interest fairly constituted a serious breach of its regulatory obligations;
- (3) simply because a given transaction has a commercial rationale does not mean that any conflicts of interest have been fairly managed. Further, the partial rebating of fees over time is not an answer to a conflict of interest relating to fees. A subsequent rebate does not cleanse an initial conflict of interest, and cannot constitute fair management of a conflict if the transaction should not have been carried out in the first place;

- (4) as set out in this Decision Notice, AFP repeatedly failed to manage conflicts of interest fairly, including failing to obtain independent valuations where these were necessary, failing to make full disclosure to the Guernsey cell directors as appropriate, and allowing Mr Farrell and/or Mr Addison to be involved in making investment decisions where this was inappropriate;
- (5) the ‘community of interest’ between the Guernsey cells and the UK Funds was insufficient to constitute or ensure fair management by AFP of conflicts. The mere fact of a broad alignment of interests does not exclude the possibility of conflicts occurring, and does not mean that conflicts will be managed fairly. Even if the Guernsey cells were just ‘wrappers’, this does not mean that AFP could not have acted in its own interests to the detriment of investors. Further, the interests of the Guernsey cells and the UK Funds were no longer aligned once there were external investors in the Guernsey cells;
- (6) during the Relevant Period AFP did not have a centralised record of conflicts information whereby the information was readily accessible, and other documents were not used consistently to record conflicts;
- (7) conflict notes were not always created including where, in the view of the FSA, they should have been. The recording of conflicts is an important aspect of conflict-management as it enables a firm not only to demonstrate that it has actively managed conflicts in an appropriate manner but also to manage those identified conflicts over time. AFP’s approach to creating documents after the event ran the risk of undue reliance on individuals’ subjective recollections and judgment. In any event, on the basis of the records available, the FSA considers that AFP did not manage all conflicts contemporaneously; and
- (8) while AFP may have had discretion under the investment management agreements to make investment decisions, FSA-authorised firms cannot contract out of their conflict management and conflict recording obligations.

Specific transactions

7.8. In relation to all four transactions, AFP made representations that:

- (1) it accepted that there was a risk of potential conflicts, which had been recognised at the time, but maintained that such risk and any potential conflicts were managed fairly and in accordance with its regulatory obligations;
- (2) neither it nor any related person or entity stood to make gains ‘at the expense of’ the Guernsey cells – the Guernsey cells received full value for their investments. Each of the transactions was entered into properly and in accordance with the investment objectives and policies of the UK Funds and the Guernsey cells concerned, and in accordance with the relevant rules and principles;
- (3) appropriate disclosure of interests had been made to the Guernsey cell directors in relation to each transaction, although this may not always have been recorded in writing; and
- (4) in each case the decision to invest had been taken by the appropriate persons - such as the portfolio managers – not by Mr Farrell or Mr Addison.

7.9. The FSA has found that:

- (1) the transactions involved not just a risk of potential conflicts of interest, but actual conflicts of interest which were not fairly managed;
- (2) as a result of AFP’s failure to manage conflicts fairly, there was a clear risk that AFP and/or related persons would make gains at the expense of the Guernsey cells. The fact that the transactions may have had a commercial rationale and been entered into in accordance with the appropriate objectives and policies did not mean that conflicts were managed fairly. The conflicts identified in this Decision Notice were not fairly managed, and AFP therefore breached relevant rules and principles;

- (3) in relation to each of the transactions, as set out in this Decision Notice, disclosure of all relevant facts was not made to the Guernsey cell directors as appropriate; and
- (4) in relation to each of the transactions, as set out in this Decision Notice, Mr Farrell and Mr Addison were involved in the decision to invest.

AGL Shares

7.10. AFP also made representations in relation to this specific transaction that:

- (1) it disclosed all relevant facts to the Guernsey cell directors. By March 2007 the Guernsey cell directors were aware that Mr Farrell was the seller of some of the shares, and knew the basis of the valuation, and they did not raise any objections at the time or subsequently; and
- (2) the valuation provided by Mr Farrell was reasonable and supported by the financial condition and results of AGL. Further, it was supported by a third party valuation. An independent valuation was therefore not necessary, and would have been a waste of money by the Guernsey cells, especially when the sale by Mr Farrell was at the same price as the acquisition of new equity by the Guernsey cells. The level of stamp duty was known and was not material.

7.11. The FSA has found that:

- (1) there are limited records of the disclosure made to the Guernsey cell directors. On the basis of the relevant material, the FSA considers that the Guernsey cell directors were not made aware of all relevant facts, including that Mr Farrell was a seller of AGL shares and that he had provided the valuation; and
- (2) the price of the shares was based on the valuation produced by Mr Farrell who was the principal beneficiary of each share sale. The third party valuation was based on information provided by AFP, and produced later, and therefore could not have influenced conflict management at the time. In light of the two serious conflicts arising from

the transaction, an independent valuation should have been obtained. Further, the stamp duty was a relevant consideration.

Investments in Company A

7.12. AFP also made representations in relation to this specific transaction that:

- (1) its role, for which it was paid a fee, was to seek to reduce the purchase price paid. AFP was successful in doing so;
- (2) the Guernsey cell directors were made aware of all relevant facts, including regarding AFP's fee; and
- (3) it followed the advice of the external compliance consultants in relation to the recording of the conflicts of interest – ICP documents record the conflict management considerations.

7.13. The FSA has found that:

- (1) the relevant material does not support the £21m valuation, and the basis of AFP's £3m fee is unclear;
- (2) the Guernsey cell directors were not made aware of all relevant facts. In particular, there is no record of them being informed of the amount of AFP's fee; and
- (3) AFP did not adequately follow the advice of the external compliance consultants. AFP did not record the rationale for the structuring of the transaction, or any consideration of the wider conflict of interest issues as opposed to the commercial rationale for the transaction.

Investments in Cru

7.14. AFP also made representations in relation to this specific transaction that:

- (1) it was not required to inform the Guernsey cell directors each time the loan facility was increased. AFP exercised its discretion appropriately; and

- (2) investments in Cru did not increase the funds under management on the basis of which AFP's fees were calculated.

7.15. The FSA has found that:

- (1) the decision to significantly increase debt investment without recourse to the Guernsey cell directors gave rise to further conflicts of interest that needed to be managed. Further, the later debt investments were on different terms; and
- (2) there was the potential for investments in Cru to grow the UK Funds, the size of which determined AFP's fees, thus presenting the risk of a conflict.

Investments in Company B

7.16. AFP also made representations in relation to this specific transaction that:

- (1) there was no requirement for profit forecasts to be independently verified to be relied upon. The valuations used were reasonable, and AFP rejected the assertion that independent valuations should have been obtained. These would have cost the Guernsey cells money and would have been unnecessary;
- (2) AFP never took any increased property management fees; and
- (3) the further investment by the Guernsey cell was beneficial for both the Guernsey cell investing and to protect the existing investment of other Guernsey cells as it gave Company B capital with which to turn its business around.

7.17. The FSA has found that:

- (1) the valuation based on Company B's own unverified profit forecasts was inadequate in the circumstances. Taking into account the clear conflict, independent figures should have been obtained;

- (2) the fact that AFP did not take any increased fees does not mean that the conflict was fairly managed at the time; and
- (3) AFP did not manage the conflict between the investing Guernsey cell and those Guernsey cells that had already invested. There was a clear risk to the funds of the investing Guernsey cell, which was not already invested in Company B.

Separation of decision making

7.18. AFP made representations that:

- (1) its investment decision making structure was not flawed. It did not accept that the decision making processes had to be entirely separate; AFP was only required to ensure that no information was used inappropriately in investment decisions and any conflicts were managed fairly. It had appropriate systems and controls in place which were capable of managing the remote risk that existed. Where individuals had material non-public information they considered it and never used that information improperly. When the risk grew in the third quarter of 2008, AFP took clear and formal steps and introduced Chinese walls to effectively manage the risk; and
- (2) in any event, deals were only carried out where there was a clear rationale for them and they were in line with the investment strategy.

7.19. The FSA has found that:

- (1) AFP's process was insufficient – in particular, relying on those individuals who had material non-public information about the Guernsey cells, and who made investment decisions on behalf of the UK Funds, not to use that information in their investment decisions was an inadequate process. AFP was therefore exposed to the risk that its decisions as investment manager to the UK Funds could be influenced by its access to material non-public information. AFP did not begin to address this issue until late 2008 and even at that time there remained a

number of individuals ‘over the wall’ i.e. individuals with material non-public information about the Guernsey cells who were involved in making investment decisions on behalf of the UK Funds; and

- (2) the rationale given in the deal tickets and the fact that the share sales and purchases were within the broad and high-level strategic asset/risk allocation of the particular funds do not demonstrate whether material non-public information was used – these matters therefore could not have assisted AFP in concluding that material non-public information was not being used in making investment decisions on behalf of the UK Funds.

Compliance monitoring

7.20. AFP made representations that:

- (1) the compliance monitoring undertaken by it during the Relevant Period was not inadequate in any material fashion. Its risk compliance monitoring was risk-responsive and tailored to the specific needs of AFP throughout the Relevant Period. Mr Addison undertook regular monitoring alongside more ad hoc monitoring and review as needed. This included the monitoring of all financial promotions, compliance with COLL, and awareness and appropriateness of the conflicts of interest policy;
- (2) the allegation that there was no documented compliance monitoring programme in place until November 2008 was incorrect – there was such a programme which was in place and adhered to. There was a formal written compliance monitoring programme in place throughout the Relevant Period. Although not all elements of it were fully implemented, there was substantive compliance with that programme;
- (3) compliance results were sufficiently recorded and reported to senior management. The senior management team at AFP was relatively small and most of the team were involved in the consideration of conflicts matters. The need for evidencing formalised reporting measures was

therefore reduced. Compliance was a standing agenda item at board meetings and senior committee discussions and when there was a topic warranting a discussion this would be discussed; and

- (4) records were made appropriately throughout the Relevant Period, albeit not in one centralised location. All staff knew the procedures and how to access all relevant information as necessary.

7.21. The FSA has found that:

- (1) the monitoring procedures in place were not adequate to detect the relevant compliance risks given the nature, scale and complexity of AFP's business. In particular, AFP did not operate a formal compliance monitoring programme for most of the Relevant Period and instead sought to rely on informal and ad hoc measures. The examples given of monitoring by Mr Addison are limited in number and scope. They do not demonstrate a sufficient programme;
- (2) there was a Compliance Procedures Manual in place from February 2008 but it was not adhered to until November 2008, and then only in part. In the case of a complex business such as AFP, a detailed and documented compliance monitoring programme is required at all times to ensure that critical risks are identified and managed in accordance with the relevant regulatory obligations. Without it AFP did not have the necessary structural controls in place to identify, mitigate and manage the risks inherent in its business;
- (3) compliance related matters may have been discussed to some extent, however the results of the monitoring conducted, and the subsequent risks and issues that affected the Firm over time, were not reported; and
- (4) AFP's lack of a centralised records system, as well as the inconsistent use of documents to record compliance matters, meant that information was not always readily accessible.

Sanction

7.22. AFP made representations that:

- (1) it consistently acted in accordance with its contractual and regulatory obligations. Even if the alleged failings had occurred, which was denied, they had not had a significant impact on AFP discharging its obligations. In particular, there was no allegation that AFP actually caused or contributed to any actual losses to investors, as a result of the failings alleged. Further, and as a result, the total number of investors was not relevant to the seriousness of the matters alleged. Therefore even on the basis of the FSA's allegations against AFP, which were denied, the notional penalty was disproportionate;
- (2) to the extent that the FSA found there to have been failings on the part of AFP, it should be recognised that AFP had not acted in a predatory way and had always tried to grapple with issues and act fairly, such as in its rebating of millions of pounds of fees; and
- (3) taking into account the sanctions imposed by the FSA on other firms in previous cases, the notional penalty against AFP was too high.

7.23. The FSA has found that:

- (1) as set out in this Decision Notice, AFP's failings were very serious. Further, they include integrity issues. Key risks were not managed – these were not isolated instances, but constituted a pattern which persisted over a significant period of time. In addition, in the FSA's view the number of investors who could potentially have been affected by AFP's failings is a relevant factor – the large number of investors who were subject to that risk increased the seriousness of AFP's failings;
- (2) all of the relevant circumstances have been taken into account in determining the appropriate level of penalty. The FSA accepts that AFP did not breach rules and principles deliberately, and that its failings could have been more serious. However, AFP demonstrated a serious

lack of competence and, in relation to the four specific transactions, acted recklessly; and

- (3) the sanctions imposed by the FSA on other firms in previous cases have been taken into account, but are useful as a guide only. In any event, the FSA considers that the notional penalty against AFP is consistent with the penalties imposed in previous cases, taking into account the seriousness of AFP's misconduct.

Third party representations

7.24. Below is a brief summary of the key representations made by AGL, a third party identified in the reasons above and to whom in the opinion of the FSA the matter is prejudicial, and how they have been dealt with. In making the decision which gave rise to the obligation to give this Decision Notice, the FSA has taken into account all of AGL's representations, whether or not set out below.

7.25. AGL made representations that it rejected any and all insinuations of impropriety on the part of AGL.

7.26. The FSA has found that the relevant facts and matters, including those in relation to AGL, are as set out in this Decision Notice.

8. PROCEDURAL MATTERS

Decision maker

8.1. The decision which gave rise to the obligation to give this Decision Notice was made by the Regulatory Decisions Committee.

8.2. This Decision Notice is given in accordance with section 388 of the Act. The following statutory rights are important.

9. The Tribunal

9.1. AFP has the right to refer the matter to which this Decision Notice relates to the Upper Tribunal (the "Tribunal"). Under paragraph 2(2) of Schedule 3 of the Tribunal Procedure (Upper Tribunal) Rules 2008, AFP has 28 days from the date on which this

Decision Notice is given to it to refer the matter to the Tribunal. A reference to the Tribunal is made by way of a signed reference notice (Form FTC3) filed with a copy of this Decision Notice. The Tribunal's address is: The Upper Tribunal, Tax and Chancery Chamber, 45 Bedford Square, London WC1B 3DN (tel: 020 7612 9700; email financeandtaxappeals@tribunals.gsi.gov.uk). Further details are contained in "Making a Reference to the UPPER TRIBUNAL (Tax and Chancery Chamber)" which is available from the Upper Tribunal website:

<http://www.tribunals.gov.uk/financeandtax/FormsGuidance.htm>

- 9.2. AFP should note that a copy of the reference notice (Form FTC3) must also be sent to the FSA at the same time as filing a reference with the Tribunal. A copy of the reference notice should be sent to Stephen Robinson at the FSA, 25 The North Colonnade, Canary Wharf, London E14 5HS.

10. Access to evidence

- 10.1. Section 394 of the Act applies to this Decision Notice. The person to whom this Decision Notice is given has the right to access:

- (1) the material upon which the FSA has relied in deciding to give this Decision Notice; and
- (2) the secondary material which, in the opinion of the FSA, might undermine that decision.

11. Third party rights

- 11.1. A copy of this Decision Notice is being given to AGL as a third party identified in the reasons above and to whom in the opinion of the FSA the matter is prejudicial. AGL has similar rights of representation and access to material in relation to the matter which identifies it.

12. Confidentiality and publicity

- 12.1. This Decision Notice may contain confidential information and should not be disclosed to a third party (except for the purpose of obtaining advice on its contents). The effect of section 391 of the Act is that no person to whom this Decision Notice is

given or copied may publish the Decision Notice or any details concerning it unless the FSA has published the Decision Notice or those details. The FSA may publish such information about the matter to which a Decision Notice or Final Notice relates as it considers appropriate. The facts and matters contained in this Decision Notice may therefore be made public.

13. FSA contact

- 13.1. For more information concerning this matter generally, contact Stephen Robinson at the FSA (direct line: 020 7066 1338).

Andrew Long

Acting Chairman, Regulatory Decisions Committee

Appendix 1 – Breaches of SYSC and COB Rules:

1. In the period prior to 1 November 2007, AFP's failure properly to record its identification and mitigation of conflicts of interest in investment decisions, and the results of AFP's compliance monitoring, constitutes a breach of **SYSC 3.2.20R(1)**. This rule provides that a firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system;
2. the inadequate and informal compliance arrangements in place at AFP from 1 November 2007 constitute a breach of **SYSC 6.1.2R**. This rule provides that a common platform firm must, taking into account the nature, scale and complexity of its business, and the nature and range of investment services and activities undertaken in the course of that business, establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under the regulatory system, as well as associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable the FSA to exercise its powers effectively under the regulatory system;
3. the informal and inadequate compliance monitoring at AFP from 1 November 2007 constitutes a breach of **SYSC 6.1.3R**. This rule provides that a common platform firm must maintain a permanent and effective compliance function which operates independently and which has the responsibilities (1) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures and procedures put in place in accordance with SYSC 6.1.2R (see above), and the actions taken to address any deficiencies in the firm's compliance with its obligations, and (2) to advise and assist the relevant persons responsible for carrying out regulated activities to comply with the firm's obligations under the regulatory system;
4. AFP's failure in the period up to 1 November 2007, adequately to manage and record conflicts of interest constitutes a breach of **COB 7.1.3R**. This rule provides that if a firm may have an interest in a transaction that is, or may be, in conflict with the interests of the firm's customers, or if a firm has customers with conflicting interests in relation to a transaction, the firm must not deal in the exercise of discretion in

relation to that transaction unless it takes reasonable steps to ensure fair treatment for the customer;

5. AFP's failure always to create or maintain minutes of meetings and properly to record and justify conflicts of interest in investment decisions, and the results of AFP's compliance monitoring, from 1 November 2007 constitutes a breach of **SYSC 9.1.1R**. This rule provides that a firm must arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it, which must be sufficient to enable the FSA to monitor the firm's compliance with the requirements under the regulatory system, and in particular to ascertain that the firm has complied with all obligations with respect to clients;
6. AFP's failure adequately to record conflicts of interest, from 1 November 2007 constitutes a breach of **SYSC 9.1.3**. This rule provides that a common platform firm must retain records in a medium that allows the storage of information in a way accessible for future reference by the FSA or any other relevant competent authority so that the conditions set out in SYSC 9.1.3 are met, in particular that the FSA must be able to access them readily and to reconstitute each stage of the processing of each transaction;
7. AFP's failure adequately to record conflicts of interest from 1 November 2007 constitutes a breach of **SYSC 10.1.6R**. This rule provides that a common platform firm must keep and regularly update a record of the kinds of service or activity carried out by or on behalf of the firm in which a conflict of interest entailing a material risk of damage to the interests of one or more clients has arisen or, in the case of an ongoing service or activity, may arise;
8. AFP's failure adequately to manage conflicts of interest from 1 November 2007 constitutes a breach of **SYSC 10.1.7R**. This rule provides that a firm must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its clients;
9. AFP's failure adequately to disclose conflicts of interest from 1 November 2007 constitutes a breach of **SYSC 10.1.8R**. This rule provides that, if arrangements made by a firm under SYSC 10.1.7R to manage conflicts of interest are not sufficient to

ensure, with reasonable confidence, that risks of damage to the interests of a client will be prevented, the firm must clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business for the client. The disclosure must be made in a durable medium, and include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises;

10. AFP's failure adequately to manage effectively its conflicts of interests by maintaining and implementing a conflicts of interest policy specific to the types of conflict inherent in the structure created by AFP from 1 November 2007 constitutes a breach of **SYSC 10.1.10R**. This rule provides that (1) a common platform firm must establish, implement and maintain an effective conflicts of interest policy that is set out in writing and is appropriate to the size and organisation of the firm and the nature, scale and complexity of its business and (2) where the common platform firm is a member of a group, the policy must also take into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group; and
11. AFP's failure adequately to manage effectively its conflicts of interests by maintaining and implementing a conflicts of interest policy specific to the types of conflict inherent in the structure created by AFP from 1 November 2007 constitutes a breach of **SYSC 10.1.11R**. This rule provides that the conflicts of interest policy (1) must identify, by reference to the specific services and activities carried out by or on behalf of the firm, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients and (2) must specify procedures to be followed and measures to be adopted in order to manage such conflicts.

Appendix 2 Relevant statutory provisions, regulatory requirements and FSA Guidance

1. Statutory provisions

(a). The FSA's statutory objectives are set out in section 2(2) of the Act. The relevant objectives for the purpose of this case are maintaining market confidence and the protection of consumers.

(b). Section 205 of the Act provides:

"If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, the Authority may publish a statement to that effect."

2. Handbook provisions

2.1. In exercising its power to impose a public censure or financial penalty, the FSA must have regard to relevant provisions in the FSA Handbook of rules and guidance. The main provisions relevant to the action specified above are set out below.

Principles for Business (“the Principles”)

2.2 Under the FSA’s rule making power, the FSA has published in the FSA Handbook the Principles which apply either in whole, or in part, to all authorised persons.

2.3 The Principles are a general statement of the fundamental obligations of firms under the regulatory system and reflects the FSA’s regulatory objectives. A firm may be liable to disciplinary sanction where it is in breach of the Principles.

2.4 Principle 1 states that: “*A firm must conduct its business with integrity*”.

2.5 Principle 2 states that: “*A firm must conduct its business with due skill, care and diligence*”.

2.6 Principle 3 states that: “*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*”.

2.7 Principle 8 states that: “*A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client*”.

Enforcement Guide (“EG”)

- 2.8 The FSA’s policy on exercising its enforcement power is set out in EG, which came into effect on 28 August 2007. It was previously set out in ENF.
- 2.9 The FSA’s policy to impose financial penalties and public censures is set out in Chapter 7 of EG.
- 2.10 EG 7.2 provides that the FSA has the power to impose a financial penalty or public censure against a firm under sections 205 and 206 of the Act.

Decision Procedure and Penalties Manual (“DEPP”)

- 2.11 Guidance on the imposition and amount of penalties is set out in Chapter 6 of DEPP, which forms part of the FSA Handbook and came into force on 28 August 2007. It was previously set out in Chapter 13 of ENF, to which the FSA has had regard in addition to DEPP as both manuals applied at separate times during the Relevant Period.
- 2.12 DEPP 6.1.2G provides that the principal purpose of imposing a financial penalty is to promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches, and demonstrating generally the benefits of compliant behaviour. Financial penalties are tools that the FSA may employ to help it to achieve its regulatory objectives.
- 2.13 DEPP 6.5.1G(1) provides that the FSA will consider all the relevant circumstances of a case when it determines the level of financial penalty (if any) that is appropriate and in proportion to the breach concerned.
- 2.14 DEPP 6.5.2G sets out a non-exhaustive list of factors that may be relevant to determining the appropriate level of financial penalty to be imposed on a person under the Act. The following factors are relevant to this case:

Deterrence: DEPP 6.5.2G(1)

- 2.15 When determining the appropriate level of financial penalty, the FSA will have regard to the principal purpose for which it imposes sanctions, namely to promote high

standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches and helping to deter other persons from committing similar breaches, as well as demonstrating generally the benefits of compliant business.

The nature, seriousness and impact of the breach in question: DEPP 6.5.2G(2)

- 2.16 The FSA will consider the seriousness of the breach in relation to the nature of the rule, requirement or provision breached, which can include considerations such as the duration and frequency of the breach, whether the breach revealed serious or systemic weaknesses in the person's procedures or of the management systems or internal controls relating to all or part of a person's business, the nature and extent of any financial crime facilitated, occasioned or otherwise attributable to the breach and the loss or risk of loss caused to consumers, investors or other market users.

The extent to which the breach was deliberate or reckless: DEPP 6.5.2G(3)

- 2.17 The FSA will regard as more serious a breach which is deliberately or recklessly committed, giving consideration to factors such as whether the person has given no apparent consideration to the consequences of the behaviour that constitutes the breach. If the FSA decides that the breach was deliberate or reckless, it is more likely to impose a higher penalty on a person than would otherwise be the case.

The size, financial resources and other circumstances of the person on whom the penalty is to be imposed: DEPP 6.5.2G(5)

- 2.19 The FSA may take into account whether there is verifiable evidence of serious financial hardship or financial difficulties if the person were to pay the level of penalty appropriate for the particular breach.

Conduct following the breach: DEPP 6.5.2G(8)

- 2.20 The FSA may take into account the degree of co-operation the person showed during the investigation of the breach by the FSA.

Other action taken by the FSA (or a previous regulator): DEPP 6.5.2G(10)

- 2.21 The FSA seeks to apply a consistent approach to determining the appropriate level of penalty. The FSA may take into account previous decisions made in relation to similar misconduct.

FSA guidance and other published materials: DEPP 6.5.2G(12)

- 2.22 The FSA will consider the nature and accessibility of the guidance or other published materials when deciding whether they are relevant to the level of penalty and, if they are, what weight to give them in relation to other relevant factors.

Appendix 3 Definitions

- (1) “ACD” means authorised corporate director
- (2) “the Act” means the Financial Services and Markets Act 2000
- (3) “AFP” (or the “Firm”) means Arch Financial Products LLP
- (4) “AGL” means Arch Group (UK) Limited
- (5) “AIGHL” means Arch International Group Holdings Limited
- (6) “APER” means the Statements of Principle and the Code of Practice for Approved Persons
- (7) the “Balanced Fund” means the CF Arch cru Balanced Fund
- (8) the “Business Associate” is defined in paragraph 4.44 of this Decision Notice
- (9) “CISX” means the Channel Islands Stock Exchange
- (10) “COLL” means the Collective Investment Schemes Sourcebook in the FSA Handbook, which has been in place since 1 April 2004
- (11) “Company A” is defined in paragraph 2.7(2) of this Decision Notice
- (12) The “Company A Acquisition” is defined in paragraph 4.45 of this Decision Notice
- (13) “Company B” is defined in paragraph 2.7(4) of this Decision Notice
- (14) “Cru” means Cru Investment Management Ltd
- (15) “DEPP” means the FSA’s Decision Procedure and Penalties Manual
- (16) the “Diversified Funds” means the CF Arch cru Diversified Funds
- (17) “EG” means the Enforcement Guide
- (18) “ENF” means the Enforcement Manual
- (19) the “Finance Fund” means the CF Arch cru Finance Fund

- (20) the “FSA” means the Financial Services Authority
- (21) the “Global Growth Fund” means the CF Arch cru Global Growth Fund
- (22) “ICPs” means Investment Committee Proposals
- (23) the “Income Fund” means the CF Arch cru Income Fund
- (24) the “Investment Funds” means the CF Arch cru Investment Funds
- (25) the “Investment Portfolio” means the CF Arch cru Investment Portfolio
- (26) the “January 2010 Conflicts File Note” is defined in paragraph 4.50 of this Decision Notice
- (27) “OEIC” means Open Ended Investment Company
- (28) “NAV” means net asset value
- (29) “NURS” means a Non-UCITS Retail Scheme.
- (30) “Relevant Period” means July 2006 to March 2009 inclusive
- (31) the “Specialist Portfolio” means the CF Arch cru Specialist Portfolio
- (32) the “Tribunal” means the Upper Tribunal (Tax and Chancery Chamber)
- (33) the “UK Funds” means the “Investment Funds” and the “Diversified Funds” together