
FINAL NOTICE

To: **Blue Gate Capital Limited**

Firm Reference Number: **478314**

Address: **Lloyds House, 18-22 Lloyd Street, Manchester M2 5WA**

Date: **18 December 2020**

1. ACTION

- 1.1. For the reasons given in this Final Notice, the Financial Conduct Authority ("the Authority") hereby imposes a statement pursuant to section 205 of the Financial Services and Markets Act 2000 ("the Act") that Blue Gate Capital Limited ("Blue Gate") contravened regulatory requirements.
- 1.2. The Authority further imposes a requirement to pay restitution of £203,007 pursuant to section 384(5)(a) of the Act reflecting the profits accrued by Blue Gate in its role as operator of the Connaught Income Fund, Series 1 ("the Fund").
- 1.3. The serious failings in this case warrant a substantial financial penalty. Blue Gate has provided verifiable evidence that payment of such a penalty would have caused the firm serious financial hardship. Had it not been for this, the Authority would have imposed a financial penalty of £10 million.

2. SUMMARY OF REASONS

- 2.1. Blue Gate was the operator and administrator of the Fund from 25 September 2009 until the Fund's compulsory liquidation on 3 December 2012.
- 2.2. The Fund was an unregulated collective investment scheme ("UCIS") established in March 2008 which commenced its business activities in and around July 2008. It was named the Guaranteed Low Risk Income Fund, Series 1 until 1 October 2009, when it was renamed the Connaught Income Fund, Series 1. The Fund was designed to allow the Specialist Partner of the Fund ("the Specialist Partner") to drawdown money invested in the Fund to provide short term bridging finance to commercial borrowers in the UK property market. The Fund was promoted by Blue Gate via Information Memorandum 3 ("IM3"), from around 2 October 2009, as a low risk investment offering a guaranteed, fixed return of between 8.15% and 8.5% per quarter. The Fund was promoted via IM3 until around May 2011, when the Authority published a warning that statements made in IM3 about the Fund's risk profile were misleading. The Fund was not in fact low risk nor was the income guaranteed and its lending was not always secured in favour of the Fund.
- 2.3. Blue Gate was the operator of the Fund from 25 September 2009 until its compulsory liquidation on 3 December 2012 ("the Relevant Period"). Since the Fund entered into liquidation, the Insolvency Service has disqualified two directors of the Fund Asset Manager and the Guarantor of the Fund ("the Guarantor") for their conduct in matters relating to the Fund.
- 2.4. As an authorised person, Blue Gate was required to carry out its duties as operator in accordance with the Authority's Principles for Businesses ("the Principles") and its obligations to investors in the Fund ("Investors") commenced on 25 September 2009, when it became operator.
- 2.5. Although the Fund itself was unregulated, in the Authority's view, investors take substantial comfort from the involvement of an authorised and regulated operator in the structure of a UCIS. Consumers expect authorised firms to take their interests into account in the way they conduct their business.
- 2.6. In its role as operator of the Fund, Blue Gate failed to carry out its business with due skill, care and diligence, in breach of Principle 2. In particular, Blue Gate failed to:

1. carry out adequate due diligence on the Specialist Partner, to which all the Fund's assets were lent;
 2. carry out adequate due diligence on the Specialist Partner's parent company, the Guarantor, which purported to guarantee the Fund's income and the Specialist Partner's borrowing from the Fund;
 3. carry out adequate due diligence on the directors and controllers of the Specialist Partner and the Guarantor;
 4. investigate potentially serious issues with the Fund which had been identified by the Previous Operator of the Fund ("the Previous Operator") and brought to Blue Gate's attention before it agreed to take on the role of operator; and
 5. establish whether the Fund was operating as it was supposed to do. In particular, whether lending from the Fund was secured with valid charges in favour of the Fund.
- 2.7. Blue Gate was responsible for issuing the Fund's Information Memoranda and issued IM3 at the start of its tenure as operator. Blue Gate failed to ensure IM3 was clear, fair and not misleading in breach of Principle 7. In particular:
1. IM3 contained statements which suggested the Fund was low risk and had income and capital guarantees. In fact, the Fund was not low risk and it appears to the Authority that the Guarantor did not have the financial means to honour the guarantee;
 2. IM3 contained a misleading statement that the Fund would hold security over property for which the Fund's assets were lent, when in fact in several instances the Fund did not have such security; and
 3. IM3 contained misleading statements that the Fund's assets would be used for short term lending, for periods of three to six months, when in fact many of the Fund's assets were lent for significantly longer terms.

- 2.8. The Authority considers that had Blue Gate carried out adequate due diligence it would have concluded that it was unreasonable to reopen the Fund to investors in the manner that it did. As a result of its failure to conduct such due diligence, Blue Gate reopened the Fund to investors and thereafter accrued profits as a result of its operation of same.
- 2.9. Accordingly, the Authority hereby imposes a requirement on Blue Gate to pay restitution of £203,007 reflecting the profits accrued by Blue Gate as a result of its contravention of Principles 2 and 7.
- 2.10. In this Notice the Authority makes no criticism of any person other than Blue Gate.

3. DEFINITIONS

- 3.1. The definitions below are used in this Notice:

“the 8 Point Letter” means the letter of 21 August 2009 setting out matters which had influenced the Previous Operator’s decision to retire;

“the Act” means the Financial Services and Markets Act 2000;

“the Authority” means the Financial Conduct Authority;

“Blue Gate” means Blue Gate Capital Limited;

“CIS” means Collective Investment Scheme;

“COBS” means the Authority’s Conduct of Business Sourcebook;

“DEPP” means the Authority’s Decision Procedure and Penalties Manual;

“Development Finance” means lending from the Fund other than for a property purchase with a view to increasing the property’s value and/or making its resale more likely;

“the Fund” means the Connaught Income Fund, Series 1, which until 1 October 2009 was named the Guaranteed Low Risk Income Fund, Series 1;

“the Fund Asset Manager” means the Asset Manager of the Fund during the Relevant Period;

“Guarantee” means the contractual guarantee and warranty made by the Guarantor in respect of the Specialist Partner’s liabilities to the Fund;

“the Guarantor” means the Guarantor of the Fund during the Relevant Period;

“IFAs” means independent financial advisors;

“IM3” means the third Information Memorandum for the Fund, which was the first Information Memorandum approved by Blue Gate around 2 October 2009;

“IM4” means the fourth Information Memorandum for the Fund, which was the second Information Memorandum approved by Blue Gate around 19 August 2011;

“Investors” means investors in the Fund (who are Limited Partners of the Fund and beneficiaries of investments which were held on trust by Limited Partners);

“Limited Partners” has the meaning given to it by section 4 of the Limited Partnerships Act 1907;

“LTV” means loan-to-value ratio, being the ratio between the value of a loan and the value of the asset held as security for that loan;

“Operation Agreement” means the contract entered between the Fund, Blue Gate, the Fund Asset Manager and another company on 25 September 2009;

“the Previous Operator” means the operator of the Fund prior to 10 September 2009;

“Principles” means the Authority’s Principles for Businesses;

“RDC” means the Regulatory Decisions Committee of the Authority (see further at paragraph 8.3 below);

“the Relevant Period” means the period from 25 September 2009 to 3 December 2012;

“the Specialist Partner” means the Specialist Partner of the Fund;

“Tri-Party Meeting” means the meeting between the Fund Asset Manager, the Previous Operator and Blue Gate held on 17 September 2009; and

“UCIS” means an unregulated CIS.

4. FACTS AND MATTERS

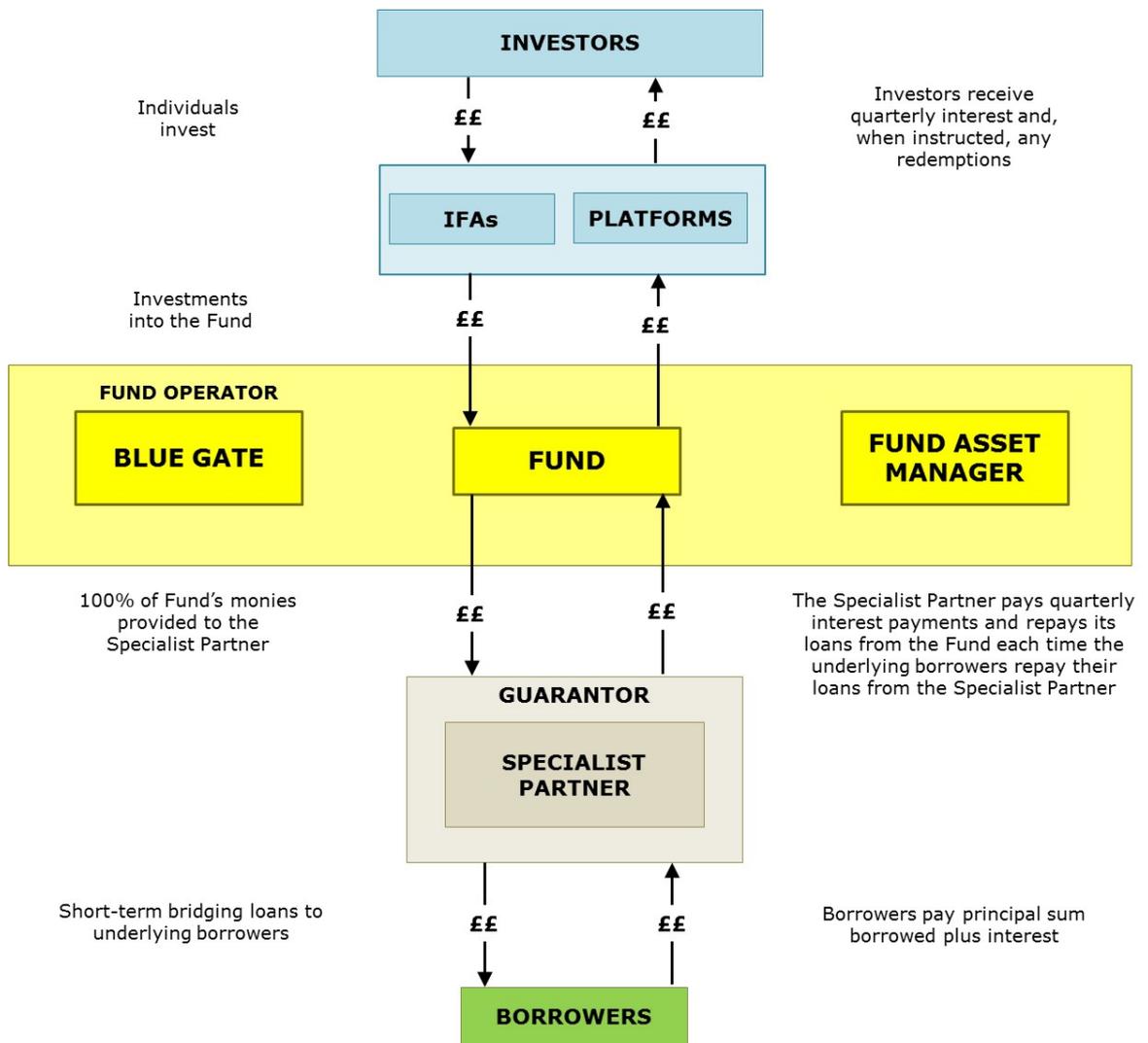
Background

4.1. The Fund was a UCIS established in March 2008. A UCIS is described as unregulated because it is not subject to the same restrictions as a regulated CIS. In particular:

1. a UCIS frequently invests in assets that are not available to a regulated CIS, for example, because they are riskier or less liquid, or are structured in a way that is different from a regulated CIS;
2. unlike a regulated CIS, a UCIS is not subject to investment and borrowing restrictions aimed at ensuring a prudent spread of risk. As a result, it is generally considered to be a high risk investment; and
3. clients may not have recourse to the Financial Ombudsman Service should they have a complaint about a UCIS, or the Financial Services Compensation Scheme, should they need to seek compensation.

The main entities involved in the Fund

4.2. A diagram illustrating the key entities and how the flow of monies in and out of the Fund operated is set out below:



4.3. The main parties/entities involved in the Fund were as follows:

1. Investors in the Fund invested either through their IFAs or through platforms. In accordance with the conditions stated in the Fund's Information Memoranda, Investors in the Fund were required to be investment professionals or suitably experienced investors. All monies invested in the Fund were paid into a bank account which was in the Fund's name but which was controlled by Blue Gate as the operator of the Fund;
2. the Specialist Partner's role was to receive monies from the Fund for the purpose of making short term loans (i.e. bridging loans) which were intended to be secured against UK property. In return for the ability to use the Fund's monies, it was intended that the Specialist Partner would service

the Fund's interest payment obligation to the Investors in the Fund. The Specialist Partner was placed into administration on 5 July 2012;

3. the Guarantor provided the Guarantee to the Fund which could be called upon if the Specialist Partner defaulted on any payment obligation to the Fund. The Guarantor was placed into administration on 28 September 2012;
4. the Fund Asset Manager was not authorised by the Authority. Its role was to manage the assets of the Fund and it was responsible for reviewing loan applications submitted by the Specialist Partner and verifying that the application complied with the terms of the Fund's Information Memoranda. If the application satisfied those terms, the Fund Asset Manager was to supply Blue Gate, as the Fund's operator, with the details of the proposed underlying loan and request that monies be paid from the Fund's accounts to the Specialist Partner; and
5. as the only firm associated with the Fund which was authorised by the Authority, Blue Gate was required to issue IM3 and IM4. In doing so, it had to ensure IM3 and IM4 complied with the Authority's rules and guidance. Blue Gate was also responsible for maintaining the Fund's books and accounts, its bank account and paying interest and capital on behalf of the Fund.

Information Memoranda

- 4.4. Information Memoranda were the main promotional documents which explained to prospective Investors the structure and key features of the Fund. Investors were entitled to rely upon the accuracy of the information contained in the Information Memoranda, which included explanations about the parameters of the loans to be granted by the Fund and the level of return which Investors could expect to receive.
- 4.5. The Specialist Partner's lending proposal ought not to have been approved if it failed to satisfy the lending parameters in the Fund's Information Memoranda. An example of a key lending parameter was that the maximum LTV ratio of any underlying loan was to be 80% (or 85% where there was a "*guaranteed exit route*", although this term was not defined in the Information Memoranda). The

Information Memoranda also explained that the Specialist Partner would issue short term loans, described as being between three and six months, so longer term loans should not ordinarily have been approved.

- 4.6. Blue Gate did not have any involvement in the Specialist Partner's lending practices and did not review or monitor the Fund's lending.
- 4.7. The first Information Memorandum and the second Information Memorandum were issued by the Previous Operator. The second Information Memorandum was in place when Blue Gate became operator and it should have informed Blue Gate about how the Fund was supposed to operate. Blue Gate issued IM3 around 2 October 2009 and issued IM4 around 19 August 2011.

The operation of the Fund

- 4.8. The Fund was designed to operate such that the Fund's monies were lent to the Specialist Partner. The Specialist Partner was to use the monies which had been released from the Fund to advance short term bridging finance loans secured on UK property.
- 4.9. Having identified potential borrowers, the Specialist Partner was to submit a loan application for each loan to the Fund Asset Manager with a request to drawdown the monies required for that specific loan. The Fund Asset Manager was to review the application and either reject it or request that Blue Gate as operator release the loan from the Fund to the Specialist Partner. Prior to drawdown, Investor money was held in the Fund's bank account which was controlled by Blue Gate.
- 4.10. When the underlying borrower repaid the principal sum borrowed to the Specialist Partner, the Fund Asset Manager was to ensure that the Specialist Partner returned these monies to the Fund's bank account.
- 4.11. The Specialist Partner was obliged to pay interest to the Fund even if it had not drawn down money from the Fund. Interest was paid until Blue Gate discovered the Specialist Partner was in serious financial difficulty, shortly before the Fund was placed into compulsory liquidation on 3 December 2012.

Mechanisms intended to secure the monies lent by the Fund to the Specialist Partner

4.12. There were three tiers in the Fund's security mechanism which together were designed to protect the monies which had been lent by the Fund to the Specialist Partner.

First tier

4.13. For each loan made by the Specialist Partner, the Fund's monies were supposed to be secured by two related but separate processes, being the registration of:

1. a mortgage charge registered at the Land Registry in the Specialist Partner's name and against the underlying borrower's property; and
2. a sub-charge registered at Companies House against the Specialist Partner and in favour of the Fund and corresponding to and noted against the mortgage charge registered at the Land Registry. As such, the sub-charges operated as a form of derivative security granted to the Fund, as the rights derived from each sub-charge corresponded to each mortgage charge.

4.14. Failure to register the charges at the Land Registry or Companies House may have resulted in the security being unenforceable.

Second tier

4.15. A debenture agreement was registered at Companies House in favour of the Fund and over all the property of the Specialist Partner, including any redemption monies held by the Specialist Partner. This was intended to provide a further layer of security in that, if the Specialist Partner failed to repay the redemption monies to the Fund on a redemption date, the Fund could exercise its rights under the debenture agreement.

Third tier

4.16. In addition, the Guarantor was obliged to pay to the Fund any sum the Specialist Partner owed to the Fund. As a minimum, this operated as a final fall-back to the Fund to be called upon in the event the Specialist Partner failed to pay interest or

repay capital to the Fund. In this event, the Fund could have called upon the Guarantor to pay any outstanding amount.

Blue Gate's responsibilities, duties and powers in respect of the Fund

- 4.17. Blue Gate's responsibilities, duties and powers in respect of the Fund were set out in the Operation Agreement. Relevant clauses are set out in Annex B to this Notice. Pursuant to the Operation Agreement, Blue Gate's responsibilities, duties and powers included:
1. operating and administering the Fund;
 2. reviewing and issuing Information Memoranda;
 3. dealing with the Fund in accordance with all relevant regulations;
 4. overseeing Investor applications, redemptions and details;
 5. maintaining proper books and records for the Fund; and
 6. overseeing the flow of monies in and out of the Fund (e.g. payment of distributions).
- 4.18. The Fund was a limited partnership established under the Limited Partnerships Act 1907 and the Fund's Investors were Limited Partners of the Fund. Under the Authority's COBS rule 3.2.3(4), Blue Gate's client was the Fund as the Fund had no separate legal personality from its general partner and its Limited Partners. Prospective Limited Partners of the Fund were also Blue Gate's clients, in accordance with COBS 3.2.1.
- 4.19. Blue Gate had the power and authority to act on behalf of and bind the Fund and the ability to terminate its relationship with the Fund (and therefore close the Fund until the appointment of a new operator) if the Fund was being administered outside the terms of IM3 and IM4 or if the Fund Asset Manager failed to provide it with the necessary information to enable it to discharge its obligations.
- 4.20. Blue Gate was contractually obliged to exercise the degree of care and skill as could reasonably be expected of a person experienced and skilled in the financial management, operation and winding-up of a CIS of such a nature as the Fund.

Blue Gate's initial due diligence and take-on procedure for the Fund

Background

- 4.21. On 2 September 2009, Blue Gate was invited to submit a proposal to act as operator of the Fund.
- 4.22. On 14 September 2009, Blue Gate visited the offices of the Previous Operator to understand the administrative requirements of operating the Fund. At the same time, the Fund Asset Manager shared the 8 Point Letter with Blue Gate which outlined matters which had influenced the Previous Operator's decision to retire as operator. The letter was addressed to another prospective operator, and made Blue Gate aware of various matters, including three ongoing and potentially serious issues with the Fund, being:
1. the most recent audited accounts of the Guarantor (and parent of the Specialist Partner) showed a substantial fall in its net asset value and disclosed that the Guarantor's banks were due to withdraw £7.5 million of lending facilities;
 2. the Fund had advanced loans which exceeded an LTV of 80% and work had not been undertaken to establish whether those loans had a guaranteed exit route, as required by the Information Memoranda in place at the time; and
 3. the Fund had allowed loans to be rolled over past their contractual terms.
- 4.23. Blue Gate met with the Fund Asset Manager and the Previous Operator at the Tri-Party Meeting on 17 September 2009 to discuss the transition of the operator role to Blue Gate. Included in the meeting agenda were the issues raised in the 8 Point Letter. At this meeting, Blue Gate did not raise for discussion any of the points in the 8 Point Letter. The meeting focused on administrative matters relating to the transfer of the operator role and the only substantive issue with the operation of the Fund which was discussed was the registration of a new debenture at Companies House. Blue Gate said it would liaise with the Fund Asset Manager directly regarding other issues with the operation of the Fund.
- 4.24. Blue Gate was aware that two other companies had already been approached to act as operator of the Fund and that they had not accepted the engagement. It was also aware an auditor had not accepted an appointment to audit the Fund.

- 4.25. Blue Gate made its proposal to act as operator on 18 September 2009, on the basis that it was expecting the Fund to have £100 million of assets and between 800 and 1,000 Investors. It proposed to act as operator and to carry out what it described as a “*full administration and accounting role in addition*”. Blue Gate recognised in its proposal that its role would involve ensuring the Fund complied with the Authority’s rules and guidance.
- 4.26. These proposals were reflected in the Operation Agreement, which Blue Gate entered on 25 September 2009, following a short period of due diligence. There were some issues with the due diligence which are discussed further below.

Financial due diligence on the Specialist Partner and Guarantor

- 4.27. The 8 Point Letter notified Blue Gate that the 2009 consolidated accounts of the Guarantor and its subsidiaries (including the Specialist Partner) showed a substantial fall in net assets and noted an upcoming withdrawal of its credit facilities. The 8 Point Letter also notified Blue Gate that the Previous Operator was no longer comfortable with the Fund’s investment strategy of placing all its assets with the Specialist Partner.
- 4.28. The Fund Asset Manager provided Blue Gate with its response to the 8 Point Letter, in which it said of the Guarantor’s financial position:
1. the fall in net asset value in the Guarantor’s 2009 consolidated accounts was caused mostly by a provision for doubtful debt, which had not previously been accounted for and which had been included to reduce corporation tax liability. The Fund Asset Manager emphasised that these were not bad debts and that their inclusion did not in fact reflect the true position of the loan book because there had been no defaults since inception and none were expected;
 2. that a balance sheet for the first three months of the next accounting period was enclosed and this showed an improvement in the Guarantor’s financial position;
 3. that the withdrawal of bank credit facilities had been instituted at the Guarantor’s request and not on the initiative of the banks concerned, as the 8 Point Letter had suggested; and

4. that Blue Gate should contact the Guarantor's financial controller if it required further clarification.
- 4.29. The Fund Asset Manager's response did not resolve the potential issues raised in the 8 Point Letter about the Guarantor's financial position, because:
1. the Fund Asset Manager said the inclusion of doubtful debt did not reflect the true position of the Guarantor's accounts, but in doing so the Fund Asset Manager was suggesting that the statement made in the Guarantor's filed accounts was inaccurate;
 2. the balance sheet produced to Blue Gate did not in fact reflect a recovery in the net asset value position sufficient to guarantee the Specialist Partner's liability to the Fund; and
 3. the Fund Asset Manager's claim that the withdrawal of facilities was on the initiative of the Guarantor was entirely inconsistent with the position stated by the Previous Operator in the 8 Point Letter and the position set out in the Guarantor's filed accounts, which the independent auditor of the Guarantor had certified to be true.
- 4.30. Despite the information it was given about possible financial risks to the Fund in the 8 Point Letter and the clear inconsistencies between the 8 Point Letter and the Fund Asset Manager's responses, Blue Gate did not conduct adequate financial due diligence on the companies responsible for investing the Fund's assets or investigate the financial position of the Guarantor or Specialist Partner. In particular, Blue Gate:
1. did not make enquiries about the provision for doubtful debts or the withdrawal of credit facilities;
 2. did not contact the Guarantor's financial controller, as had been suggested by the Fund Asset Manager;
 3. did not assess whether the Guarantor's guarantee would protect client assets if the Specialist Partner was unable to meet its obligations to the Fund; and
 4. did not carry out adequate due diligence on the Guarantor, the Specialist Partner, or their controllers.

- 4.31. When Blue Gate allowed the Fund to reopen to new money it did so in the knowledge that all the Fund's assets would be placed with the Specialist Partner and it did not understand the risks this might present to Investor money because it had not carried out adequate due diligence on the Specialist Partner. In addition, it allowed the Fund to reopen in the knowledge that the Previous Operator had retired because of, among other things, its concerns about the Guarantor's financial position.
- 4.32. In July 2011, Blue Gate told the Fund Asset Manager that it had "*concerns regarding the financial strength of [the Guarantor] and the loan position mainly due to a lack of information*" and Blue Gate sought to create reporting arrangements. From the start of its tenure in September 2009 until July 2011, Blue Gate had not sought any information about the financial strength of the Guarantor despite knowing of the Previous Operator's concerns in the 8 Point Letter. Those concerns later crystallised when the Guarantor and Specialist Partner became insolvent and a significant proportion of the Fund's assets could not be recovered for Investors.

LTV ratios

- 4.33. IM3 used the LTV ratios of the Fund's lending as a measure of risk and set a number of limits for the Fund's exposure to LTV ratios.
- 4.34. The 8 Point Letter informed Blue Gate that the Previous Operator had become aware that the Fund had advanced loans which exceeded LTV ratios of 80% (although it did not specify the number, value or percentage of those loans). Blue Gate did not then ascertain the number, value or percentage of those which exceeded 80%, so could not take an informed view about the severity of the issue.
- 4.35. The second Information Memorandum in place when Blue Gate became operator of the Fund indicated that:
1. the Fund's lending would not exceed an average LTV ratio of 75%;
 2. 90% of loans would not exceed an LTV ratio of 75%;
 3. only 10% of loans would be provided at an LTV ratio over 75% up to 80% LTV (or up to 85% where there was a "*guaranteed exit route*"); and
 4. LTVs over 85% were not permitted.

The same lending limits were replicated in IM3, which was approved and issued by Blue Gate.

4.36. In response to the LTV issues raised in the 8 Point Letter the Fund Asset Manager said that:

1. the Fund had never provided loans with an LTV in excess of 80%;
2. in a minority of cases money had been advanced for Development Finance and funding lines had been provided by the Specialist Partner to cover the initial advance;
3. the post-development work was inspected by the Specialist Partner's internal property team; and
4. the post-development LTVs were significantly lower than 75%.

4.37. The Fund Asset Manager's response did not fully resolve the issue raised in the 8 Point Letter relating to LTV, because:

1. the Fund Asset Manager appeared to be suggesting that when Development Finance was advanced, the pre-development consolidated lending might exceed 80% LTV;
2. if Development Finance meant total lending exceeded 80% LTV, that would be inconsistent with the first statement that the Fund had never provided loans in excess of 80% of open market valuation; and
3. the provision of Development Finance on this basis was not explained in the second Information Memorandum in place at the start of Blue Gate's tenure as operator, and presented risks which had not been disclosed to Investors.

4.38. The 8 Point Letter put Blue Gate on notice that loans might have been advanced inconsistently with the Information Memoranda, and might therefore have been exposed to risks which were greater than Investors expected, but it did not investigate the issue further, in that it did not:

1. obtain information about the LTV ratios in order to understand the nature and extent of the issue;

2. carry out any analysis to understand whether Development Finance resulted in consolidated LTVs in excess of 80%; or
 3. take any other steps to consider the risks posed to the Fund as a result of the issue.
- 4.39. The risk highlighted by the Previous Operator crystallised by the time Blue Gate conducted analysis of the Fund's outstanding loans, late in its tenure as operator. By the end of Blue Gate's tenure, £21 million worth of loans were at or exceeding 80% LTV. In one example, the Fund had lent £626,302 for the development of land worth £420,000, representing an LTV of 149%.

Rolling over of loans

- 4.40. The second Information Memorandum in place when Blue Gate became operator of the Fund indicated to Investors that the Fund's lending would be "*short term*" which was described as "*between three and six months*". It said that "*each loan has an agreed contractual term*", although it cautioned that the timeframe for redemption could not be guaranteed to be within the contractual term. A rolled over loan in this context is one which remains outstanding beyond its contractual term.
- 4.41. The 8 Point Letter notified Blue Gate that the Fund had allowed loans to be rolled over. The Previous Operator did not quantify this issue in terms of the volume or value of loans or the duration of roll over involved.
- 4.42. The Fund Asset Manager's response to the 8 Point Letter said, in relation to the rolling over of loans, that:
1. allowing loans to roll over was "*very sound commercial thinking*";
 2. although borrowers typically requested terms of six months, the loans were mostly written for 12 months to "*allow for more difficult market conditions*";
 3. sometimes it was necessary to further extend loans for commercial reasons, for instance to allow the refurbishment of a property to be completed; and
 4. whenever an extension was given beyond a 12 month term, the Specialist Partner would re-underwrite the loan and the exit route.

4.43. The Fund Asset Manager's response did not resolve the issue raised in the 8 Point Letter, as:

1. the response did not explain how many loans were beyond their original term, their value, or how far beyond the original term they were;
2. the second Information Memorandum in place when Blue Gate became operator of the Fund indicated to Investors that the Fund's lending would be "*short term*", which was described as "*between three and six months*";
3. the practice of underwriting loans for 12 months was not a feature of the Fund's operation which was set out in the Fund's Information Memoranda; and
4. the loan book showed expected repayment dates of various lengths, which did not correlate with the Fund Asset Manager's statement that loans were typically underwritten for 12 months.

4.44. Loans being extended beyond their contractual term could have indicated that some borrowers had difficulty repaying, that the correct loan processes were not being followed, or that the money had been misused in some way. Despite the lack of information about the number and duration of loan extensions and inconsistencies between the Fund Asset Manager's responses and the way the Fund was supposed to operate according to the Information Memoranda, Blue Gate did not investigate the issue of rolling over of loans, in that it:

1. did not request information about the number of loans which had rolled over beyond their original terms, their value and for how long they had been extended;
2. took the Fund Asset Manager's response at face value; and
3. took the view that the practice of rolling over loans was standard in the bridging loan market. It assumed that this presented no risk to the Fund. It made this assumption even though it did not know the extent of the issue.

4.45. Had it investigated this issue when taking on the Fund, Blue Gate would have found that:

1. out of 105 outstanding loans, representing a value of £43.7 million, only nine loans had expected terms of less than six months;
 2. the majority of loans had expected terms of six to 12 months;
 3. 19 loans, representing a value of £6.7 million, had expected terms of more than 12 months; and
 4. six loans, representing a value of £880,000, were expected to be repaid nearly two years after they were issued.
- 4.46. On 11 July 2011, nearly two years after it became operator of the Fund, Blue Gate carried out a review of the loan book and raised concerns with the Fund Asset Manager that:
1. 88 loans had rolled over past their original term;
 2. 36 of those were outstanding by more than 12 months; and
 3. ten of the outstanding loans had been advanced to entities in the same group as the Specialist Partner.
- 4.47. The risk that rolling over might have indicated the correct loan processes were not being followed crystallised in September 2011 when the Fund Asset Manager informed Blue Gate that in 19 cases, the Specialist Partner had engaged in loan recycling.
- 4.48. Blue Gate's lack of adequate due diligence when it became operator meant that it missed clear opportunities to understand and manage risks associated with the Fund's lending strategy. As a result, Blue Gate did not understand whether the Fund's lending was in accordance with the limits set by the Information Memoranda for at least the first 21 months of its tenure, until such time as the risks presented by the practice of rolling over loans had crystallised.

Security over the Fund's assets

- 4.49. The second Information Memorandum in place at the start of Blue Gate's tenure stated that money lent from the Fund was to be secured by a legal charge over the relevant property in favour of the Fund. This remained a key feature in IM3, which Blue Gate issued to Investors around 2 October 2009.

- 4.50. Blue Gate received a spreadsheet of loans from the Previous Operator at the outset of its tenure which provided it with basic information about lending from the Fund. This included the addresses of properties for which money from the Fund had been lent, the amount which had been lent, the date the loan was paid and the date it was expected to be repaid.
- 4.51. Blue Gate did not check whether charges over the properties had been registered in favour of the Fund, therefore it did not know if the charges were in place for at least the first 21 months of its tenure. Had it carried out this aspect of due diligence on the Fund at the outset of its tenure, it would have found that a significant number of loans were not secured by a valid charge in favour of the Fund.
- 4.52. It was not until September 2011 that Blue Gate was told by the Fund Asset Manager that legal charges against several properties had not been correctly registered and as a result there was no enforceable security for the Fund in respect of those loans.

Reopening the Fund

- 4.53. Blue Gate did not carry out due diligence to resolve the concerns raised in the 8 Point Letter, but instead took at face value the responses provided by the Fund Asset Manager and did not raise any questions about the points raised in the 8 Point Letter with the Previous Operator at the Tri-Party Meeting or otherwise.
- 4.54. By 17 September 2009, Blue Gate had agreed in principle to act as the Fund's operator and, on 24 September 2009, it set out in an email several outstanding matters to be resolved before it would allow the Fund to reopen to new investments. This list did not include any of the matters in the 8 Point Letter.
- 4.55. Neither did Blue Gate go on, prior to agreeing to become operator, to properly investigate the issues raised in the 8 Point Letter or to conduct any review of whether the Fund was operating as it should.
- 4.56. On 25 September 2009, Blue Gate signed the Operation Agreement, 23 days after it entered discussions with the Fund Asset Manager about taking on the role. It allowed the Fund to reopen to new investment around the same time.

Inaccurate and potentially misleading statements in IM3

- 4.57. Blue Gate was responsible for reviewing and approving the Fund's financial promotions during its tenure. It approved IM3 for issue on or around 2 October 2009.
- 4.58. IM3 contained statements which were materially inaccurate or potentially misleading, which indicated:
1. the Fund was a low risk investment;
 2. income from the Fund and its capital was guaranteed;
 3. the Fund's assets would be lent for periods of three to six months; and
 4. the Fund's assets would be lent at conservative LTV ratios to increase the likelihood of full recovery in the event of default; and
 5. lending from the Fund for bridging loans would be secured.

'Low risk'

- 4.59. At the outset of its tenure as operator, the Fund name was changed from the Guaranteed Low Risk Income Fund, Series 1 to the Connaught Income Fund, Series 1 and Blue Gate removed some explicit references in IM3 to income and capital and guarantees.
- 4.60. However, a number of statements in IM3 continued to give the misleading impression that the Fund was low risk. For example:
1. the first sentence of the Executive Summary introduced the Fund Asset Manager as a company which offered "*investment opportunities directly into the investment market based and secured against tangible assets to minimise investment risk...*";
 2. the Executive Summary introduced the Specialist Partner as a company which "*never failed to claim back the full capital amount lent on any of [its] loans*" and said this was "*a reflection of its low risk lending criteria...*";
 3. the Fund invested exclusively in the bridging finance market and, under the heading "*Why invest in Bridging Finance?*", said "*Bridging finance is a*

very low risk lending business” and “potentially offers an excellent low risk investment opportunity for investors”;

4. also under the heading “*Why Invest in Bridging Finance*”, IM3 contained a prominent graph comparing the Fund’s rate of return with the deposit rates of various UK banks and building societies;
 5. “*As an example, 75% of the value of the property will be lent [from the Fund] as part of a low risk loan*”; and
 6. “*The Fund will minimise risk by focussing on loans that fall within the low risk (70-75% LTV) category*”.
- 4.61. The Fund was not low risk because it was a UCIS which lent all its assets to the Specialist Partner, an unregulated private company, which invested directly in property in a specialist sector.
- 4.62. Comparisons in IM3 between the Fund’s return and returns available from various UK banks and building societies were misleading because cash on deposit is very low risk and is protected by the Financial Services Compensation Scheme. Because the Fund was a UCIS, Investors had no recourse to the Financial Services Compensation Scheme in the event the Fund or the Specialist Partner became in default, which ultimately happened.

‘Guaranteed’

- 4.63. IM3 indicated that income from the Fund would be guaranteed by presenting the return rate of between 8.15% and 8.5% as “*fixed returns*”, stating that “*investors will receive 100% of their [investment] back...*” and stating that it was “*legally underwritten by the Specialist Partner and is underwritten by their parent Company as Guarantor.*”
- 4.64. IM3 also stated that the Specialist Partner’s obligations to the Fund were guaranteed by the Guarantor: “*the Guarantor will on demand in writing made on the Guarantor pay or discharge to [the Fund] all monies and liability which shall be duly owing or incurred by the Specialist Partner to [the Fund].*”
- 4.65. The 8 Point Letter should have indicated to Blue Gate that the Previous Operator had concerns about the Guarantor’s ability to honour the Guarantee. The

Guarantor's audited accounts for the year ending 2009 showed its assets were not sufficient to meet the Specialist Partner's outstanding obligations to the Fund.

'Short term lending'

- 4.66. IM3 indicated to Investors that the bridging loans, for which the Fund's assets would be exclusively used, would be "short term" and "between three and six months".
- 4.67. The investment objective stated that "The Specialist Partner will lend to a range of customers who are looking to utilise short term funding..." and "The majority of loans will be to fund a property purchase with a short completion deadline, to fund a short term renovation or project or to refinance to raise capital."
- 4.68. Blue Gate was aware from the 8 Point Letter that loans had rolled over beyond their original terms, but it did not investigate the nature and extent of that issue. If it had taken steps to examine the loan schedules, as explained above, it would have found that only a very small percentage of loans were offered for a term of between three and six months.
- 4.69. Additionally, Blue Gate had been told by the Fund Asset Manager that the majority of loans were underwritten for 12 months and typically rolled over for a longer term than agreed. The statement that the Fund would invest in loans of three to six months was, therefore, inaccurate.

'Conservative LTV ratios'

- 4.70. IM3 stated that the Fund would only lend to an averaged maximum of 75% LTV "to ensure that the bridging monies are protected in the event of any loan default." It said of bridging finance generally that it was "a very low risk lending business because it rarely allows the lending to be more than 80% (a higher percentage lending is only allowed when the borrower has a guaranteed exit route but never exceeds 85%). This was misleading because a conservative LTV does not mean the lending is low risk. The borrower's creditworthiness and the validity and priority of the Fund's security over the asset were also relevant.
- 4.71. The Fund's investment objective in IM3 set out the lending criteria, including LTV ratios, within which the Fund would lend. It stated that all borrowers would be "prime" (with reference to their credit history) and introduced its own risk profile:
1. an LTV of less than 70% was described as 'Very Low Risk';

2. an LTV of between 70% - 75% was describe as 'Low Risk'; and
 3. an LTV of up to 85% was described as 'Medium Risk'.
- 4.72. The Fund's target investment risk exposure was stated in IM3 to be 90% in 'Very Low Risk' or 'Low Risk' loans and up to 10% in 'Medium Risk' loans. This gave a misleading impression that investment in the Fund was low risk.
- 4.73. The 8 Point Letter informed Blue Gate that the Previous Operator had become aware that the Fund had advanced loans which exceeded LTVs of 80%. Blue Gate did not have, nor did it seek from the Fund Asset Manager, any data on the Fund's LTV exposures prior to approving IM3, so it was unable to substantiate the claims made in IM3 about the Specialist Partner's approach to lending.
- 4.74. When Blue Gate eventually investigated the LTV ratios, nearly two years after approving IM3, it found that over £21 million was lent at LTVs at or exceeding 80%, some of which exceeded 85%, which represented a far greater exposure than was indicated to Investors in IM3.

Secured lending

- 4.75. The claims in IM3 about "*low risk lending*" and that the Fund's money would be "*protected in the event of a loan default*" relied on the Fund holding valid legal charges over the land for which the Fund's money was lent. If the Fund did not have a valid legal charge, its lending was unsecured and high risk, regardless of the LTV ratio.
- 4.76. IM3 stated: "*Security on all properties monies are loaned against [...] will be registered to the [Fund]*".
- 4.77. Blue Gate had not carried out any assessment of whether in fact security had been registered in favour of the Fund prior to approving IM3. Had it done so, it would have found several instances where charges were not registered.

Winding-up and Investor losses

- 4.78. The Fund was suspended on 7 March 2012 and in August 2012 Blue Gate determined that the Specialist Partner could not meet an interest distribution. A decision was made to wind-up the Fund.

4.79. The Fund was placed into compulsory liquidation by order of the High Court on 3 December 2012, at which time there were over 1,600 Investors in the Fund and approximately £104 million of capital and interest was owed to Investors.

5. FAILINGS

Relevant statutory and regulatory provisions

- 5.1. The regulatory provisions relevant to this Notice are referred to in Annex A.
- 5.2. The Authority's statutory objectives are set out in section 1B of the Act. This Notice supports the Authority's objective of securing an appropriate degree of protection for consumers.
- 5.3. Throughout the Relevant Period, Blue Gate was an authorised firm and was required to conduct its business in relation to the Fund in accordance with the Principles. In respect of the Principles, the Fund's Investors constituted Blue Gate's clients.

Blue Gate's breach of Principle 2

- 5.4. Blue Gate failed to act with due care, skill and diligence when it failed to carry out adequate due diligence, failed to investigate potentially serious issues with the Fund which had been identified by the Previous Operator and failed to establish whether the Fund was operating as it was supposed to do.
- 5.5. As set out at paragraphs 4.21 – 4.26 above, Blue Gate knew before it reopened the Fund to new business, or it had assumed when it submitted a proposal to become operator of the Fund, that:
1. it was responsible for the Fund's operation and administration, including responsibility for its books, its bank account and overseeing the flow of money in and out of the Fund – from Investors to the Specialist Partner and vice-versa;
 2. it expected the Fund to receive around £100 million from 800-1,000 Investors, some of which would be from pension savings;
 3. all the Fund's assets would be borrowed by the Specialist Partner, which the Specialist Partner would lend onwards in the short term bridging loan market;

4. the Specialist Partner's borrowing from the Fund was to be guaranteed by its parent, the Guarantor; and
 5. two other operators had been approached to take over as operator of the Fund from the Previous Operator but that they had not done so; and an auditor had not accepted an appointment to audit the Fund.
- 5.6. Prior to reopening the Fund, Blue Gate had been informed in the 8 Point Letter of issues with the Fund which were potentially serious:
1. the Previous Operator had concerns about the financial position of the Guarantor;
 2. the Fund's assets had been lent at LTV ratios which may have exceeded limits set out in the Fund's Information Memoranda; and
 3. that loans from the Fund had been rolled over past their contractual term.
- 5.7. The Fund Asset Manager's response to the 8 Point Letter downplayed those concerns but did not resolve them. In some respects, the Fund Asset Manager's response was implausible and unsatisfactory, for the reasons set out at paragraphs 4.29, 4.37 and 4.43 above. This ought to have given Blue Gate cause to make further enquiries.
- 5.8. Blue Gate failed to test the veracity of the Fund Asset Manager's responses, taking what it had said at face value, and did not conduct adequate due diligence on the Specialist Partner, the Guarantor, or its ultimate controllers. Blue Gate went on to allow the Fund's assets to be borrowed exclusively by the Specialist Partner throughout its tenure as operator.
- 5.9. Blue Gate did not understand whether the Fund's assets were being invested in accordance with the Information Memoranda for at least the first 21 months of its tenure as operator, despite being informed at the outset of its tenure that there were two potentially serious issues with how the Fund had been invested. When it eventually investigated, it found irreparable and serious issues with the Fund. These issues remained at the point of the Fund's failure.
- 5.10. Security over the Fund's assets was a key feature of the Fund's Information Memoranda and was central to the risks Investors were exposed to. Although it had the information required to do so, Blue Gate did not check whether charges over

properties had been registered in favour of the Fund for the first 21 months of its tenure. Had it done so, it would have found that a significant number of loans were not secured in favour of the Fund.

- 5.11. Blue Gate was required by Principle 2 to conduct its business with due skill, care and diligence and was contractually required to exercise the level of skill and care of a competent operator of a CIS. In failing to make adequate enquiries to understand how and by whom the Fund's assets were being invested for the first 21 months of its tenure, and failing to check that loans were secured, it failed to conduct its business with due skill, care and diligence in breach of Principle 2.
- 5.12. The fact that Blue Gate was told by the Previous Operator of potentially serious issues with the Fund and it failed to examine those issues makes this failing particularly serious.

Blue Gate's breach of Principle 7

- 5.13. IM3 was the main document used to market the Fund to prospective Investors from the start of Blue Gate's tenure as operator. Among other things, IM3 communicated the risks to which Investor capital would be exposed if they invested in the Fund.
- 5.14. IM3 contained incorrect or misleading statements. In particular:
 1. statements indicating that income from the Fund and the Specialist Partner's lending from the Fund were guaranteed by the Guarantor. These statements were misleading because the Guarantor's filed accounts indicated it did not have the financial means to honour the guarantee;
 2. a statement that security over property for which the Fund's assets were lent would be registered in favour of the Fund. This was misleading because charges were not always registered in favour of the Fund;
 3. statements that the Fund would be low risk, primarily because of the observance of certain maximum LTV ratios. This was misleading because the prospect of successfully recovering capital loaned in the event of default involves numerous factors, including the creditworthiness of the borrower, the priority of the lender's security, and the lender's ability to take possession and sell the property at a value at or exceeding the value of the loan. IM3 used a risk classification approach linked solely to LTV ratios, which was overly simplistic; and

4. statements that assets from the Fund would be used for short term lending of three to six months. In fact, the Fund's assets were lent for periods far in excess of this period.
- 5.15. Allowing IM3 to be issued with these misleading and inaccurate statements was particularly egregious because it had the effect of attracting Investors with a low tolerance for investment risk when in fact their capital would be placed at significant risk. If Blue Gate had reacted appropriately to the information it was given by the Previous Operator and carried out adequate due diligence on the Fund it would have known this.
- 5.16. By issuing IM3 with these inaccurate and misleading statements, Blue Gate failed to communicate with its clients in a way which was clear, fair and not misleading, in breach of Principle 7.

6. SANCTION

- 6.1. The Authority considers that a financial penalty of £10 million in respect of Blue Gate's breaches of Principle 2 and 7 during the Relevant Period is appropriate. However, Blue Gate has provided verifiable evidence that payment of such a penalty would cause the firm serious financial hardship. For this reason, the Authority hereby imposes a public censure in relation to Blue Gate.
- 6.2. The Authority considers that the public censure and the requirement to pay restitution of £203,007 for the benefit of Investors supports the Authority's objective of securing an appropriate degree of protection for consumers.
- 6.3. The Authority's policy for the imposition of a sanction is set out in Chapter 6 of DEPP. All references to DEPP in this section refer to the version of DEPP in force during the Relevant Period.
- 6.4. The Authority will consider the full circumstances of each case when determining whether to take action for a public censure or financial penalty. DEPP 6.2G lists the relevant circumstances including those listed below.

The nature, seriousness and impact of the breach (DEPP 6.2.1G(1))

- 6.5. In determining the appropriate sanction, the Authority has had regard to the seriousness of the breaches, the nature and extent of the breaches, their duration, and the number of Investors who were exposed to the risk of loss. Although not

deliberate or reckless, Blue Gate's failure to ensure that IM3 was clear, fair and not misleading as well as its failure to carry out the role of operator with due skill, care and diligence exposed Investors in the Fund to unacceptable risk of serious loss.

The extent to which the breach was deliberate or reckless (DEPP 6.2.1G(1)(a))

- 6.6. The Authority does not consider that Blue Gate's actions were deliberate or reckless.

Conduct of the person after the breach (DEPP 6.2.1G(2))

- 6.7. Blue Gate cooperated with the Authority during the investigation of the breach.

Disciplinary record and compliance history (DEPP 6.2.1G(3))

- 6.8. Blue Gate has no prior disciplinary history.

Decision to impose a financial penalty or public censure (DEPP 6.4.2G)

- 6.9. DEPP 6.4.2G sets out factors that may be of particular relevance when the Authority determines whether it is appropriate to impose a financial penalty. The criteria are not exhaustive and DEPP 6.4.1G provides that the Authority will consider all the relevant circumstances when deciding whether to impose a penalty or issue a public censure. The Authority considers that the factors below are particularly relevant in this case.

Deterrence (DEPP 6.4.2G(1))

- 6.10. The Authority does not consider deterrence would be effectively achieved by issuing a public censure alone.

Seriousness of the breach (DEPP 6.4.2G(3))

- 6.11. For the reasons stated above, the breaches in this matter were serious. This is an indicator that a financial penalty is appropriate.

The level of the financial penalty (DEPP 6.5)

- 6.12. In determining the appropriate level of financial penalty, the Authority is required to consider all the relevant circumstances of a case. DEPP 6.5.2G identifies a non-exhaustive list of factors that may be relevant in determining the level of financial

penalty. The factors referred to above are relevant factors for the purposes of DEPP 6.5.2G. In addition, the Authority has taken into account action taken by the Authority in relation to other authorised persons for comparable behaviour.

- 6.13. The Authority considers that Blue Gate's breaches of Principles 2 and 7 merit a financial penalty of £10 million. However, as Blue Gate has provided verifiable evidence that the imposition of such a penalty would cause financial hardship, the Authority has decided to impose a public censure in this matter.

Restitution

- 6.14. Under section 384 of the Act, the Authority has the power, if it is satisfied that a person has breached a relevant requirement and that profits have accrued to them as a result of the contravention, to require the person concerned to pay to the appropriate person or distribute among the appropriate persons such an amount as appears to the Authority to be just having regard to the profits appearing to the Authority to have accrued. The Authority has published guidance on the exercise of its power under section 384 of the Act in Chapter 11 of the Enforcement Guide.
- 6.15. The Authority therefore hereby imposes a requirement on Blue Gate to pay restitution of £203,007 for its contravention of Principles 2 and 7 to reflect the profits accrued by Blue Gate in its role as operator of the Fund.
- 6.16. In assessing the value of the restitution to be paid, the Authority has had regard to the Authority's proceedings against the Previous Operator, in which it was agreed to return the amount originally invested by Investors including those who invested during Blue Gate's period as operator, less income, redemptions, dividends and other payments received. The intention of those payments was to place all Investors as closely as possible back in the position they would have been in if they had never invested in the Fund.
- 6.17. Over £58 million has now been repaid to Investors together with previous distributions of £22 million. However, the Authority is aware that there may be outstanding but unspecified claims for which it is unable to calculate an amount for the purposes of section 384 of the Act. The requirement to pay restitution is therefore intended to address those claims as far as possible.

- 6.18. The Authority considers that the public censure and the requirement to pay restitution of £203,007 for the benefit of Investors supports the Authority's objective of securing an appropriate degree of protection for consumers.

7. REPRESENTATIONS

- 7.1. Annex C contains a brief summary of the key representations made by Blue Gate and how they have been dealt with. In making the decision which gave rise to the obligation to give this Notice, the Authority has taken into account all of the representations made by Blue Gate, whether or not set out in Annex C.

8. PROCEDURAL MATTERS

- 8.1. This Notice is given to Blue Gate under and in accordance with section 390 of the Act.
- 8.2. The following paragraphs are important.

Decision maker

- 8.3. The decision which gave rise to the obligation to give this Notice was made by the RDC. The RDC is a committee of the Authority which takes certain decisions on behalf of the Authority. The members of the RDC are separate from the Authority staff involved in conducting investigations and recommending action against firms and individuals. Further information about the RDC can be found on the Authority's website:

<https://www.fca.org.uk/about/committees/regulatory-decisions-committee-rdc>

Manner and time for payment

- 8.4. The restitution must be paid in full by Blue Gate to the Authority (on behalf of the Investors) no later than 8 January 2021.

If the restitution is not paid

- 8.5. If all or any of the restitution is outstanding on 9 January 2021, the Authority may enforce payment of it pursuant to section 390(10) of the Act.

Publicity

- 8.6. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this Notice relates. Under those provisions, the Authority must publish such information about the matter to which this Notice relates as the Authority considers appropriate. The information may be published in such a manner as the Authority considers appropriate. However, the Authority may not publish information if such publication would, in the opinion of the Authority, be unfair to you or prejudicial to the interests of consumers or detrimental to the stability of the UK financial system.
- 8.7. The Authority intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

Authority contact

- 8.8. For more information concerning this matter generally, contact Gareth Buttrill at the Authority (email: Gareth.Buttrill@fca.org.uk).

Laura Dawes

Head of Department

Financial Conduct Authority, Enforcement and Market Oversight Division

ANNEX A

1. RELEVANT STATUTORY PROVISIONS

- 1.1 The Authority's operational objectives established in section 1B of the Act include the strategic objective to ensure that the relevant markets function well and the operational objective to protect and enhance the integrity of the UK financial system.

2. RELEVANT REGULATORY PROVISIONS

Principles for Businesses

- 2.1 The Principles are a general statement of the fundamental obligations of firms under the regulatory system and are set out in the Authority's Handbook. They derive their authority from the Authority's rule-making powers as set out in the Act and reflect the Authority's regulatory objectives.

- 2.2 Principle 2 states:

"A firm must conduct its business with due skill, care and diligence."

- 2.3 Principle 7 states:

"A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading."

DEPP

- 2.4 Chapter 6 of DEPP sets out the Authority's approach to deciding whether to issue a public censure. In particular, DEPP 6.4.2G sets out factors that may be of particular relevance when the Authority determines whether it is appropriate to issue a public censure rather than impose a financial penalty.

ANNEX B

1. RELEVANT CONTRACTUAL PROVISIONS

Operation Agreement dated 25 September 2009

1.1 Pursuant to Clause 3.1 of the Operation Agreement, Blue Gate was appointed to act as “operator and administrator of the Fund” with full power and authority to act on behalf of the Partnership, and with the power to bind the Partnership, to undertake the following aspects of the operation of the Partnership:

Clause 3.1.1 *“to maintain, or cause to be maintained, the Partnership’s records and books of account at the Partnership’s or (to the extent permitted by the Act) the Operators own principal place of business, to procure that (so far as it is reasonable to do so) such records and books of account are properly and accurately maintained and at all times up to date including all taxation affairs”*

Clause 3.1.4 *“(subject to counter-signature by or on behalf of the General Partner in accordance with the relevant bank mandates from time to time) to make arrangements for the issuing of cheques or other payment instructions on a Bank Account in respect of*

Clause 3.1.4.1 *payments of distributions of net income and Capital and Repayments of Loan Participations*

...

Clause 3.1.4.4 *the payment of all other expenses of the Partnership and other liabilities of the Partnership as they fall due”*

...

Clause 3.1.9 *“to serve all notices in respect of, and to register or record any assignments of any interest of any Limited Partner and otherwise fulfil the functions of the General Partner pursuant*

to the Partnership Agreement, it being hereby agreed that the Operator shall have the benefit of and shall be subject to the provisions in that agreement which are expressed to limit or qualify the liabilities or limit and restrict the obligations of the General Partner and that the Operator shall not be obliged to register any assignment of Partnership Interests which is not duly stamped

...

Clause 3.1.13 *to do all or any other acts as are required of the Operator by this Agreement or the Partnership Agreement or as are in the Operator's reasonable opinion necessary or desirable, to give effect to the terms of this Agreement"*

Clause 4.1 *"The General Partner shall be entitled by notice in writing to the Operator to veto any decision of the Operator relating to any transaction which in the opinion of the General Partner is inconsistent with the purpose of the Partnership specified in the Partnership Agreement or which is otherwise unacceptable to the General Partner, provided always that:*

Clause 4.1.1 *the exercise of any such veto shall not affect the validity or enforceability of actions taken or obligations incurred in accordance with the terms of this Agreement before notice of such exercise is received by the Operator"*

...

Clause 8.3 *"The Operator shall have responsibility in respect of treasury management of deposited funds of the Partnership"*

Clause 8.4 *"In performing its responsibilities, duties and powers hereunder the Operator shall exercise that degree of skill and care as could reasonably be expected of a person experienced and skilled in the financial management, operation and winding up of a collective investment scheme in the nature of the Partnership"*

Clause 8.6 *"The Operator undertakes to the Partnership to comply at all times with its obligations under the FSMA and the FSA [FCA] rules in respect of performance of its obligations under this Agreement"*

Clause 13.1 *"The Operator shall keep or cause to be kept records of all of the assets of the Partnership of which the Operator is aware or ought reasonably to be aware and of transactions undertaken by it or with its knowledge on behalf of the partnership in accordance with proper accounting practices together with all necessary receipts and vouchers."*

ANNEX C

REPRESENTATIONS

1. Blue Gate's representations and the Authority's conclusions in respect of them are set out below.

An order for restitution is futile and will not act as a deterrent

Blue Gate's representations

2. Blue Gate is solvent but it has very limited assets. On no view can it afford to pay the sum which is sought by way of restitution.
3. Thus, if it orders Blue Gate to make a restitutionary payment in the sum of £203,007, the Authority will be requiring Blue Gate to do something which it knows Blue Gate can never do. Blue Gate will be driven into liquidation and the order will never be satisfied. If the purpose of the order is to provide restitution to investors, the Authority will be making it in the certain knowledge that it will never achieve that purpose. If the purpose is to deter others who might be minded to contravene the Principles in the future or to secure consumer protection, it will do neither; consumers are not protected by an order which is known to be unenforceable as soon as it is made, and potential malefactors are not deterred. Blue Gate does not suggest that the absence of means is, in and of itself, a bar to the making of an order to pay restitution, but it is a highly relevant factor on any view, and on the facts of this case it should be decisive.
4. In deciding to impose a censure instead of a financial penalty of £10 million, on the basis that there was verifiable evidence that payment would have caused Blue Gate serious financial hardship, the Authority appeared to recognise the futility of imposing any order upon Blue Gate requiring it to pay any money. The principle remains the same in relation to the sum proposed by way of restitution; if a company has no, or virtually no, assets, it will not be able to pay and will sustain serious financial hardship, whether required to pay £10 million or £200,000.
5. It may be argued that, albeit futile, the imposition of a restitutionary order on Blue Gate is necessary to mark disapproval of its conduct. But that adds nothing to the censure which Blue Gate accepts.

Authority's conclusions

6. The Authority notes that Blue Gate accepts that a lack of means on the part of the subject of a proposed restitution order is not, of itself, a reason not to make such an order. In this case, the Authority concludes that a restitution order is appropriate notwithstanding that Blue Gate says it will be unable to comply with such order. To the extent Blue Gate does not have the means to pay the restitution ordered, it is a matter for Blue Gate's shareholders whether they seek to recapitalise it.
7. The Authority notes the guidance at DEPP 6.5.2(6)G that a financial penalty should be consistent with the principle that a person should not benefit from the breach; it also notes the guidance at DEPP 6.7.2G that the Authority's discount policy for early settlement does not apply to that part of a financial penalty which specifically equates to the disgorgement of profit accrued or loss avoided. By analogy, the Authority considers that Blue Gate should not benefit from the profits it derived from its breaches, even if this might put Blue Gate's solvency in jeopardy. As noted above, it is a matter for Blue Gate's shareholders whether they seek to recapitalise the firm in such circumstances.
8. A financial penalty and an order for restitution of profits differ from both a legal and a policy perspective. The primary purpose of a financial penalty is to promote high standards of conduct by deterring persons who have committed breaches from committing further breaches, helping to deter others from committing similar breaches and demonstrating generally the benefits of compliant behaviour. The fact that Blue Gate does not have to pay the £10 million financial penalty in this case does not dilute its deterrent effect and importance. In contrast, restitution of profits serves to prevent firms from profiting from their misconduct and to ensure that those affected by the misconduct are compensated. The Authority has decided not to impose a financial penalty on Blue Gate because it considers it more appropriate for Blue Gate's profits to be paid to Investors, by means of a restitution order. This supports the Authority's objective of securing an appropriate degree of protection for consumers.

Section 384 of the Act and the Enforcement Guide

Blue Gate's representations

9. Restitution forms part of the law of unjust enrichment. It focuses on the benefit received by the defendant at the expense of the claimant. Its function is to reverse such benefits. It is not intended to be compensatory.

Authority's conclusions

10. The Authority's power to require restitution is a statutory power. The test for the exercise of the power is set out in section 384 of the Act and the jurisprudence on the restitution for unjust enrichment at common law is not relevant.

Blue Gate's representations

11. It appears that the Authority proposes to impose the restitution order by virtue of section 384(1)(a) of the Act. This permits the Authority to exercise its power under subsection (5) of section 384 to require a firm *"to pay to the appropriate person or distribute among the appropriate persons such amount as appears to the [Authority] to be just having regard ... to the profits appearing to the [Authority] to have accrued"*. By subsection (6), an *"appropriate person"* means *"a person appearing to the [Authority] to be someone ... to whom the profits mentioned in paragraph (a) of subsection (1) are attributable"*. The Authority has not specified who is/are the appropriate person(s). It cannot be the investors in the Fund because they have already assigned their claims to the Fund, which has been pursuing legal proceedings against Blue Gate and the Previous Operator in the Commercial Court. Even if it were, it is not clear which investors e.g. whether it is just the investors who invested while Blue Gate was the operator of the Fund. It appears that the claims of such investors, albeit assigned to the Fund, have already been satisfied by virtue of payments made by, or on behalf of, the Previous Operator. If that is so, the payment of any profits made by Blue Gate would be a windfall to the Fund. If the restitution sought were to be paid and distributed to the 1,200 or so investors, it would result in a payment, before administrative expenses, of about £166 per investor. There is no transparency or clarity about these matters, which are relevant in the context of the Authority's application of the criteria in Chapter 11 of the Enforcement Guide, for determining to exercise its powers to obtain restitution.

Authority's conclusions

12. Blue Gate is correct that the Authority is imposing the restitution order in this case by virtue of section 384(1)(a) of the Act, to be read alongside section 384(5)(a) and (6)(a). As set out at paragraph 6.18 of this Notice, the requirement to pay restitution is imposed for the benefit of Investors (as defined in section 3 of this Notice), and accordingly they are the "*appropriate persons*". The statutory power to order restitution is not prevented by the assignment by the Investors of certain rights of action to the liquidator of the Fund. The Authority is not 'standing in the shoes' of a private law claimant and pursuing a private law claim; it is using a statutory power defined by the terms of section 384 of the Act. In the Authority's view, the amount of restitution that each individual investor might receive is immaterial to the principle involved. In any event, it is the Authority's intention to keep administration costs to a minimum in arranging the payment of restitution to Investors.

Blue Gate's representations

13. Chapter 11.2 of the Enforcement Guide sets out a non-exhaustive list of 11 factors which the Authority "*will consider*" along with "*all the circumstances of the case*". Blue Gate comments on those which are relevant as follows:

- a. Factor (1) – Are the profits quantifiable? The Guide states: "*The [Authority] will consider whether quantifiable profits have been made which are owed to identifiable persons. In certain circumstances it may be difficult to prove that the conduct in question has resulted in the person concerned making a profit. It may also be difficult to find out how much profit and to whom the profits are owed. In these cases it may not be appropriate for the [Authority] to use its powers to obtain restitution.*" It is accepted that Blue Gate's audited accounts show an aggregate profit over the Relevant Period and Blue Gate does not seek to go behind that. But, had the directors taken their remuneration by way of salary rather than dividends, there would have been no profit at all.
- b. Factor (2) – Are the losses identifiable? The Guide states: "*The [Authority] will consider whether there are identifiable persons who can be shown to have suffered quantifiable losses or other adverse effects. In certain circumstances it may be difficult to establish the number and identity of those who have suffered loss as a result of the conduct in question. It may also prove difficult in those cases to establish the amount of that loss and whether the losses have*

arisen as a result of the conduct in question. In these cases it may not be appropriate for the Authority to use its powers to obtain restitution." There is no clarity as to whether any identifiable persons have suffered quantifiable losses. A substantial number of investors assigned their claims to the Fund. Subject, possibly, to re-assignment, those investors no longer have any claims. Even if some persons do have claims, it will be extremely difficult to establish their number and identity and even more problematic to establish any causative link between the losses of any persons and any contravention by Blue Gate.

- c. Factor (3) – The number of persons affected. The Guide states: "*The [Authority] will consider the number of persons who have suffered loss or other adverse effects and the extent of those losses or adverse effects. Where the breach of a relevant requirement by a person, whether authorised or not, results in significant losses, or losses to a large number of persons which collectively are significant, it may be appropriate for the [Authority] to use its powers to obtain restitution on their behalf. ... [W]here a large number of persons have been affected or the losses are substantial it may be more appropriate for the [Authority] to seek or require restitution from a firm. ...*". Albeit the liquidator of the Fund has pursued a large number of claims assigned to it by investors, there is simply not sufficient clarity as regards the number of persons who might have suffered loss, or the extent of those losses, to reach any conclusion on the application of this factor.
- d. Factor (4) – Authority costs. The Guide states: "*The [Authority] will consider the cost of securing redress and whether these are justified by the benefit to persons that would result from that action. The [Authority] will consider the costs of exercising its powers to obtain restitution and, in particular, the costs of any application to the court for an order for restitution, together with the size of any sums that might be recovered as a result. The costs of the action will, to a certain extent, depend on the nature and location of assets from which restitution may be made. ...*". Ultimately this may be an issue for the Authority and it may apply more in circumstances where an application to court is envisaged. But if the issue is contested, the costs will be disproportionate and may not even be recoverable.
- e. Factor (5) – Is redress available elsewhere? The Guide states: "*The [Authority] will consider the availability of redress through the Financial Ombudsman*

Service or the compensation scheme. This will be relevant where the loss has resulted from the conduct of a firm ...". Blue Gate does not make any positive submissions on this issue. It is aware that some claims may have been referred to the Financial Ombudsman Service and the Financial Services Compensation Scheme. But it has very limited information and it is not clear to Blue Gate what steps might be taken by investors in the future.

- f. Factor (7) – Can persons bring their own proceedings? The Guide states: *"The [Authority] will consider whether persons who have suffered losses are able to bring their own civil proceedings. In certain circumstances, it may be appropriate for persons to bring their own civil proceedings to recover losses. This might be the case where the person who has suffered loss is an eligible counterparty and so may be expected to have a high degree of financial experience and knowledge. When considering whether this might be a more appropriate method of obtaining redress, the [Authority] will consider the costs to the person of bringing that action and the likelihood of success in relation to the size of any sums that may be recovered."* As noted above, the Fund's liquidator, as assignee for a large number of investors in the Fund, has brought proceedings against Blue Gate and the Previous Operator. Substantial recoveries have already been made on behalf of investors from the Previous Operator and the claim against Blue Gate was stayed until recently. This was and is the appropriate forum for redress.
- g. Factor (8) – Is the firm solvent? The Guide states: *"The [Authority] will consider the solvency of the firm or unauthorised person concerned. Where the solvency of the firm or unauthorised person would be placed at risk by the payment of restitution, the [Authority] will consider whether it is appropriate to seek restitution. In those cases, the [Authority] may consider obtaining a compulsory insolvency order against the firm or unauthorised person rather than restitution. When considering these options, the [Authority] may also take account of the position of other creditors who may be prejudiced if the assets of the firm or unauthorised person are used to pay restitution payments prior to insolvency."* The solvency of Blue Gate will be placed at risk by an order to pay restitution because it will not be able to pay it. It is not clear whether the Authority considered any alternative orders but, in any event, it has not suggested any. But the absence of any suitable alternative order does not make it appropriate

to impose an order which is otherwise wholly inappropriate, not to mention futile.

Authority's conclusions

14. The Authority responds as follows in respect of each of the factors identified as relevant by Blue Gate:

- a. Factor (1) – The Authority refers to paragraphs 17 to 19 below, which discuss the issue of the relevant profits of Blue Gate. It considers that the profits are quantifiable at £203,007.
- b. Factor (2) – This factor is relevant to restitution on the basis of losses or other adverse effects pursuant to section 384(1)(b) of the Act, which is not the basis for the order in this case. The Authority does not consider that, to require restitution in relation to profits, it must also establish that there have been identifiable losses or other adverse effects.
- c. Factor (3) – Again, this factor is relevant to restitution on the basis of losses and other adverse effects pursuant to section 384(1)(b) of the Act. The Authority does not consider that, to require restitution in relation to profits, it must establish the number of persons who have suffered loss or other adverse effects.
- d. Factor (4) – As Blue Gate appears to accept, the Authority's costs are more relevant in a case where it is making an application to court for an order for restitution, which it is not doing in this case. Nevertheless, it has taken into account the costs of securing restitution in making its decision to make the order. As noted above, the Authority intends to keep administration costs to a minimum in arranging the payment of restitution to Investors.
- e. Factor (5) – The Authority notes that Blue Gate has made no positive submissions on this issue. Any payments to Investors (for example by IFAs) in settlement of awards made by the Financial Ombudsman Service in favour of Investors were taken into account in the distribution of the sums paid by the Previous Operator to prevent Investors being compensated twice for what is effectively the same loss. The Authority is not aware of any plans on the part of the Financial Services Compensation Scheme to compensate Investors.

- f. Factor (7) – [not included in this Notice].
- g. Factor (8) – The Authority does not dispute that if matters are as asserted by Blue Gate, the requirement to pay restitution in this Notice may place Blue Gate’s solvency at risk. It refers to paragraph 6 above, where this issue is discussed in more detail.

Inconsistent treatment of the Previous Operator

Blue Gate’s representations

15. No order for restitution was made against the Previous Operator. That may be because it was thought to be inappropriate in circumstances where the Previous Operator had the financial means to make, and made, such a substantial payment by way of compensation but if it made profits from its role as operator it is significant that it was not required to disgorge them. Blue Gate should not be treated any differently.

Authority’s conclusions

16. The Authority considers every case on its own facts and, in the Authority’s view, the restitution order that it has decided to impose on Blue Gate by this Notice is appropriate, for the reasons explained in this Notice. However, the Authority notes that, while the Previous Operator was not ordered to pay restitution, this was unnecessary because it was willing to fund a payment voluntarily and committed to making a significant financial contribution, albeit on a different basis to that imposed on Blue Gate in this Notice.

Profits

Blue Gate’s representations

17. In accounting terms, Blue Gate does not dispute that its aggregate profits (shown in its audited accounts) during the Relevant Period were £203,007, but those profits arose because the directors of Blue Gate chose to take dividends in lieu of salary. If the sums paid by way of dividend had in fact been paid by way of salary, Blue Gate would have made no profits at all from acting as operator of the fund during the Relevant Period. Instead, as demonstrated by a spreadsheet produced by Blue Gate, it would have made an aggregate loss over the Relevant Period of £90,005. If Blue Gate is required to

make restitution it will end up making payment twice over. Such an outcome should be avoided.

18. Blue Gate does not seek to go behind its audited accounts. Blue Gate says only that this point should be taken into account by the Authority in the exercise of its discretion in the particular circumstances of the case.

Authority's conclusions

19. The Authority notes that Blue Gate does not dispute the profits figure attributable to its work as operator of the Fund, as derived from its audited accounts and, indeed, Blue Gate supplied the profits figure of £203,007 to the Authority. The Authority does not accept that it should have regard to a theoretical scenario whereby remuneration would have been paid to directors by way of salary, rather than dividends. Further, the suggestion that, if required to pay restitution, Blue Gate would "*end up making payment twice over*" suggests the payment of dividends to Blue Gate's shareholders can be equated with the payment of restitution to Investors. The profits accrued to Blue Gate as a result of the contraventions of relevant requirements, as set out in this Notice. In the Authority's view, it is not appropriate to permit Blue Gate to avoid an order for restitution of profits on the basis that its shareholders (who are also its only directors and were so throughout the Relevant Period) have already received the profits which resulted from its misconduct, through dividend payments.