FINANCIAL CONDUCT AUTHORITY

25 The North Colonnade
Canary Wharf
London
E14 5HS

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

FINAL NOTICE

To: **Capita Financial Managers Limited ("CFM")**

FRN: **119197**

Address: **6th Floor, 65 Gresham Street, London EC2V 7NQ**

Date: **10 November 2017**

1. ACTION

1.1 For the reasons given in this Notice, the Authority hereby imposes a statement pursuant to section 205 of the Financial Services and Markets Act 2000 to the effect that CFM contravened regulatory requirements.

1.2 CFM agreed to resolve these matters. As part of the resolution, CFM has agreed to make a payment of up to £66 million which will be distributed to all investors who had outstanding claims against the Guaranteed Low Risk Income Fund, Series 1 (later renamed the Connaught Income Fund Series 1) ("the Fund") when the Fund entered into liquidation on 3 December 2012 ("the Fund's Investors"). The Fund's Investors include those who invested in the Fund after CFM's tenure as Operator of the Fund. Given CFM is not in a position to make

this payment in its entirety, CFM's ultimate parent, Capita plc ("Capita plc"), has agreed to fund any shortfall up to £66 million.

1.3 The aim of the payment is to return to the Fund's Investors their capital investments less any amounts which they have already received in interest and by way of redemptions, distributions, payments or dividends. The payment also provides for an interest rate of 0.52% to be applied over the period from each Fund Investor's capital investment and until the date on which those monies were returned to each investor. The mechanism by which CFM's payment will be distributed to investors is outlined in Annex D.

1.4 The serious failings in this case warrant a substantial penalty. The Authority has taken account of the fact that CFM itself would not have been able to make the payment referred to in paragraph 1.2 above and that this will only be possible with the financial support given to CFM by its ultimate parent, Capita plc. In all the circumstances of this case the Authority does not consider that it would be appropriate to require CFM to pay a financial penalty.

1.5 Had it not been for CFM's (with the assistance of its ultimate parent company, Capita plc) agreement to make the payment then the Authority would have imposed a financial penalty of £15 million. In that event CFM would have qualified for a 30% discount (stage 1) in accordance with the Authority's executive settlement procedure, which would have reduced the penalty to £10.5 million.

2. SUMMARY OF REASONS

2.1 The Fund was an unregulated collective investment scheme ("UCIS") which was established in March 2008 and which commenced its business activities in and around July 2008. The Fund was designed to allow the Specialist Partner to drawdown the money invested in the Fund so that it could provide short term bridging finance to commercial borrowers in the UK property market.

2.2 The misconduct in question took place between 7 April 2008 and 25 September 2009 ("the Relevant Period"). Throughout the Relevant Period CFM was an authorised person and the Operator of the Fund. At the end of the Relevant Period CFM resigned as Operator of the Fund and was replaced by the

Replacement Operator. The Replacement Operator retained this role until the Fund entered into liquidation on 3 December 2012.

2.3 The Fund was promoted to investors during CFM's tenure as Operator via IM1 and IM2. IM1 was approved by CFM on 7 April 2008 and it was later updated and replaced by IM2, which CFM reviewed and approved on 29 January 2009. The IMs stated that investors in the Fund could expect to receive a fixed return of interest on their investment.

2.4 The Fund itself was established and directly managed by the Fund Asset Manager which was not an authorised person. CFM, as Operator, retained the primary responsibility for managing the investments of the Fund, although the Fund, acting via its General Partner, accepted that CFM was not holding itself out as competent to manage the investments of the Fund. The Operator's Agreement made clear that the management would be carried out by the Fund Asset Manager.

2.5 The Fund's final suspension began in April 2012 and it was placed into liquidation in December 2012. Since the Fund entered into liquidation, the Insolvency Service has disqualified two directors of the Fund Asset Manager and the Guarantor for their conduct in matters relating to this Fund. In July 2014 the liquidators of the Fund brought a civil claim against CFM which was settled in January 2016 resulting in a *pari passu* distribution of £18.5 million among the Fund's Investors.

2.6 As an authorised person, CFM was required to carry out its duties as Operator in accordance with the Authority's Principles for Businesses ("the Principles") and its obligations to the investors in the Fund commenced on 7 April 2008, when CFM approved the Fund's main promotional document, IM1. It was important for CFM to comply with the Principles because consumers expect an authorised firm to conduct its business in such a way that their interests are properly taken into account. UCIS can carry a high risk of investors losing some or all of their money, as they frequently invest in assets that are not available to regulated CIS and they are not subject to investment and borrowing restrictions aimed at ensuring a prudent spread of risk. As a result they are generally considered to be high risk investments and accordingly there are restrictions on persons to whom such investments may be promoted. 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.

2.7 CFM breached Principle 2 (Skill, care and diligence) in that it did not carry out its contractual obligations as Operator of the Fund with due skill, care and diligence. In particular:

1. CFM's due diligence and take-on process contained basic failings such that at the point at which CFM became the Operator of the Fund it did not adequately understand the structure of the Fund's business or its responsibilities and duties as Operator;

2. CFM failed to rectify its initial due diligence and take-on failings fully, even when it recognised that its processes had been inadequate. An important consequence of this failing was that CFM missed opportunities to understand its role and the structural arrangements relating to the Fund better;

3. CFM continued to allow monies to be invested in the Fund despite its developing concerns that the Fund's IMs were not clear, fair and not misleading, until suspending the Fund to new investors in July 2009;

4. throughout most of its tenure as Operator CFM failed to monitor the Fund adequately to ensure that the Fund's contractual counterparties were operating in accordance with their contractual obligations;

5. towards the end of its tenure as Operator CFM became aware that its contractual counterparties had breached the Fund's procedures and parameters, and that consequently the Fund's monies were potentially at greater risk. Some of these issues meant that some of the Fund's monies were not secured with the appropriate legal protection. CFM had already decided to exit this Fund and other such funds in the context of its strategic review of investment funds. On becoming aware of various issues which arose in respect of the Fund, CFM considered all options for the Fund including winding it down. However, it ultimately decided to seek to secure an alternative operator. In

continuing to pursue a strategy of handing over the Fund, CFM failed to ensure that it either:

a. took action to address all of the issues of which it became aware (or conclude, if warranted, that the Fund should be closed without delay); or

b. informed the Replacement Operator fully about the issues which had arisen; and

6. although the Replacement Operator was provided with some information in respect of most of the issues identified by CFM, many of the deficiencies in the Fund continued unaddressed after handover.

2.8 CFM breached Principle 7 (Communications with clients) in that it did not communicate information to the Fund's investors in a way which was clear, fair and not misleading. In particular CFM approved the IMs which contained a number of inaccuracies, omissions, and unclear or potentially misleading statements, such as describing the Fund as "*low risk*" and "*guaranteed*" and naming a particular firm as auditor when in fact that firm was not instructed.

2.9 As a consequence of making investments into the Fund, losses were suffered by the Fund's Investors who collectively made approximately 1,200 investments directly into the Fund as well as those who invested through platforms. The Authority understands that approximately 25% of the Fund's Investors invested during CFM's tenure as Operator.

2.10 CFM, with the assistance of its ultimate parent (Capita plc), has previously made a payment of £18.5 million to the Fund's Investors.

2.11 As described in paragraph 1.2 above, CFM has agreed to pay up to £66 million for the benefit of the Fund's Investors. The Authority considers that this payment will be sufficient to ensure that the Fund's Investors' outstanding principal capital investment in the Fund is returned to them together with interest applied at the rate described above.

2.12 The Authority notes, however, that CFM itself would not have been able to pay a sum of up to £66 million, and this will only be possible with the financial

support given to CFM by its ultimate parent, Capita plc. For this reason, the Authority hereby imposes a statement that CFM has breached regulatory responsibilities rather than impose a financial penalty, so that available funds are directed towards the Fund's Investors. This action supports the Authority's operational objective of securing an appropriate degree of protection for consumers.

2.13 For the sake of clarity, this notice makes no criticism of any person, whether individual or body corporate, other than CFM.

2.14 The FCA's investigations into other parties are continuing.

3. DEFINITIONS

The definitions below are used in this Notice:

"the 6 August 2009 Board Paper" means the paper produced for a meeting which included some members of CFM's board and other employees on 7 August 2009

"the 8 Point Letter" means the letter of 21 August 2009 CFM sent to the PRO

"ACD" means Authorised Corporate Director

"the Act" means the Financial Services and Markets Act 2000

"the Authority" means the body corporate previously known as the Financial Services Authority and renamed on 1 April 2013 as the Financial Conduct Authority

"the business unit compliance function" means the compliance function of the business unit of which CFM formed part

"Capita plc" means the entity which throughout the Relevant Period was CFM's ultimate parent company

"CCJ" means County Court Judgment

"CFM" means the entity known throughout the Relevant Period as Capita Financial Managers Limited and which is now known as Link Fund Solutions Limited

"CIS" means collective investment scheme

"COBS" means the Authority's Conduct of Business Sourcebook

"Debenture Agreement" means the Debenture Agreement between the Specialist Partner and the Fund dated 10 September 2009

"DEPP" means the Authority's Decision Procedure and Penalties Manual

"the First Delegate" means another entity within the same business unit as CFM to which CFM delegated a number of administrative functions until September 2008

"the Fund" means the Guaranteed Low Risk Income Fund, Series 1 (which was later renamed the Connaught Income Fund, Series 1)

"the Fund Asset Manager" means the Asset Manager of the Fund during the Relevant Period

"the Fund General Partner" means the general partner of the Fund during the Relevant Period

"the Fund's Investors" means all investors who had outstanding claims against the Fund when the Fund entered into liquidation on 3 December 2012

"the Guarantee" means the contractual guarantee between the Guarantor and the Fund

"the Guarantor" means the firm which provided the Guarantee

"the Guarantor's 2008/9 Accounts" means the Guarantor's published financial statements and accounts for the year ending 2008/09

"Information Memoranda" or "IMs" means together IM1 and IM2

"IFAs" means independent financial advisors

"IM1" means the first information memorandum which CFM approved for the Fund on 7 April 2008

"IM2" means the second information memorandum which replaced IM1 and which CFM approved for the Fund in January 2009

"Investment Policy" means the Fund's Investment Policy and Procedure Manual, dated April 2008

"IRAT" means CFM's Initial Risk Assessment Template process

"LP" means limited partnership

"LTV" means loan-to-value

"the Mortgage Charge" means, in respect of each loan made by the Specialist Partner, a mortgage charge registered at the Land Registry in the Specialist Partner's name and against the underlying borrower's property to secure the Fund's monies

"the Operator" means the Operator of the Fund

"Principles" means the Authority's Principles for Businesses

"PRO" means potential replacement operator

"Relevant Period" means from 7 April 2008 to 25 September 2009

"the Replacement Operator" means the firm which replaced CFM as Operator of the Fund on 25 September 2009

"the Second Delegate" means another entity within the same group as CFM to which CFM delegated a number of administrative functions from September 2008

"Security Mechanism" means collectively i) the registration of the Mortgage Charges and Sub-Charges; ii) the registration of the Debenture; and iii) the Guarantee

"the Specialist Partner" means the Specialist Partner which was a role defined under the Information Memoranda and the entity which drew down the Fund monies, which was a subsidiary of the Guarantor

"the Sub-Charge" means, in respect of each loan made by the Specialist Partner, a sub-charge registered at Companies House against the Specialist Partner and in favour of the Fund, corresponding to and noted on the Mortgage Charge registered at the Land Registry in respect of the same loan

"Termination Agreement" means the Termination Agreement entered into between amongst others CFM, the Replacement Operator, the Fund and the Fund Asset Manager on 23 September 2009

"Tri-Party Meeting" means the meeting between the Fund Asset Manager, CFM and the Replacement Operator held on 17 September 2009

"UCIS" means unregulated collective investment scheme

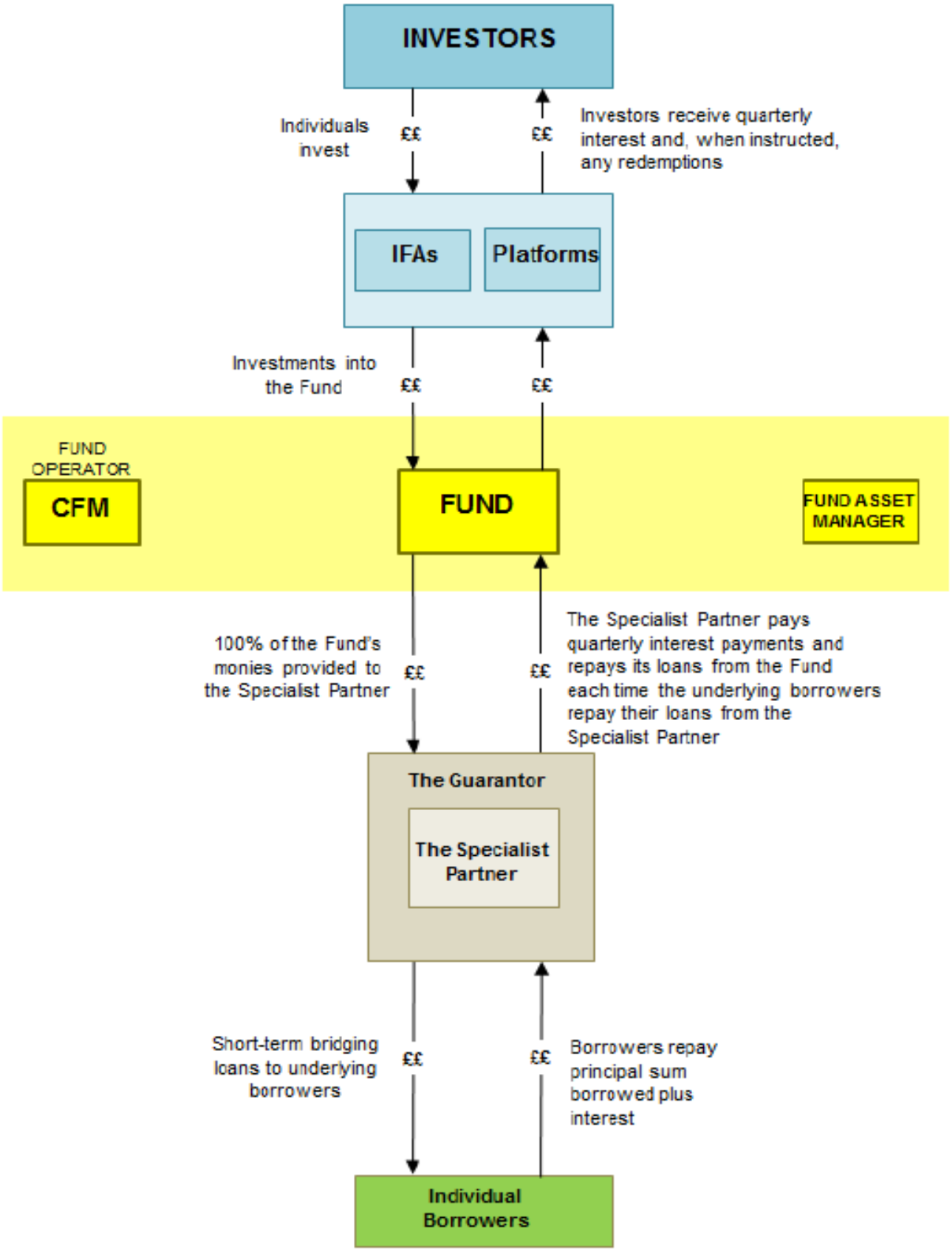
4. FACTS AND MATTERS

Background

The main entities involved in the Fund

4.1 A diagram illustrating the key entities and flow of monies in and out of the Fund is set out below.

Diagram illustrating the key entities and flow of monies in and out of the Fund



4.2 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 this Fund's IMs, 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 CFM 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 secured loans (i.e. bridging loans) which were intended to be secured against UK property.

3. 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.

4. 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.

5. The Guarantor was placed into administration on 28 September 2012. The Specialist Partner was placed into administration on 5 July 2012.

6. The Fund Asset Manager's role was to manage the assets of the Fund and was not authorised by the Authority. The Fund Asset Manager was responsible for reviewing loan applications submitted by the Specialist Partner and verifying that the application complied with the terms of the Fund's IMs. If the application satisfied those terms, the Fund Asset Manager was to supply CFM, 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.

7. As Operator, CFM's role was to review and approve the draft Information Memoranda which was drafted by the Fund Asset Manager. Pursuant to the Fund's contractual documentation, CFM delegated to the Fund Asset Manager the task of managing the investments of the Fund and, although CFM retained the primary responsibility for this, it

specifically did not hold itself out as being competent to manage the investments of the Fund.

The Information Memoranda

4.3 CFM reviewed IM1 and approved it on 7 April 2008. IM1 was replaced in February 2009 following CFM's approval of IM2. The Fund's IMs were intended to be the main promotional documents explaining to potential investors the structure and key features of the Fund. The explanations included the parameters of the loans to be granted and the level of return which investors would receive.

4.4 The Specialist Partner's underlying lending proposal ought not to have been approved if it failed to satisfy the lending parameters in the Fund's IMs. An example of a key lending parameter was that the Specialist Partner was only to advance loans to "*prime borrowers*"; that is, borrowers with no CCJs, previous loan defaults, mortgage arrears or missed credit card payments in the last 12 months. In addition, 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 IMs. However, these percentages were stated to be a guideline and it was open to the Fund to issue loans outside of these parameters if the Fund Asset Manager deemed it appropriate. The IMs also specified that the Specialist Partner would issue short term loans, ranging from between three and six months. The Investment Policy published with the IM provided in two places that the Fund would invest in short term bridging finance with typically between a three and 12 month repayment period, although it did go on to state that the term of the loan could be extended with the written consent of the Fund Asset Manager.

The operation of the Fund

4.5 The way the Fund was designed to operate was 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.

4.6 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 CFM as Operator release the loan from the Fund to the Specialist Partner. Prior to drawdown, all of the investors' money was held in the Fund's bank account which was controlled by CFM.

4.7 In practice, CFM did not ensure that the Specialist Partner's lending practices were reviewed and monitored adequately by the Fund Asset Manager for most of the Relevant Period and this allowed some loans to be made outside of the parameters set out in the IM.

4.8 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.

4.9 IM1 specified that the investors would receive interest of either 8.15% or 8.5% per annum, the interest rate being dependent on the size of their investment. These returns were adjusted in IM2 to either 8.4% or 8.77% if the investor elected to reinvest their income. The Specialist Partner was obliged to pay interest to the Fund regardless of whether or not it had drawn down the Fund's monies. These interest payments were made throughout the Relevant Period.

<u>Mechanisms intended to secure the monies lent by the Fund to the Specialist Partner</u>

4.10 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

4.11 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.

4.12 Security taken in connection with the loans was to be registered at Companies House and the Land Registry. Failure to do so could have affected the priority of the security against third parties.

Second tier

4.13 A Debenture Agreement was supposed to be registered at Companies House in favour of the Fund and over the real property of the Specialist Partner, including any redemption monies held by the Specialist Partner. The Debenture Agreement 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 then the Fund could exercise its rights under the Debenture Agreement.

Third tier

4.14 In addition, the Guarantor provided the Guarantee to the Fund. The Guarantee operated as a final fall-back to the Fund which was only to be called upon in the event and to extent that the Specialist Partner failed to make the required payments to the Fund, pursuant to the Debenture Agreement or otherwise.

4.15 Paragraphs 4.57 to 4.59 and 4.102 to 4.114 below address the deficiencies which occurred in respect of each tier in the Security Mechanism.

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

4.16 CFM's responsibilities, duties and powers in respect of the Fund were set out in the Operator's Agreement (entered into between CFM and the Fund) and the Sponsorship Agreement (entered into, among others, between CFM and the Fund Asset Manager). Relevant clauses from both Agreements are set out in Annex C. According to those contractual documents, CFM's responsibilities, duties and powers included:

1. establishing the Fund;

2. reviewing and approving the IM;

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 to investors).

4.17 The Fund was a limited partnership established under the Partnership Act 1907. The Fund therefore had no legal identity separate from its partners, who were the individual investors in the Fund. Under COBS 3.2.3(4), CFM's client was the Fund notwithstanding that it had no separate legal personality.

4.18 CFM was contractually obliged under clause 4.2 of the Operator's Agreement to act in the best interests of the Fund and to exercise that degree of care and skill as could reasonably be expected of a person experienced and skilled in the management, operation and administration of a limited partnership. CFM was also required to exercise the care and diligence expected of a professional adviser in selecting the third parties to whom it might delegate its rights and obligations and in monitoring and supervising any such third parties.

4.19 Whilst CFM had primary responsibility for managing the investments of the Fund, it had not held itself out as competent to manage such investments and had delegated this activity to the Fund Asset Manager. CFM was not responsible for the acts or omissions of the Fund Asset Manager. This made the extent of CFM's contractual duties as the Operator to supervise and monitor the Fund and its overall operation unclear.

4.20 CFM was throughout the Relevant Period an authorised firm. Accordingly CFM was required to carry out its duties as Operator in accordance with the Principles.

CFM and its group companies

4.21 CFM offered various services to clients including acting as ACD of authorised funds or authorised unit trust manager. CFM's experience before and during the Relevant Period was predominantly in regulated CIS as opposed to UCIS. For example, as at 30 June 2009 CFM provided services to approximately 336 funds. Of these, 328 were regulated CIS in which CFM was the ACD or authorised unit trust manager, and eight were UCIS in which CFM acted as the Operator.

4.22 Initially, CFM delegated the fund administration activities to another entity in the same group which operated as, among other things, the in-house administrator for CFM ("the First Delegate"). In early September 2008, these activities were transferred to a different entity in the group ("the Second Delegate").

4.23 The delegated activities which were to be carried out by the Second Delegate included:

1. reviewing the information provided by the Fund Asset Manager for each loan application;

2. having responsibility for the Fund's bank account from which drawdowns were made to the Specialist Partner;

3. carrying out regular reconciliations of the monies held in the Fund's bank account to ensure it was able to maintain accurate records and accounts. In order to satisfy this requirement it was required to monitor investors' subscriptions and redemptions; and

4. overseeing the quarterly payment of interest to investors.

4.24 The above activities were purely of an administrative nature. Notwithstanding the delegation of these administrative tasks, CFM at all times was responsible for overseeing and monitoring the activities of the Second Delegate. The Second Delegate was not itself the Operator and had no role in relation to the Fund outside of acting on instructions from CFM.

4.25 CFM also used the business unit compliance function to procure information. CFM was at all material times responsible for overseeing and monitoring the business unit compliance function.

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

4.26 A diagram showing key events within the Relevant Period is set out in Annex A.

4.27 In early 2008 CFM's process for considering whether it should take-on new business was referred to as IRAT. This process culminated in an IRAT Committee meeting. The IRAT Committee meeting was the key decision making process for taking on new business or making significant changes to current business. It is noted that CFM initiated and implemented a range of enhancements to the IRAT process over the Relevant Period and subsequently. However, in early 2008 these enhancements had not been implemented.

4.28 The IRAT Committee met on 26 March 2008 to consider, among other things, whether CFM should take-on the Fund. Ahead of this meeting the IRAT Committee was provided with a two page briefing document (the IRAT form). The information set out in the IRAT form contained inaccuracies and omissions. The IRAT form:

1. stated that the name of the Fund included the words "*Low Risk Income Fund*" when by this point the Fund Asset Manager was giving consideration to including the word "*Guaranteed*" in the proposed name. The IRAT Committee therefore did not consider whether the Fund could appropriately be named and promoted as "*The Guaranteed Low Risk Income Fund*";

2. was incorrect in stating that an accountancy firm had been appointed as the auditor of the Fund, whereas in fact no auditor had been appointed; and

3. did not set out what aspects of CFM's responsibilities and duties as Operator were non-standard.

4.29 The CFM member of staff proposing the new business did not attend the IRAT Committee meeting. Accordingly, no CFM employee who might have had

additional relevant information attended the Fund's IRAT Committee meeting. The minutes of the IRAT Committee meeting did not show that any consideration was given to what CFM's responsibilities as Operator of the Fund would be or whether CFM was capable of discharging these responsibilities.

4.30 On 17 September 2009, and shortly before CFM's tenure as Operator terminated, CFM produced and circulated internally a paper which analysed CFM's IRAT process for this Fund. CFM's own findings were that at the take-on stage for the Fund, and then throughout its entire tenure as Operator, CFM had failed to understand what the role of Operator required. The internal CFM paper stated that at the point at which CFM agreed to take-on the Fund it thought that: "*… the Operator role was that of providing basic fund administration and transfer agency functions….*". In addition, it stated that had a more robust IRAT process occurred: "… *this case would have been highlighted at* [the IRAT Committee] *and given more consideration before approval, and likely would have been rejected given the name, risks, and nature of the* [Fund]".

4.31 However, in March 2008 the IRAT Committee did not reject the Fund. Based on the information contained in the IRAT form, and subject to obtaining the agreement of the First Delegate (who it was envisaged would have the responsibility for undertaking CFM's administrative activities for the Fund), it approved the new business.

4.32 The First Delegate subsequently raised several concerns regarding the potential risks of taking on the Fund, including:

1. noting that the Operator's Agreement placed duties on CFM which it "*would not usually cover off and which have a high risk of being missed*", and accordingly questioned how many people within CFM had had sight of this agreement;

2. whether there was adequate resource and structures in place to undertake this work;

3. whether any due diligence had been carried out on the Guarantor; and

4. what ongoing monitoring would take place if the Fund was accepted.

4.33 To address some of these concerns it was agreed that the First Delegate would take-on the administrator role in a temporary capacity until it could be transferred to the Second Delegate. However, in practice these concerns were not adequately addressed prior to the Fund being taken on by CFM.

4.34 After the IRAT Committee had considered the take-on proposal the business unit compliance function was asked to conduct a review of the proposal. The review which was conducted was limited and identified no deficiencies with IM1. On 7 April 2008 the business unit compliance function confirmed that it had reviewed the paperwork provided and confirmed that it was "*in order*". CFM treated this confirmation as being the final approval which it required in order to accept the Fund and approve IM1.

4.35 Shortly afterwards IM1 was made available to IFAs. After allowing a period for subscriptions the Fund became operational and was formally launched in July 2008.

Potentially misleading statements in IM1

4.36 The name of the Fund, as described in IM1, was "*the Guaranteed Low Risk Income Fund, Series 1*" and there are numerous references throughout IM1 to the Fund being guaranteed and low risk. For example, IM1 stated that: "*The guaranteed income in the Fund varies between 8.15% and 8.5%, depending on the amount invested*". The Authority considers that this statement is potentially misleading because the IM did not highlight the risk that the Guarantee that was in place was dependent on the strength of the Guarantor.

4.37 While IM1 includes a number of risk factors including that an investment *"involves a degree of risk"*, it also contained statements that suggested the investments were secure and low risk, for example:

1. "*Guaranteed Liquidity after 6 months*";

2. "*Investors will receive 100% of their initial Participations back*";

3. "*Low Risk… In the context of this investment described* [sic] *the fact that 100% of the investors* [sic] *capital, together with any interest*

due, will be returned on request, subject to the conditions of the Fund";

4. "*The* [Fund] *has been developed to make this market accessible directly to investors whilst reducing risk levels through…investment diversification; a first charge secured against the asset…*"; and

5. "[Income in the Fund] *is very favourable when comparing* [sic] *to other fixed rate products such as savings accounts and bonds available from high street and internet providers*" and "*internet searches suggest that the best rates achievable from long-term savings accounts are less than 6.5%*".

4.38 IM1 also stated that a named firm of auditors had been appointed to the Fund when in fact no auditors had been appointed, and despite CFM's later attempts to address this no auditors were appointed throughout CFM's tenure as Operator.

The business unit compliance function's concerns regarding the initial due diligence on the Fund

4.39 The business unit compliance function conducted a routine compliance visit to the Fund Asset Manager on 2 October 2008 and the next day its observations were reported internally. The business unit compliance function observed that the due diligence performed on the Fund Asset Manager before the Fund was taken on was focused on an examination of the Fund Asset Manager's compliance arrangements and directors' profiles. Although the business unit compliance function assumed that CFM's staff and the IRAT Committee had considered the details of the Fund it noted that it had not been able to find any information to support this assumption. The business unit compliance function also expressed concerns about the use of the words "*guaranteed*" in IM1.

4.40 Within the business unit compliance function, discussions on these concerns continued through to the end of November 2008 without resolution. During these discussions the business unit compliance function set out that:

"*The terms "guarantee" and "guaranteed" appear to feature throughout the marketing documentation in different contexts in relation to both*

income and liquidity claims and we must realise that this could be construed against us (expensively)."

4.41 However, notwithstanding the business unit compliance function's concerns regarding the Fund being marketed as "*Guaranteed*", no changes to IM1 were recommended until CFM made the change of the Fund's name a condition of handing over the Fund to a replacement operator.

Approval of IM2

4.42 On 20 January 2009 the Fund Asset Manager emailed an updated version of IM1 to CFM. The Fund Asset Manager explained that the purpose of updating IM1 was to reflect developments in the markets and changes to interest rates on any reinvestment of investors' returns. The Fund Asset Manager requested that the business unit compliance function review the document. On 29 January 2009, the business unit compliance function commented on the draft document which in due course became IM2. Despite the business unit compliance function having raised concerns regarding the description of the Fund as set out in paragraphs 4.39 and 4.40 above, the members of the business unit compliance function who reviewed this document again failed to identify and address the inaccuracies, omissions and unclear and potentially misleading statements in the updated IM. Instead, the business unit compliance function's comments were limited to correcting minor typographical errors and some inconsistencies in the text. These comments were forwarded to the Fund Asset Manager on 29 January 2009. Subject to these comments being incorporated, CFM approved the updated IM which became IM2. In material respects the content of IM2 was the same as IM1.

Further concerns raised by the business unit compliance function

4.43 From around November 2008 the Fund Asset Manager began attempts to promote the Fund in an overseas jurisdiction. In order to operate in this jurisdiction it had first to obtain approval from that jurisdiction's financial services regulator. After providing information in support of its application the overseas regulator raised questions about certain gaps and anomalies in the Fund Asset Manager's submissions. In particular, the overseas regulator noted that the submissions had omitted to mention that certain employees of the

Fund Asset Manager had links to a collapsed unlawful collective investment scheme and questioned the extent to which the Fund Asset Manager had been candid in its application.

4.44 The questions raised, together with those raised internally, prompted CFM to instruct the business unit compliance function to review the overseas regulator's concerns. On 8 January 2009, the business unit compliance function advised CFM about its:

> "...*concerns vis-à-vis initial due diligence, the nature of the scheme and its similarities to the unlawful collective investment scheme and the potential exposure the business may have if the schemes are not to standard*".

4.45 On 9 January 2009, the business unit compliance function communicated to CFM that: "*There are many questions being asked which should have been asked when the business was taken on…*".

4.46 Between 23 January 2009 and 6 March 2009 the business unit compliance function provided three due diligence reports to CFM. The conclusion of the First Due Diligence Report, which was repeated in both the Second and Third Due Diligence Reports, was that if the take-on of the business had been considered at that point in time then the results of these due diligence enquiries would have "*yielded a recommendation to the CFM Board that the business relationship should not be entered into*". However, the reports ultimately concluded that "*we have reached a position where this business arrangement can be satisfactorily continued, subject to the usual oversight arrangements*".

4.47 CFM recognised that the connection between the unlawful collective investment scheme (which had collapsed) and the Fund "*could taint the Fund*" and that although it did not think that the Fund was a "*scam*" it recognised that there were risks associated with having this connection.

4.48 CFM subsequently ensured that steps were taken to sever the Fund Asset Manager's key links to the unlawful collective investment scheme, consistent with the ultimate recommendations of the Due Diligence Reports produced by the business unit compliance function. Although there were some questions at

least in the Second Delegate regarding the effectiveness of the steps taken, at the very least the Authority considers that knowledge of the links between the Fund Asset Manager and the unlawful collective investment scheme ought to have acted as a warning sign to CFM to ensure that the Fund was being managed properly and ought to have been viewed as a matter of serious concern if it was not.

March 2009 to May 2009

4.49 On 9 March 2009 CFM instructed the Second Delegate to review all payments made out of all of the funds in which it had dealings with the Fund Asset Manager, including the Fund. However, and specifically in respect of the Fund, the Second Delegate considered that the records handed over from the First Delegate to the Second Delegate were incomplete. These records took several months to be properly organised and brought up to date.

4.50 In the meantime, on 14 April 2009, the business unit compliance function advised CFM that the name of the Fund should be immediately changed and expressed concern that under this arrangement CFM was required to approve the promotional documentation for the Fund which was considered to be outside CFM's business model. On 20 April 2009 CFM informed the Fund Asset Manager that the business unit compliance function required the words "*Guaranteed*" and "*Low Risk*" to be removed from the Fund's name. The business unit compliance function was concerned about the risk of mis-selling; specifically, that investors may have been investing in the mistaken belief that that they would never lose their capital. This risk was considered by the business unit compliance function in the context of the professional or suitably experienced investors to whom the Fund was intended to be marketed.

4.51 However, the name of the Fund was not in fact changed until CFM handed over the Fund to the Replacement Operator (where CFM made it a condition of the transfer) and nor were any significant changes made to IM2. New subscriptions continued to be accepted into the Fund on the basis of this description of the Fund until 23 July 2009 with top-ups by existing investors being permitted throughout CFM's tenure as Operator.

4.52 During April 2009 the relationship between CFM and the Fund Asset Manager deteriorated. On 5 May 2009 the Fund Asset Manager wrote to CFM criticising CFM's approach in its dealings with the Fund Asset Manager and its performance as Operator. The Fund Asset Manager also considered that CFM was overstepping the bounds of its role as Operator, as set out in the Fund's contractual documentation. In a draft response circulated internally within CFM it was noted that:

> "*Underlying many of the issues we have experienced with this relationship is the lack of specialist knowledge within all of* [CFM] *concerning exactly what our responsibilities and liabilities are*".

May 2009: CFM's decision to resign as Operator

4.53 At a meeting between CFM and the Fund Asset Manager on 15 May 2009 CFM told the Fund Asset Manager that "*it was best for both organisations to have a parting of ways*". CFM requested in May 2009 that no new investors enter the Fund until a replacement Operator had been appointed. The Fund Asset Manager explained that this would be an unacceptable disruption to its business but that it understood CFM's position. On 23 June 2009 CFM added an update at the end of these minutes of this meeting, stating that it had allowed the Fund's bank account to remain open "*so as not to disrupt business or impact investors*".

4.54 CFM subsequently considered whether it should take a more limited administrator role in relation to the Fund. However, in a meeting on 26 May 2009 at which several CFM Board members were present, the business unit compliance function expressed the view that "*if the profit for* [CFM] *was insubstantial it would be beneficial not to provide any work for* [the Fund General Partner]*, bearing in mind the wider reputational implications for* [CFM]." In the event, CFM decided not to take-on this more limited administrator role.

4.55 The decision to withdraw from the role of Operator of the Fund was also made in the context of a wider strategic decision by CFM to cease acting as operator of all unregulated funds and focus on its core business of acting as the ACD of regulated funds with authorised fund managers, which was implemented.

July 2009: CFM's decision to close the Fund to new subscriptions

4.56 On 22 July 2009, and following CFM's instruction, the Second Delegate emailed the Guarantor's 2008/9 Accounts to the business unit compliance function noting that "*the accounts show that* [the Guarantor] *made a loss in the year to 31st March 2009 of £1.4m, which draws into question the ability of* [the Fund] *to guarantee a rate of return on* [the Fund]*, which it was assumed* [the Guarantor] *would cover…*". The business unit compliance function recorded on 24 July 2009 that CFM, the Second Delegate and the business unit compliance function considered that the Guarantor might not have been financially stable and that the Fund "*… may not be able to meet its guarantee to pay 8.15* [or] *8.5% to investors with no risk to capital*".

4.57 On 22 July 2009 CFM recorded its view that the Guarantor was not in a position to "*back up*" the Guarantee. As a result members of CFM, the Second Delegate and the business unit compliance function arranged to meet the Fund Asset Manager the following day to inform the Fund Asset Manager that it would stop taking new subscriptions into the Fund with immediate effect and seek reasons from the Fund Asset Manager as to why it should not begin to wind up the Fund within one week of this meeting.

4.58 In this meeting it was agreed that the Fund would be closed to new investors and that new subscriptions to the Fund would cease immediately. This was put into effect on 25 July 2009 from which date CFM formally suspended the Fund to new subscriptions.

4.59 This was, however, not a full suspension of the Fund's operation. Despite CFM's concerns about the misleading promotional documentation, its serious concerns about the strength of the Guarantee and the various issues which CFM became aware of in the weeks that followed 23 July 2009 (as set out below) CFM continued to accept further investments from existing investors both in the form of top-ups and re-invested interest throughout the remainder of its tenure as Operator. Between 25 July 2009 and 25 September 2009 (being the date on which the Fund was handed over to the Replacement Operator) CFM permitted existing investors to invest a further £3.23 million into the Fund. CFM also continued to process loan drawdowns from the Fund to the Specialist Partner until mid-September 2009.

25 July 2009 onwards: CFM's actions to identify and consider further issues with the Fund

4.60 In August 2009 CFM and the Second Delegate analysed in more depth the operation of the Fund. Some of the issues which became apparent ought to have been identified much earlier.

Breaches of the LTV ratio parameters as set out in the IMs

4.61 After CFM had suspended new subscriptions to the Fund, the Second Delegate began to monitor the drawdown requests it received to ensure that the drawdown requests were within the LTV ratio parameters set out in IM2. As a result of this the Second Delegate then rejected a drawdown request on the basis that the prospective LTV ratio would have exceeded the parameters of IM2 and continued, on behalf of CFM, to reject requests where these appeared to be outside the terms of IM2.

4.62 On 4 August 2009 the Second Delegate informed CFM that some historic loans which had already been approved had exceeded the 80% LTV ratio parameter. The Second Delegate also told CFM that it was uncomfortable with the Fund Asset Manager's application of a "*Special Asset Value*" to properties "*in order for the 80%* [LTV ratio] *to not be breached*". These issues were raised with the Fund Asset Manager who provided CFM with assurances in relation to its concerns.

4.63 On 20 August 2009 the Second Delegate provided the business unit compliance function with a loan schedule which detailed the LTV ratios which, as part of its review into LTV ratios, it had been able to identify at the time. The schedule showed that two loans had been drawn down in respect of one property which had resulted in a collective LTV ratio of 152%. The Second Delegate stated that it was aware of two loans which breached 80% LTV ratio, but added that it did "*not know all the LTV ratios*", despite it or the First Delegate having approved all of these loans.

4.64 The Authority has reviewed a sample of 38 of 113 loans packs for loans approved during CFM's tenure as Operator. Of the loans reviewed, the Authority has identified seven loans which were approved during CFM's tenure which had LTV ratios in excess of 85%. Subsequent to the Relevant Period CFM

conducted an investigation which showed that of 116 loans drawn down during CFM's tenure as Operator, 14 appear to have exceeded an LTV ratio of 85%.

4.65 Before CFM began to identify potential issues in relation to the Fund it did not routinely procure adequate checks of loan requests or ensure that adequate records were being maintained of the loans which had been approved.

4.66 At a meeting between the Fund Asset Manager and CFM on 16 September 2009 CFM reiterated to the Fund Asset Manager that the practice of issuing loans with LTV ratios which breached the IMs must not continue. This issue (among others) was also raised at a meeting the following day with the Replacement Operator.

Rolling over loans

4.67 The IMs informed investors that bridging finance "*is specifically utilised for funding short term property mortgages*" and that the term of the loans would be "*between three and six months*". However, a different period was set out in the Investment Policy which was published with the IMs and which was intended to be read in conjunction with them. The Investment Policy provided that the Fund would invest in short term bridging finance with a repayment period of typically between three months and 12 months. This period was also capable of being extended with the written consent of the Fund Asset Manager.

4.68 Not all loans which were approved during CFM's tenure as Operator had fallen due at the point of handover to the Replacement Operator. However, by early August 2009, the Second Delegate had identified that capital repayments for a number of loans which ought to have matured had not at that point been repaid to the Fund. On 5 August 2009 the Second Delegate wrote to the Fund Asset Manager to ask why of the 25 loans that had been made by the end of September 2008 only seven of those loans had been repaid to the Fund as at 31 July 2009. The Fund Asset Manager told the Second Delegate on 7 August 2009 that the Specialist Partner, with the approval of the Fund Asset Manager but without CFM or the Second Delegate being aware, had been allowing the term of those loans to roll over.

4.69 CFM ought to have been in a position such that it could identify the rolling over of the loans. However, partly due to the length of the loans and in any event

because the loan book and the corresponding reconciliations of the Fund's bank account were not being adequately monitored, CFM was not aware until August 2009 that any loans had been rolled over, and therefore that monies had not been returned to the Fund's bank account when due. While the Fund Asset Manager was able to provide explanations for the loans that had been rolled over, the practice could have masked the extent to which the borrower might have defaulted on the repayment had it been called upon when due instead of the loans being allowed to roll over. Therefore, CFM did not know the extent to which these loans may have been distressed loans which exposed the Fund to an adjustment in risk levels.

Recycling loans

4.70 On 6 August 2009 the Second Delegate circulated the 6 August 2009 Board Paper for a meeting on 7 August 2009. This was an ad hoc meeting which was convened to discuss the Fund and was attended by various CFM employees, including several board members.

4.71 The 6 August 2009 Board Paper provided a summary of the issues pertaining to the Fund including LTV ratio breaches and the recycling of loans.

4.72 The 6 August 2009 Board Paper recorded that the Second Delegate believed that it had identified five instances where the Specialist Partner had recycled monies which had been repaid to it by its borrowers and had then used these monies to issue new loans to different borrowers without CFM's awareness or approval. Subsequent analysis conducted after the Relevant Period shows that the actual number of instances was either three or four.

4.73 This issue had been identified by CFM as part of its enquiries in relation to loans that were due for repayment. When queried with the Fund Asset Manager, it confirmed that certain of these loans had been repaid and the monies advanced to a new borrower. The Fund Asset Manager stated this had been done in the early stages of the Fund with the Fund Asset Manager's express permission.

4.74 CFM considered this to be an administrative error which was resolved following discussions with the Fund Asset Manager. It also believed any further instances would have been identified by its ongoing monitoring of the redemptions. However, the Authority considers that this was a serious breach of the Fund's

procedure. By bypassing CFM, the Fund Asset Manager prevented CFM from having sight and control over the whereabouts of these monies. Had CFM ensured that its reconciliations were being adequately performed and ensured that the Security Mechanisms were in place for each loan, it could have identified this issue when it first arose in October 2008 and then taken steps to ensure that it did not occur repeatedly.

4.75 The Second Delegate's own assessment of the Fund Asset Manager's explanation as to why recycling had been allowed was that it did not make much sense. However, beyond challenging the Fund Asset Manager (referred to at 4.74 above) and seeking an explanation, neither CFM nor the Second Delegate made any further enquiries to the Fund Asset Manager as to why it had allowed recycling to occur or why it had not brought this to CFM/the Second Delegate's attention prior to the Fund Asset Manager being prompted to do so. Nor did CFM make specific enquiries as to whether the new loans which had been made were in accordance with the IMs or whether the Mortgage Charges and Sub-Charges had been put in place in respect of these new loans. Subsequent to the Relevant Period, CFM conducted an investigation which showed that the appropriate charges had, in fact, been registered in respect of these recycled loans.

4.76 As set out above, in August 2009 the Second Delegate began assessing when all the loans were due to be returned to the Fund, monitored when they had not, and made enquiries to the Fund Asset Manager, as appropriate. The Authority considers that whilst these steps might have reduced the risk that future recycling may occur, CFM should not have considered the issue of recycling loans to have been fully resolved.

CFM's internal meeting on 7 August 2009

4.77 On 7 August 2009 some members of the CFM Board and others employees met to discuss the funds in which CFM and the Fund Asset Manager were involved. This meeting was specially convened and was not intended to be a formal board meeting, although it was referred to by an employee of the Second Delegate internally as a board meeting. A document entitled "*summary of points for CFG Board*" was prepared ahead of it. However, despite the importance of the matters being discussed, no minutes of this meeting were

taken. In the ordinary course the Authority would expect regulated firms to take detailed notes and minutes of meetings of such importance.

4.78 The 6 August 2009 Board Paper was produced for the purpose of this meeting. As well as setting out several issues identified with the Fund, the 6 August 2009 Board Paper set out the nature of some of the risks to CFM as a consequence of its involvement in the Fund and recommended next steps.

4.79 The 6 August Board Paper noted that CFM's exposure to investors in the Fund was £47 million; although the basis on which this statement was made is unclear. It considered whether the Fund ought to be handed over "*where* [CFM's] *exposure could escalate, or do we maintain that* [the Fund] *should be put into run off and we remain Operator until* [the Fund] *is fully closed*". It explained that in run off CFM would be able to "*manage… and potentially minimise* [its] *liability*".

4.80 At this meeting CFM affirmed its earlier decision to retire from the Fund. However, notwithstanding the consideration of winding up the Fund, CFM began corresponding with the PRO thereby taking steps to retire from the Fund by securing a replacement operator.

CFM's interactions with the PRO

4.81 In July 2009 the Fund Asset Manager approached the PRO to discuss whether it might take over as Operator of the Fund. By 11 August 2009 CFM had communicated to the Fund Asset Manager its intention to try to hand over the Fund to the PRO.

4.82 On 13 August 2009 CFM recorded that it would not:

> "*release the* [Fund] *to* [the PRO] *as Operator until we are comfortable that it is functioning properly, e.g. that loans are redeeming back into the* [Fund] *… and that auditors are appointed*".

4.83 Although both these issues remained unresolved, on 16 August 2009 CFM recorded that its "*primary focus is on the transfer of* [the Fund] *to* [the PRO] *at the earliest juncture*".

4.84 On 17 August 2009, the PRO told the Fund Asset Manager that it required a letter from the Fund Asset Manager setting out its reasons for wanting to resign as Operator of the Fund. Whilst awaiting this letter, an internal email exchange took place within the PRO on 18 and 19 August 2009. In this email exchange an individual within the PRO queried "*Why is* [CFM] *pushing to get rid of this business so quickly? Are we sure we have all the information about the breakdown in communication between them and* [the Fund Asset Manager]".

4.85 On 21 August 2009 CFM sent to the PRO a letter setting out its reasons for wanting to resign ("the 8 Point Letter"). CFM explained that it had taken a strategic decision to not operate collective funds where the asset manager was not an authorised person and it did not want to continue to issue financial promotions. The following six points were also included:

1. CFM was "*no longer willing to operate* [the Fund] *in the absence of a guarantee from a UK authorised bank.* [The Guarantor] *is not a UK authorised bank*";

2. the Guarantor's Accounts showed a "*substantial fall in net assets from £2,430k at 31 March 2008 to £148k at 31 March 2009*". CFM also noted that two banks intended to withdraw their facilities to the Guarantor;

3. CFM was no longer comfortable with the Fund Asset Manager's strategy of investing all of the monies in the Fund in loans issued by the Specialist Partner and which were guaranteed by the Guarantor;

4. CFM had recently become aware that the Fund had advanced loans in excess of 80% of LTV. CFM stated that it had not conducted any work to assess whether these loans had a guaranteed exit route, as the IMs stated that they would;

5. CFM had become aware that loans were being rolled over for longer periods than stated in the IMs; and

6. the named auditor in the Fund's IMs had not accepted the appointment and no auditor had been appointed.

4.86 The PRO immediately reconsidered whether it "*still wanted to take on the business*" after receiving the 8 Point Letter. CFM was informed that the PRO "…*was not of the opinion that* [the Fund Asset Manager] *had informed* [the PRO] *of all the issues*." It was recorded that "…*This came as a bit of a shock to CFM as we were informed by* [the Fund Asset Manager] *that* [the PRO] *were fully aware of all the concerns outlined in the* [8 Point Letter]".

4.87 On 21 August 2009 the Second Delegate noted that there was a concern regarding whether the Fund Asset Manager had been open and honest with the PRO. The Second Delegate observed that responding to questions was not the same as being open and honest.

4.88 Between 21 August 2009 and 2 September 2009, the PRO carried out additional due diligence and carried out a site visit to the Second Delegate. On 2 September 2009 the PRO, by letter to the Fund Asset Manager and copied to CFM, stated that it would not accept the role of Operator and that it was withdrawing from the take-on process. The PRO's letter stated that:

1. certain information in the Fund's documents was "*inaccurate and misleading and that the operational procedures currently in place do not reflect those set out in the limited partnership agreement and the information memorandum relating to the Fund*";

2. current investors may have "*been misinformed as to the nature of the Fund and its investments, due to a number of inaccuracies contained in the offer documentation*";

3. it was not satisfied that the Fund currently, and in the short term, would be "*at a satisfactory level of compliance with its stated objectives or, indeed, that these are achievable*"; and

4. The PRO did not have a level of satisfaction with the operation of the Fund that it would both desire and that is incumbent upon an authorised operator to ensure.

4.89 The Authority's view is that the PRO's withdrawal letter reaffirmed to CFM that the Fund was in a serious condition.

4.90 Following the PRO's withdrawal letter, the relationship between CFM and the Fund Asset Manager further deteriorated. On 2 September 2009, the Fund Asset Manager blamed the PRO's withdrawal on the manner in which CFM relayed its position regarding the Fund to the PRO. The Fund Asset Manager had already threatened CFM with legal action if the transfer to the PRO did not come into effect by 21 August 2009. Now that the PRO had withdrawn from the process, the Fund Asset Manager told CFM that if an alternative replacement to CFM could not be found in the next few days or if CFM did not lift the Fund's suspension to new subscriptions, then the Fund Asset Manager would begin litigation. The Fund Asset Manager also communicated to CFM that "*it is vital that* [CFM] *discuss with us in detail any further communication with potential operators*" and that the Fund Asset Manager would now "*approach* [the Replacement Operator] *and others with regard to the Operator role and would expect* [CFM] *to facilitate the move in quick time and with a high level of cooperation*".

4.91 On 7 September 2009 the Fund Asset Manager repeated its warning to CFM that any written communications to either the potential incoming Operator or to investors regarding CFM's retirement from the Fund must first be approved by the Fund Asset Manager. However, there is no evidence to show that the Replacement Operator was provided with any less information than the PRO.

September 2009: CFM's decision to try to secure the Replacement Operator as its replacement

4.92 In September 2009, the Fund Asset Manager sought to secure the Replacement Operator as the replacement Operator. CFM reassessed its options, namely whether to wind down the Fund, which could not have been done without the agreement of the Fund General Partner, and/or resign as Operator (which would have required giving the Fund six months' notice), or find a replacement operator. CFM decided that its preferred option was to transfer the role of Operator (this time to the Replacement Operator) and that resigning or winding down the Fund was its fall-back option.

4.93 After the PRO's withdrawal from the handover process, CFM was concerned that the Replacement Operator might also decline to take-on the Fund. On 3 September 2009 CFM recorded internally that it ran "*the risk of* [the

Replacement Operator] *not taking on this Fund. Therefore* [this Fund] *does remain a high risk!".*

4.94 One explanation for why this Fund was described as being "high risk" is that by this point in time CFM had graded all UCIS as being "high risk". However, this description appeared to be pertinent in respect of this Fund and the next day CFM further recorded that: "*So far as* [it was] *concerned this has the potential of being a 42m* [sic] *problem and another regulatory issue that could potentially double the impending fine on arch* [Cru] *and is a very complex issue*". CFM also noted that it was "*heading for a potential situation with* [the Fund Asset Manager]".

The business unit compliance function's risk assessment

4.95 On 7 September 2009 a further meeting to discuss the Fund took place between various members of CFM's board and other employees. Whilst this meeting was also referred to as a "*board meeting*" and several members of CFM's board attended it, as with the 6 August 2009 meeting no minutes or formal notes of the 7 September 2009 meeting were taken.

4.96 Ahead of the meeting on 7 September 2009, a "*CFM Board paper*" was produced which set out the key risks associated with the Fund. This paper was circulated ahead of the meeting on 7 September 2009. The paper stated under the heading "*FSA Principles 1 and 2*", that the incoming Operator should:

1. be provided with appropriate access to information prior to accepting the appointment to enable it to carry out appropriate due diligence. This included providing appropriate information in relation to "*open*" issues;

2. have a proper appreciation of CFM's reasons for retiring in addition to disclosure of "*open*" issues. This was seen as minimising the risk of future claims by the new Operator and action by the Authority; and

3. issue a disclosure letter. It was noted that this would not eliminate the risk of there being other matters that the new Operator could claim ought to have been known to CFM and which should have been disclosed. The view expressed by the business unit compliance function

was that this risk, "*is minimised by giving the new operator full access, disclosure of all relevant documentation and sufficient time so as to enable them to undertake appropriate due diligence*".

4.97 CFM's board took the view that if CFM was to comply with its regulatory obligations then it ought to ensure that the Replacement Operator had a proper understanding of CFM's reasons for retiring in addition to the Replacement Operator being provided with appropriate information regarding the "open" issues with the Fund.

September 2009: CFM's understanding of further additional issues with the Fund

4.98 After the PRO's withdrawal CFM became aware of further serious issues with the Fund. CFM did not take steps to address all of these issues. Instead CFM continued to focus efforts on securing the Replacement Operator as a replacement operator.

<u>The continued rolling over of loans</u>

4.99 During this period, as part of its monitoring of the Fund CFM became aware that the Specialist Partner's practice of rolling over loans was continuing. On 15 September 2009, CFM recorded that the Fund Asset Manager had agreed to notify CFM when the Fund was not going to receive the repayment of its loans. CFM noted that this process appeared to be working as the Fund Asset Manager had advised CFM of two instances where this had occurred the previous day. However, this did not accord with the correspondence between CFM and the Fund Asset Manager the previous day in which CFM requested an explanation for why none of the five loans which were due to be repaid on 10 September 2009 had been returned to the Fund. Following this enquiry the Fund Asset Manager confirmed an extension had been granted to the term of these loans.

4.100 At a meeting between CFM and the Fund Asset Manager, as part of the discussion of issues prior to a meeting with the Replacement Operator on 16 September 2009, CFM reiterated to the Fund Asset Manager that its practice of allowing loans to roll over must stop as it was outside the parameters of the IMs.

Debenture Agreement

4.101 In early September 2009 CFM identified and informed the Fund Asset Manager that the Debenture Agreement, which should have been registered at Companies House prior to any lending taking place, had not been so registered. The Fund Asset Manager only registered the Debenture Agreement at Companies House on 10 September 2009. The Fund Asset Manager told CFM that it would seek to ensure the Fund's rights under the Debenture Agreement would have retrospective effect. However, there is no evidence to show that the Debenture was backdated. As a result, there existed an unmitigated risk that the priority of the Debenture Agreement as a form of security could have been affected.

4.102 At this point, therefore, CFM knew that the Debenture Agreement (being the second tier in the Security Mechanism) was not effective. CFM also had concerns around the Guarantor's ability to meet the Guarantee (being the third tier in the Security Mechanism) if it were called upon to do so. As a result, neither the second nor third tier offered the necessary protection to the monies which the Fund had lent to the Specialist Partner. This increased the risk profile of the Fund.

<u>The registration of securities in the first tier of the Security Mechanism</u>

4.103 As explained in paragraphs 4.11 to 4.12 above, in respect of the first tier in the Security Mechanism there were two separate (but linked) processes. These were (i) the registration of a Mortgage Charge in favour of the Specialist Partner at the Land Registry and over a borrower's property; and (ii) the registration of a Sub-Charge in favour of the Fund and corresponding to the relevant Mortgage Charge.

Mortgage Charges

4.104 CFM instructed the Second Delegate on 9 March 2009 to obtain a list of the Mortgage Charges. In the period following this instruction this exercise was not conducted in respect of those charges connected to the Fund's business. Instead, it appears that this instruction was understood to relate to the other funds which CFM and the Fund Asset Manager were involved with. During a meeting on 26 May 2009 (at which several CFM board members were present)

it was recorded "*that if* [CFM] *were to perform any work for* [the Fund Asset Manager]*, the issues surrounding registration of titles and the basis of property valuation would be non-negotiable*". The other funds were land funds which invested directly in land rather than having indirect interests via bridging loans. CFM did not immediately consider whether the Fund had been affected by the same issues as, unlike these other funds, the arrangement of this Fund was such that it did not hold title to properties.

4.105 On 9 September 2009 CFM asked the Fund Asset Manager to clarify how the Mortgage Charges (in respect of the Fund) were being registered at the Land Registry and asked the Fund Asset Manager to provide examples to show this. On 14 September 2009 CFM recorded as an action point that all Land Registry records were to be obtained in order to ensure that CFM had a full record. Prior to this date CFM had not checked that the Fund Asset Manager had ensured that this security was properly in place.

4.106 On 16 September 2009, the business unit compliance function reported that its preliminary checks of the Land Registry showed that a member of the Guarantor's group of companies owned ten of the properties in respect of which loans had been issued. This could have raised questions regarding the Specialist Partner's independence from the loans which it had made and whether because of this there were appropriate controls and safeguards in place to ensure the Fund's lending was not at risk. CFM had not investigated this issue before processing the drawdown to the Specialist Partner and did not investigate it once it became aware of the issue.

4.107 At the same time the business unit compliance function recorded the following additional concerns:

1. records for 35 loans could not be identified at the Land Registry. Subsequent to the Relevant Period CFM conducted an investigation which showed that 19 of these 35 loans had been registered; and

2. for several loans the Land Registry records showed that the Specialist Partner was not the company which had the benefit of the charge.

4.108 The failure to register these charges was a key breach of the Services Agreement entered into between the Fund and the Specialist Partner. Where

charges were not correctly registered the effect was that the Fund was not protected by the first tier in the Security Mechanism in circumstances where there were competing creditor claims over the same asset.

4.109 The Authority considers that, whilst in isolation this issue was serious, in the context of the other potential failings and concerns with respect to the second and third tier of the Security Mechanism it should have been clear to CFM that the Security Mechanism of the Fund was materially flawed in practice. At this point CFM knew that errors or concerns had arisen in respect of each layer in the Security Mechanism with the effect that adequate protection was not in place. Despite the seriousness and extent of this issue, CFM did not take any action to address it.

Sub-Charges

4.110 During September 2009 CFM and the Second Delegate also began making enquiries into the registration of the Sub-Charges at Companies House.

4.111 As explained in paragraphs 4.11 and 4.12, the Sub-Charges should have been registered in favour of the Fund and have corresponded to the Mortgage Charges in favour of the Specialist Partner. However, on 8 September 2009 the Second Delegate informed CFM that certain Sub-Charges might have been registered in the name of the Guarantor at Companies House, although the property details were not held on the Companies House website which meant that these charges could not be linked to any particular property/loan related to the Fund.

4.112 On 11 September 2009 CFM informed the Fund Asset Manager that it had reviewed the Sub-Charges registered at Companies House and found that approximately 20 loans did not have a corresponding charge. The total value of these loans was £6.3 million. CFM asked the Fund Asset Manager for an explanation. The Fund Asset Manager did not respond and CFM did not pursue the matter any further. Whilst a key individual within the business unit compliance function (at a subsequent interview with the Authority) described registration generally as being "*absolutely critical*", CFM did not take steps to address this issue, viewing this issue as being "*administrative in nature*" as it affected a comparatively small proportion of the total loan book. Subsequent to

the Relevant Period CFM conducted an investigation which showed that security for ten of these loans was in fact registered.

4.113 Later that same day CFM recorded internally that the total value of charges exceeded the total value of loans, as some charges had not been removed for loans which had been repaid and some charges had been duplicated or incorrectly filled out. It appears that CFM took comfort from this. However, the Authority considers that CFM should not have done so. Instead, at this point in time CFM understood that the first tier in the Security Mechanism had failed to apply to loans with a total value of £6.3 million, and that elsewhere across the loan book the registration process was not always operating as intended.

4.114 On 15 September 2009 it was further reported internally within CFM that it had "*a good handle on the security of the assets in the Fund (re debenture and charges)*…" and that "… *all in all we are happy to continue the transition to the new operator*". Notwithstanding CFM's review of the charges, the Authority does not consider that CFM had any credible grounds to conclude that it had a good understanding of this issue.

4.115 On 17 September 2009 the business unit compliance function identified that four Sub-Charges had been registered in the name of persons connected to the Fund's General Partner and not in the name of the Fund. This was a further indication that the Security Mechanism was not always functioning correctly. Despite this, CFM did not take steps to address this.

CFM's understanding of the structural arrangements connected to the Fund

4.116 As late as September 2009, neither CFM nor the Second Delegate understood which entity within the Guarantor's group was the lending entity. The Second Delegate sent an email to CFM and the business unit compliance function on 8 September 2009 in which it stated: "*We are sending money to* [the Guarantor], *we are not sure if they onward lend to* [the Specialist Partner], *or direct to the borrower*."

4.117 To address this on 9 September 2009 CFM emailed the Fund Asset Manager and asked it to confirm whether the Specialist Partner was the lending entity as the IMs did not clearly reflect this.

4.118 In response, the Fund Asset Manager confirmed that the lending entity was the Specialist Partner. CFM reacted to this in the following three ways:

1. CFM recognised that the IMs did not accurately set out which was the lending entity within the Guarantor's group and therefore the recipient of the Fund's monies. The business unit compliance function recognised this was "*fundamental*" and that the IMs were misleading;

2. CFM decided to prohibit further drawdowns from the Fund; and

3. CFM raised this as part of the handover to the Replacement Operator and potential solutions to take this forward after CFM's resignation were discussed.

4.119 On 16 September 2009 CFM communicated to the Fund Asset Manager that lending the monies invested in the Fund to only the Specialist Partner resulted in a concentration risk which was not adequately reflected in the risk warnings in IM2, which needed to be updated accordingly. In response to this the Fund Asset Manager commented that there had been no companies of a realistic size to deal with over the previous 18 months but this was changing and the Fund Asset Manager intended to review these new lenders.

4.120 CFM ought to have identified at take-on stage:

1. which entity within the Guarantor's group received and lent out the Fund's money to the borrowers; and

2. that lending 100% of the Fund's money to only one entity, even where that entity was lending to multiple counterparties itself, resulted in a concentration risk.

4.121 In the event, these matters were not identified until two weeks before CFM ceased to be the Operator of the Fund, although CFM did make the Replacement Operator aware of them.

CFM's interactions with the Replacement Operator and the Fund Asset Manager

4.122 The Fund Asset Manager identified the Replacement Operator as a prospective successor to CFM. The Replacement Operator signed and returned a confidentiality agreement to CFM on 11 August 2009 and thereafter CFM exchanged information about the Fund with the Replacement Operator.

4.123 On 3 September 2009, the Fund Asset Manager told CFM that it had met the Replacement Operator the previous day. The Fund Asset Manager said that it had not provided a copy of the 8 Point Letter to the Replacement Operator but that the content of "*the points in general and* [the Fund Asset Manager's] *response in particular*" had been discussed. The Fund Asset Manager described the meeting as disclosing "*warts and all*". However, a report produced for a meeting of members of CFM's board on 7 September 2009 recorded that "*in light of the* [PRO] *scenario and the apparent informality of the meeting* [with the Replacement Operator]*,* [CFM had] *doubts as to how much has been declared*".

4.124 The Fund Asset Manager informed CFM that the Replacement Operator would take-on CFM's role on the basis that the issues with the Fund were "*legacy issues*" which would be resolved by the Replacement Operator and the Fund Asset Manager. The report for CFM's Board meeting on 7 September 2009 set this out and noted that the Fund Asset Manager might not have fully explained the situation to the Replacement Operator.

4.125 On 11 September 2009 the Second Delegate sent an internal email to CFM and the business unit compliance function in which it queried:

> "*Would we not want to set the scene with* [the Fund Asset Manager]*, before meeting* [the Replacement Operator]*? So* [the Fund Asset Manager] *know where we stand in terms of situation, remedies etc.. it would not look good to have a disagreement with* [the Fund Asset Manager] *in front of* [the Replacement Operator]*. Which could well happen…*".

4.126 Shortly after this email CFM and the business unit compliance function spoke to the Replacement Operator. The note of this call recorded that the Replacement

Operator would visit the Second Delegate's office but that: "*The discussion around the reasons for* [CFM's] *wish to exit this relationship will not be conducted then as* [CFM] *want* [the Fund Asset Manager] *present for that meeting*." This appeared to stem from a desire by CFM to ensure that the Fund Asset Manager had an opportunity to hear CFM's characterisation of the issues and to provide its own views given the difficulties in the ongoing relationship between CFM and the Fund Asset Manager.

4.127 The Replacement Operator carried out its site visit to the Second Delegate's office (which was in a separate location to CFM's offices) on 15 September 2009. The Replacement Operator's internal assessment of this visit was that:

> "*It was not clear who controlled or managed the whole process of operation of the Fund and this appeared to be because the Fund was not a typical fund of the type for which* [CFM] *regularly undertook roles as Fund Operator*".

4.128 After the Replacement Operator's visit CFM recorded that it had not received any communication from either the Replacement Operator or the Fund Asset Manager to suggest that the Replacement Operator was "*put off from taking the* [Fund]".

4.129 CFM and the Fund Asset Manager agreed to meet on 16 September 2009, the day before the Tri-Party Meeting with the Replacement Operator. Ahead of its meeting with the Fund Asset Manager on 16 September 2009, CFM produced an internal briefing note. This note explained that the purpose of this meeting was to "*make it clear to* [the Fund Asset Manager] *that* [CFM would] *be verbally sharing our reasons for exiting this relationship with the new Operator"* during the Tri-Party Meeting. It also explained that "[The PRO had] *pulled out, possibly because* [it was] *scared off*".

4.130 The note of this meeting recorded that:

1. notwithstanding the issues with the Fund CFM was "*committed to making the transition as smoothly and swiftly as possible, and that all assistance would be given where possible*";

2. if the Replacement Operator withdrew from the process then CFM would support the Fund Asset Manager's efforts to try to locate an alternative replacement; and

3. if a replacement could not be found and CFM gave three months' notice to resign then "*the* [Fund] *will have no choice to wind up as it cannot operate without the appropriately authorised entity performing that function*".

4.131 The Tri-Party Meeting was the only meeting in which CFM, the Fund Asset Manager and the Replacement Operator were present. As such, this meeting was an opportunity for CFM to inform the Replacement Operator directly of the issues that it had identified with the Fund and the steps that it had taken to try to remedy them. It failed to do so adequately.

4.132 Interview evidence suggests that CFM wanted the handover to the Replacement Operator done "*in the right way*" and that its main priority was to ensure the new operator "*had an understanding of the issues that we'd identified" and be "open and honest*". The business unit compliance function's view of what CFM's disclosure obligations entailed was that: "*if there are things that* [CFM] *knows as operator, that it would be beneficial for the new operator to know to enable them to do their job properly, they should be communicated*." However, the record of the Tri-Party Meeting does not show that CFM disclosed the full extent of the Fund's problems at the Tri-Party Meeting.

4.133 CFM drafted and circulated an agenda for the Tri-Party Meeting which set out some details of CFM's reasons for exiting the role of Operator. The agenda contained the following nine points:

> "*1) … rationale for terminating the agreement with* [the Fund Asset Manager]
>
> *Risk appetite to act as Operator*
>
> *Name of the Fund*
>
> [the Fund Asset Manager] *not authorised by FSA*

2) Additional issues

Information Memorandum needs to be amended

Guarantee – concerns with Balance Sheet of [the Guarantor]

Debenture not filed at Companies House until 10 September 2009

[the Specialist Partner] *not authorised by FSA*

Loans being rolled over

Loans made outside terms of IM"

4.134 In addition, CFM understood that the Fund Asset Manager had shown the Replacement Operator its 8 Point Letter. CFM recorded that its approach to disclosing issues to the Replacement Operator would be to ask the Replacement Operator if it was aware of all of the points referred to in the agenda. If the Replacement Operator communicated that it was aware of these points then CFM would be satisfied that the Replacement Operator was aware of the relevant issues. Beyond this, CFM also proposed to answer any questions which the Replacement Operator raised which would be informed by the 8 point letter and the due diligence that the Replacement Operator was carrying out. This approach was not adequate.

4.135 The attendance note of the Tri-Party Meeting recorded that this meeting lasted for 40 minutes and the discussion around the issues outlined in the agenda was very limited. The Replacement Operator's recollection is that "*it was agreed that most of the issues were either historic, had been resolved, were in the process of being resolved or could be easily remedied with the changes to the information memorandum at Operator transfer*." The Replacement Operator determined that none of the issues was significant enough to require the continued suspension of the Fund and that it would accept the role as Operator. It noted that CFM "*did not disagree*". The meeting finished with it being agreed that the Replacement Operator would liaise directly with the Fund Asset Manager in respect of any questions that it might have had regarding the transfer and the agenda items.

4.136 It is unclear whether CFM informed the Replacement Operator about the recycling of loans issue which had arisen. There is also no evidence that CFM, at the Tri-Party Meeting, informed the Replacement Operator about the discrepancies found in respect of the first tier in the Security Mechanism. Whilst an employee of the business unit compliance function considered this latter issue (in their account at interview with the Authority) to be a "*material disclosure*" and was "*absolutely*" something which ought to have been disclosed, this issue was only just emerging around the time of the handover and was being investigated by CFM. However, CFM could have informed the Replacement Operator of this issue at any point after the Tri-Party Meeting. There is no evidence that CFM did so.

Matters arising after the Tri-Party Meeting

4.137 In an internal paper dated 17 September 2009, CFM recorded that it did not understand fully what the responsibilities and duties of an Operator were and that "*work was underway now to clarify this before any more Operator business is taken on*".

4.138 On 23 September 2009 a Termination Agreement was entered into by, among others, CFM, the Replacement Operator, the Fund and the Fund Asset Manager. Pursuant to clause 1(c) of the Termination Agreement, CFM was to "*use all reasonable endeavours…* [to] *deliver all records relating to the operator's business…and shall do all such further acts and things as* [the Replacement Operator] *may reasonably require in consequence of such retirement*". However, there is no evidence of any discussion taking place between CFM and the Replacement Operator following the Tri-Party Meeting.

4.139 On 24 September 2009 CFM wrote to all investors explaining that the Replacement Operator would replace it on 25 September 2009. CFM stated that IM2 would be withdrawn and replaced by a new IM which would be issued by the Replacement Operator. CFM also enclosed a copy of the Guarantor's 2008/9 Accounts and drew this to investors' attention in the context of the Guarantee. The Replacement Operator took over as the Operator on 25 September 2009.

5. FAILINGS

Relevant statutory and regulatory provisions

5.1 The statutory provisions relevant to this Notice are referred to in Annex B.

5.2 The Authority's statutory objectives are set out in section 1B(3) of the Act. This Notice supports the Authority's objective of securing an appropriate degree of protection for consumers.

5.3 CFM was required to carry out its duties as Operator in accordance with the Principles from the time of its approval of IM1. For these purposes the Fund (and the investors in it) constituted CFM's client.

CFM's breach of Principle 7

Statements in IM1 and IM2

5.4 In breach of Principle 7, CFM failed to ensure that both IM1 and IM2 were clear, fair and not misleading. Specifically, the IMs represented that the Fund was "*guaranteed*" and "*low risk*".

"Guaranteed"

5.5 The IMs failed to make clear that investors' capital would be at risk. On the contrary, the IMs named the Fund as the "Guaranteed Low Risk Income Fund". The IMs also included such statements as:

1. "*Investors will receive 100% of their initial Participations back*" (under the heading "*Guaranteed Liquidity within 6 months*"); and

2. "*The guaranteed income in the Fund varies between 8.15% and 8.5%, depending on the amount invested*";

This conveyed the impression that the income and capital returns were guaranteed, without making clear that the Guarantee was dependent on the financial strength of the Guarantor.

"Low risk"

5.6 The IMs named the Fund as the "*Guaranteed Low Risk Income Fund*". The IMs also contained statements such as:

1. "*Low risk… In the context of this investment described the fact that 100% of the investors* [sic] *capital, together with any interest due, will be returned on request, subject to the conditions of the Fund*";

2. "*The* [Fund] *has been developed to make this market accessible directly to investors whilst reducing risk levels through…investment diversification; a first charge secured against the asset*…"; and

3. "[Income in the Fund] *is very favourable when comparing* [sic] *to other fixed rate products such as savings accounts and bonds available from high street and internet providers*" and "*internet searches suggest that the best rates achievable from long-term savings accounts are less than 6.5%*".

5.7 These statements conveyed to investors the potentially misleading impression that the Fund was a low risk investment. The Authority considers that UCIS funds are rarely to be considered to be low risk and, aside from how the Fund was allowed to be operated in practice, the structural arrangement of the Fund did not, in the Authority's view, support this statement.

5.8 CFM did, during its tenure as Operator, conclude that there was a concentration risk associated with only lending the Fund's monies to a single counterparty and that the risk warnings in the IMs should be updated.

5.9 As described in paragraph 4.39 above, the IMs incorrectly named a well-known firm of accountants as the auditors to the Fund. In fact, when CFM approved IM1 and later IM2, no auditors had been appointed, and despite CFM's later attempts to address this no auditors were appointed during CFM's tenure as Operator. This incorrect statement risked misleading investors by suggesting that the Fund would be audited by a particular well-known firm of accountants.

5.10 The above statements were left uncorrected throughout CFM's tenure as Operator. As a result, the Authority considers that throughout CFM's tenure it

failed to 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.

CFM's breach of Principle 2

5.11 CFM breached Principle 2 in that it failed to conduct its business in relation to the Fund with due skill, care and diligence.

Failings in CFM's initial due diligence

5.12 As CFM later recognised, when it conducted due diligence on the Fund when deciding whether to become Operator, it failed to obtain an adequate understanding of the following critical information:

1. the structure of the Fund's business;

2. its responsibilities and duties as Operator; and

3. whether it was capable of adequately fulfilling these duties and ensuring that the Fund operated within the envisaged parameters.

5.13 CFM's process by which it decided to take on the Fund culminated in the consideration of the Fund by the IRAT Committee. CFM failed to ensure that the IRAT Committee considered accurate information about the proposed Fund including that "*Guaranteed*" would be part of the Fund's name and that auditors for the Fund had not been appointed. The IRAT Committee then failed to ensure that the matters referred to in paragraph 5.12 above had been adequately considered and addressed.

5.14 In failing to undertake these basic steps, CFM proceeded with the launch of the Fund without having a proper understanding of how to perform its role as Operator competently.

CFM's knowledge that the initial due diligence was inadequate

5.15 Between October 2008 and March 2009 CFM was aware that its initial due diligence when deciding whether to become the Operator of the Fund had been

inadequate. However, CFM did not take appropriate steps to revisit its initial due diligence and ensure that the critical information in paragraph 5.12 was obtained.

5.16 CFM therefore missed opportunities to gain adequate clarity as to the structure of the Fund's business, its responsibilities and duties as Operator, and whether it was capable of adequately fulfilling these duties and ensuring that the Fund operated within the envisaged parameters.

5.17 As a consequence:

1. for almost all of CFM's tenure as Operator it allowed investors' monies to be both invested in and released from the Fund without properly understanding which entity received and then lent out these monies; and

2. throughout CFM's tenure as Operator it did not fully understand what its responsibilities and duties were, although the practical steps taken by CFM increased towards the end of its tenure.

5.18 CFM also continued to allow investments to be made into the Fund despite its concerns that the Fund's IMs contained inaccuracies and were not clear, although the Fund was suspended to new investors in July 2009.

<u>CFM's failure to monitor and supervise the Fund appropriately</u>

5.19 Pursuant to its contractual duties CFM had responsibility for monitoring the Fund and providing supervisory scrutiny. Throughout most of CFM's tenure as Operator it did not adequately monitor the Fund, which meant that it was unable to provide adequate scrutiny. For example, CFM failed to ensure that:

1. before it approved drawdown requests and released the Fund's monies to the Specialist Partner, it took steps to ascertain whether the proposed loan was within the parameters of the IMs;

2. the repayment of loans from the Specialist Partner to the Fund was adequately monitored;

3. records of what monies had been lent out and to whom were adequately maintained; and

4. the monies which were lent by the Fund to the Specialist Partner were done so on a secured basis and in accordance with the Security Mechanism.

5.20 CFM failed to carry out these straightforward checks. As a consequence, and for almost the entire Relevant Period, CFM did not necessarily know whether the Fund was operating as investors had been led to believe it would be. Notwithstanding CFM's lack of understanding, CFM continued both to allow investors' money to be invested in the Fund (although, as indicated, this was subject to the suspension of the Fund to new investors in July 2009), and throughout almost all of the Relevant Period it continued to approve lending from the Fund to the Specialist Partner. This increased the amount of investors' money which was put at risk.

5.21 Had CFM adequately monitored the Fund from the outset, it might have become aware of the deficiencies which it ultimately identified with the Fund at an earlier stage. For example, only around the end of July 2009 (being 12 months since the Fund opened for business) did CFM begin to monitor and report on these matters. As a result, in the period following July 2009:

1. loan requests which exceeded the specified LTV ratio began to be identified and rejected;

2. CFM became aware that because loans had been allowed to be rolled over and recycled the Fund had not always received from the Specialist Partner the repayment of its loans when due; and

3. CFM became aware that the monies which the Fund lent to the Specialist Partner had not been adequately secured as a consequence of the widespread and serious failings in the implementation of the Security Mechanism.

CFM's provision of information to the Replacement Operator

5.22 CFM should not have handed over its role as Operator to another regulated entity without first ensuring that:

1. it fully addressed the serious issues which had arisen with the Fund, such that it could be handed over to a replacement Operator in the knowledge that investors' monies were safeguarded in the way they expected (or to conclude, if appropriate, that the Fund should be closed without delay); or

2. the Replacement Operator was made fully aware of the condition of the Fund so that it could make a well informed decision as to whether to take-on the role.

5.23 The Authority considers that CFM dealt with both aspects inadequately.

Condition of the Fund

5.24 The Fund was not being run in the manner that investors had been informed it would be and CFM knew that it faced risks and potential liability as a consequence.

5.25 Prior to its handover to the Replacement Operator, CFM was aware that the Fund Asset Manager had links to a collapsed and unlawful collective investment scheme. The Authority considers that these links ought to have acted as a warning sign to CFM to ensure that the Fund was being managed properly, and it ought to have been viewed as a matter of serious concern if it was not.

5.26 After becoming aware of the Guarantor's financial position, CFM became concerned about the strength of the Guarantee and chose to suspend the Fund to new investors and began to conduct closer monitoring and supervision of the Fund. As a result, it identified for the first time a series of issues including the occurrence of LTV ratio breaches and the Specialist Partner's rolling over and recycling of loans. CFM considered its options including winding down the Fund but decided to continue instead with the process of handing over to a replacement operator.

5.27 After discussions, the PRO withdrew from the take-on process citing serious concerns which it had with the Fund. This was a further warning sign for CFM. By this stage CFM considered the Fund to be "*high risk*" and meetings between senior board members were being convened specifically to discuss the Fund.

5.28 Subsequent to this, CFM became further aware of errors or concerns in respect of each layer of the Security Mechanism with the effect that adequate protection was not always in place.

5.29 It was open to CFM at all times to address and resolve all of the issues of which it was aware and thereby ensure that the Fund's monies were adequately protected. However, CFM instead chose to retire and handover the Fund to a new Operator.

Provision of information to the Replacement Operator

5.30 CFM was, during the handover period, the regulated entity with responsibility for acting in the interests of the Fund and its investors.

5.31 CFM's board took the view that if CFM was to comply with its regulatory obligations then it ought to ensure that the Replacement Operator had a proper understanding of CFM's reasons for retiring in addition to the Replacement Operator being provided with appropriate information regarding the "open" issues with the Fund.

5.32 The Authority considers that this would have been appropriate and in the investors' best interests. In the context of the issues which had arisen, it was of paramount importance that any potential replacement operator was provided with full and open disclosure of these issues (some of which took CFM itself over 12 months to identify) so that there was no delay in addressing them.

5.33 The PRO had withdrawn when it became aware of the issues with the Fund and CFM was concerned that the Replacement Operator would do the same. As a consequence, although CFM had understood that it needed to provide appropriate information to the Replacement Operator, CFM's communication of its reasons for retiring and the condition of the Fund was carefully managed.

5.34 The Authority considers the CFM's conduct on handover fell short of the standards it would expect in that:

1. its provision of information relating to its concerns with, and its reasons for wanting to retire from, the Fund were largely disseminated to the Replacement Operator through the bullet points set out in the agenda for the Tri-Party Meeting and those in the 8 Point Letter. The information contained in these documents was limited such that CFM could not have been sure that they were properly understood by the Replacement Operator who prior to this had only received explanations from the Fund Asset Manager; and

2. the failures in the registration of the Mortgage Charges and Sub Charges were not adequately disclosed to the Replacement Operator. In addition, CFM did not make clear to the Replacement Operator that the Fund's Asset Manager had permitted the recycling of loans.

5.35 The Authority considers that CFM did not put the Replacement Operator in a position, having taken on the role as Operator, to address all of those issues without delay. As a consequence, CFM allowed the Fund (including both its current and any future investors) to continue to be exposed to these risks and issues which had arisen and that it in doing so it acted in breach of Principle 2.

6. SANCTION

6.1 The Authority considers that a financial penalty of £15 million (£10.5 million after the application of a 30% discount (stage 1) in accordance with the Authority's executive settlement procedure) in respect of CFM's breaches of Principle 2 and 7 during the Relevant Period is appropriate. However, the Authority has taken account of the fact that CFM itself would not have been able to make a payment of up to £66 million for the benefit of the Fund's Investors, and that this has only been possible with the financial support given to CFM by its ultimate parent, Capita plc. For this reason, the Authority does not consider that it would be appropriate to require CFM to pay a financial penalty, and instead hereby imposes a public censure in relation to CFM. The Authority considers that a public censure and CFM's payment for the benefit of

the Fund's Investors supports the Authority's operational objective of securing an appropriate degree of protection for consumers.

6.2 The Authority's policy for imposing a financial penalty or publishing a statement of misconduct is set out in Chapter 6 of DEPP. All references to DEPP in this section are references to the version of DEPP which came into force on 28 August 2007.

6.3 The Authority will consider the full circumstances of each case when determining whether or not to take action for a financial penalty or public censure. DEPP 6.2.1G provides a list of relevant factors including those factors referred to below.

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

6.4 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.

6.5 Although not deliberate or reckless, CFM's failure to ensure the IMs were clear, fair and not misleading as well as its failure to understand and carry out the role of regulated operator with due care and skill exposed investors in the Fund to unacceptable risks of loss.

Conduct following the breach (DEPP 6.2.1G(2))

6.6 The Authority has taken into account the fact that CFM and its ultimate parent Capita plc were investing and continued to invest in significant steps to address certain similar issues, notably investing over £33 million in a substantial programme of enhancements to CFM's systems and processes, including investing in systems and technology infrastructure, strengthening its control functions and improving its oversight of investment manager delegates. This included the creation in April 2009 of a specialist team to oversee the activities of investment manager delegates.

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

6.7 CFM has previously been the subject of disciplinary action by the Authority. On 13 November 2012, the Authority issued a Final Notice to CFM for breaches of Principle 2 and Principle 3 in respect of its role as ACD of the Arch Cru Funds during the period June 2006 and March 2009. The Authority publicly censured CFM, in light of the specific circumstances of the case, including the fact that CFM voluntarily contributed, without admission of liability, £32 million towards a payment scheme for investors. The Authority took account on that occasion of the fact that CFM itself would not have been able to fund such a significant contribution to the payment scheme, and that this was only possible with the financial support given to CFM by its ultimate parent, Capita plc.

6.8 The Authority notes that CFM's breaches in this case are to a large degree contemporaneous to its breaches in relation to the Arch Cru funds.

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 public censure. 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:

1. CFM did not profit as a result of its breach;

2. CFM took steps to improve its knowledge and monitoring of the Fund during the relevant period and took some remedial action in relation to the issues that it had identified with the Fund;

3. CFM, with the assistance of its ultimate parent (Capita plc), has previously made a payment of £18.5 million to the Fund's Investors;

4. The total amount required to be paid to the Fund's Investors by way of a payment of no more than £66 million. The Authority considers that this payment will be sufficient to ensure that the Fund's Investors' outstanding principal capital investment in the Fund is returned to

them together with a rate of interest of 0.52% being applied on this sum;

5. CFM itself will not be able to make a payment of up to £66 million, and this will only be possible with the financial support of Capita plc; and

6. CFM and its senior management have co-operated fully with the FCA during its investigation.

6.10 The serious nature of the breaches identified in this Notice would ordinarily have led the Authority to impose a penalty of £15 million (£10.5 million after the application of a 30% discount (stage 1) in accordance with the Authority's executive settlement procedure). However, the Authority considers that its objectives may appropriately be achieved by means of a public censure and the payment of a sum of up to £66 million. In all the circumstances of this case the Authority does not consider that it would be appropriate to require CFM to pay a financial penalty, and hereby imposes a public censure in relation to CFM.

7. PROCEDURAL MATTERS

Decision maker

7.1 The decision which gave rise to the obligation to give this Notice was made by the Settlement Decision Makers.

7.2 This Final Notice is given under, and in accordance with, section 390 of the Act. The following statutory rights are important.

Confidentiality and publicity

7.3 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 these 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 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 CFM or

prejudicial to the interests of consumers or detrimental to the stability of the UK financial system.

7.4 The Authority must publish such information about the matter to which a Decision Notice or Final Notice relates as it considers appropriate. A Decision Notice or Final Notice may contain reference to the facts and matters contained in this Notice.

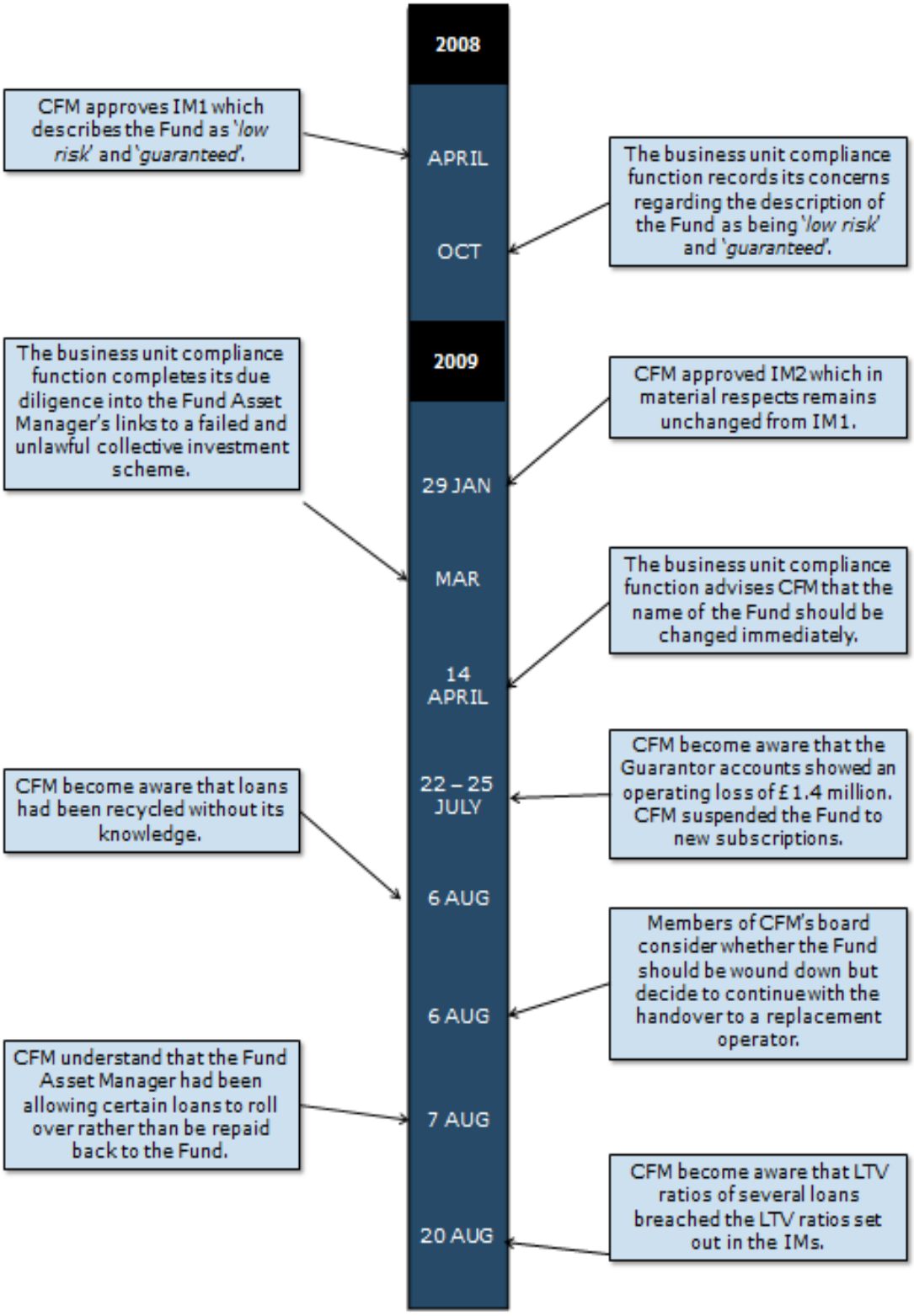
Authority contacts

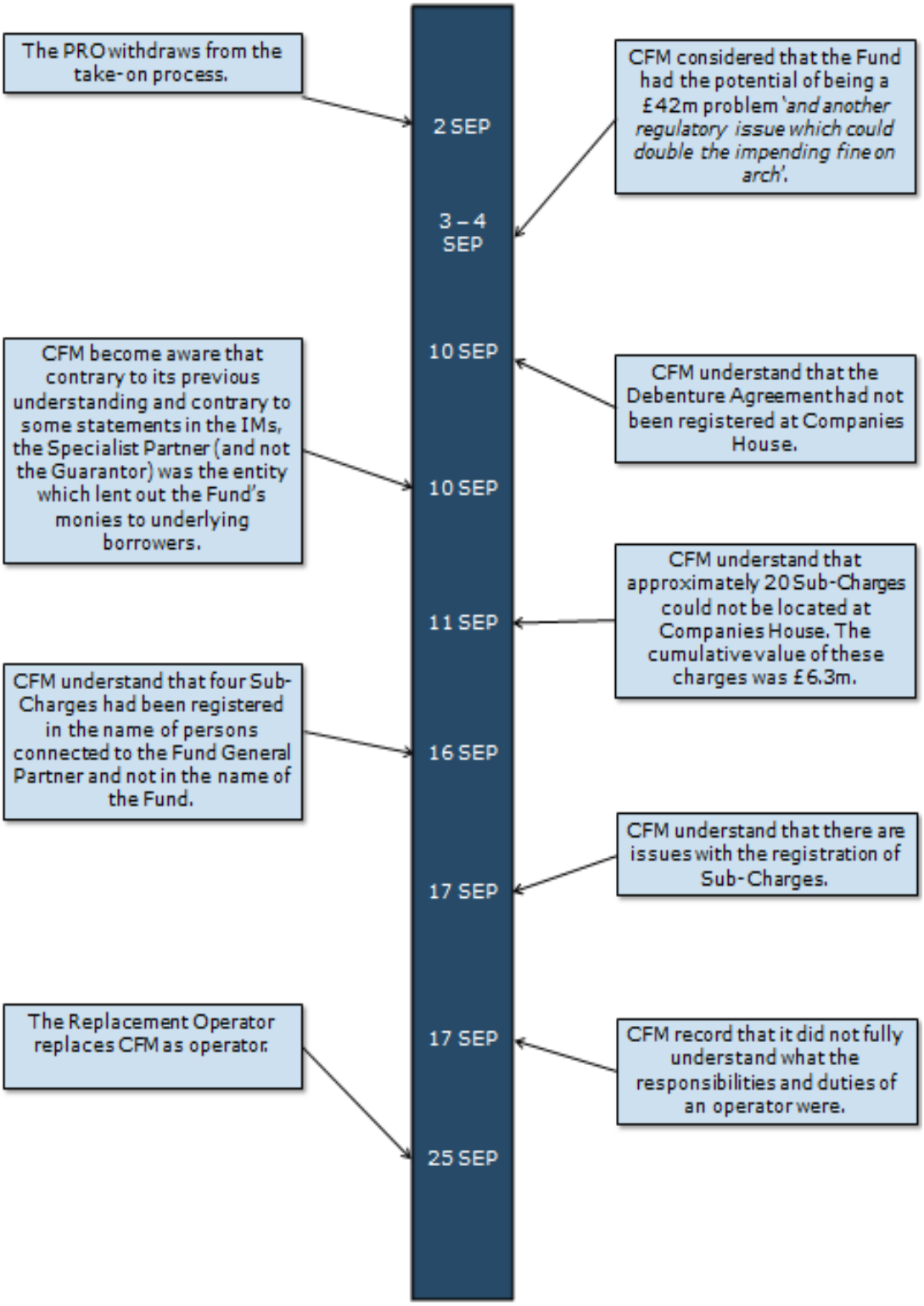
7.5 For more information concerning this matter generally, contact Matthew Hendin at the Authority (direct line: 020 7066 0236).

Laura Dawes
Financial Conduct Authority, Enforcement and Market Oversight Division

ANNEX A

The key events within the chronology are set out below.




The PRO withdraws from the take-on process.
2 SEP
CFM considered that the Fund had the potential of being a £42m problem *'and another regulatory issue which could double the impending fine on arch'.*
3 – 4 SEP
CFM become aware that contrary to its previous understanding and contrary to some statements in the IMs, the Specialist Partner (and not the Guarantor) was the entity which lent out the Fund's monies to underlying borrowers.
10 SEP
CFM understand that the Debenture Agreement had not been registered at Companies House.
10 SEP
CFM understand that approximately 20 Sub-Charges could not be located at Companies House. The cumulative value of these charges was £6.3m.
11 SEP
CFM understand that four Sub-Charges had been registered in the name of persons connected to the Fund General Partner and not in the name of the Fund.
16 SEP
CFM understand that there are issues with the registration of Sub-Charges.
17 SEP
The Replacement Operator replaces CFM as operator.
17 SEP
CFM record that it did not fully understand what the responsibilities and duties of an operator were.
25 SEP

ANNEX B

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.

Provisions of the Act

1.2 Section 391 of the Act provides as follows:

(1) "*In the case of a warning notice falling within subsection (1ZB)-*

(a) neither the regulator giving the notice nor a person to whom it is given or copied may publish the notice,

(b) a person to whom the notice is given or copied may not publish any details concerning the notice unless the regulator giving the notice has published those details, and

(c) after consulting the persons to whom the notice is given or copied, the regulator giving the notice may publish such information about the matter to which the notice relates as it considers appropriate.

(1ZA)…

(1ZB) A warning notice falls within this subsection if it is given under-

…

(k) section 207;"

1.3 Section 394 of the Act provides as follows:

(1) "*If* [a regulator] *gives a person ("A") a notice to which this section applies, it must-*

(a) allow him access to the material on which it relied in taking the decision which gave rise to the obligation to give the notice;

(b) allow him access to any secondary material which [in the regulator's opinion] *might undermine that decision."*

1.4 Section 205 of the Act provides as follows:

"*If the appropriate regulator considers that an authorised person has contravened a relevant requirement imposed on the person, it may publish a statement to that effect.*"

2. RELEVANT REGULATORY PROVISIONS

2.1 The Authority's Statements of Principle for Businesses have been issued under section 64 of the Act.

2.2 During the Relevant Period, Principle 2 stated:

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

2.3 During the Relevant Period, Principle 7 stated

"*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*".

COBS rules and guidance

2.4 COBS 3.2.3(R)(4): "*In relation to business that is neither MiFID or equivalent third country business, if a firm provides services to a fund that does not have separate legal personality, that fund will be the firm's client*."

2.5 COBS 4.2.1R: "*A firm must ensure that a communication or a financial promotion is fair, clear and not misleading*."

2.6 COBS 4.2.4G provides guidance on the what a firm should ensure for fair, clear and not misleading financial promotions referred to in COBS 4.2.1R

2.7 COBS 4.2.4G(1): A firm should ensure that a financial promotion, "*for a product or service that places a client's capital at risk makes this clear*".

2.8 COBS 4.5.2R: "*A firm must ensure that information:*

(2) *is accurate and in particular does not emphasise any potential benefits of relevant business or a relevant investment without also giving a fair and prominent indication of any relevant risks; and*

(3) is sufficient for, and presented in a way that it likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received."

2.9 COBS 18.5.3R(1): "*The COBS rules specified in the table in COBS 18.5.2R apply to an operator when it is carrying on scheme management activity with the following modifications:*

(1) subject to (2), references to customer or client are to be construed as references to any scheme in respect of which the operator is acting or intends to act, and with or for the benefit of which the relevant activity is to be carried on;

(2) in the case of an unregulated collective investment scheme, when an operator is required by the rules in COBS to provide information to, or obtain consent from, a customer or client, the operator must ensure that the information is provided to, or consent is obtained from, a participant or a potential participant in the scheme as the case may be."

DEPP

2.10 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 impose a financial penalty.

ANNEX C

1. **RELEVANT CONTRACTUAL PROVISIONS**

Operator's Agreement dated 10 July 2008 between, among others, the Fund and CFM

1.1 Pursuant to the Recital section of this agreement, CFM was appointed to act as "*operator and manager of the* [Fund]".

1.2 Pursuant to clause 2.2 of the Operator's Agreement, CFM had, "*primary responsibility for managing the investments of the LP's funds PROVIDED that the GP on behalf of the LP and the Limited Partners acknowledges and agrees that:*

the Operator may and will delegate to Connaught Asset Management Limited ("Connaught") the managing of such investments;

the Operator will have no liability for the acts of omissions of Connaught;

if the delegation to Connaught comes to an end for any reason (or the Operator reasonably expects that such delegation will come to an end) then the Operator will (after consultation with the GP) as soon as practicable identify a suitable party to replace Connaught; and

The Operator has not held itself out as competent to manage such investments (and does not do so by entering into this Agreement)."

1.3 Clause 4.2 of the Operator's Agreement provided that:

> "*In performing responsibilities, duties and powers hereunder the Operator shall act in the best interests of the LP and shall exercise that degree of skill and care as could reasonably be expected of a person experienced and skilled in the management, operation and administration of a limited partnership*."

1.4 Clause 9.1 of the Operator's Agreement provided that:

> "*The Operator may, with the written approval of the LP and subject to compliance with any regulatory requirements, delegate the performance of all or any of the rights and obligations on its part contained in this Agreement to third parties whose costs and expenses shall be borne by the Operator. The Operator shall exercise the care and diligence expected of a professional advisor operating limited partnerships and managing the regulatory and administrative aspects of limited*

partnerships in selecting the third parties to whom it may delegate its rights and obligations and in monitoring and supervising such third parties. Subject thereto the Operator shall not be liable for the acts or omissions of such third parties. Where appropriate the Operator will require such third parties to acknowledge a duty of care direct to the LP."

Sponsorship Agreement dated 10 July 2008 between, among others, CFM and the Fund Asset Manager

1.5 Pursuant to clause 1 of the Sponsorship Agreement: "*CFM shall establish the Scheme in accordance with this Agreement*".

1.6 Pursuant to clause 6 of the Sponsorship Agreement: "*CFM will take responsibility as issuer of the Information Memorandum*".

Asset Management Agreement dated 10 July 2008 between CFM and the Fund Asset Manager

1.7 Pursuant to Recital A of the Asset Management Agreement "*The Operator has primary responsibility for advising the Fund on investment of its funds and managing those investments*". Recital B provides that "*The Operator wishes to appoint* [the Fund Asset Manager] *as an asset manager to the Fund to provide advice and management services in relation to loans to be made by the Fund*".

1.8 Pursuant to clause 3 of the Asset Management Agreement, "[the Fund Asset Manager] *shall be responsible for:*

(i) sourcing, identifying, negotiating and arranging suitable Loans;

(ii) Managing and monitoring Loans;

(iii) Arranging and negotiating the repayment or disposal of Loans;

in each case in accordance with the Investment Policy. [the Fund Asset Manager] *shall, in the performance of its duties hereunder, use all reasonable endeavours to:*

3.1.2 give the Partnership the benefit of its best judgement in relation to the Loans in the light of the Investment Policy;

3.1.3 perform the obligations set out in this Agreement and procure that any Delegate performs its obligations, in a good and efficient, proper and professional manner with the degree of

skill and judgement expected of an experienced professional in the field of bridging finance;

3.1.4 ensure that the Partnership complies with all applicable laws and legislation in force from time to time but only to the extent that they fall within the scope of [the Fund Asset Manager's] *duties hereunder; and*

3.1.5 make available sufficient, competent and efficient personnel and equipment to enable it to carry out its duties hereunder properly and efficiently."

1.9 Pursuant to clause 5.1.3 of the Asset Management Agreement, excluded from the Fund Asset Manager's obligations were "*any activity which would constitute regulated activity for the purposes of the Financial Services and Markets Act 2000*".

Services Agreement dated 1 April 2008 between the Fund and the Specialist Partner

1.10 The Services Agreement refers to "*Facilities*" which are "*monies made available by the* [Fund] *for bridging loans*". Clause 3 of the Services Agreement states that "*The Facilities will take the form of a Revolving Credit Facility, the limit of which being such available funds as* [CFM] *and* [the Fund Asset Manager] *make available from time to time*."

1.11 Clause 4 of the Services Agreement states that:

"*The facilities will only become available once the* [Fund] *has received and is satisfied as to the form and content of the following items*

4.1 A debenture in the form of a fixed and a floating charge over the assets of [the Specialist Partner] *granted in favour of the* [Fund]*.*

4.2 A [Guarantee] *by* [the Guarantor] *for all obligations of* [the Specialist Partner] *to the* [Fund] *as principal.*

4.3 A sub Mortgage over all legal charges granted by [the Specialist Partner] *in favour of the* [Fund]*.*

4.4 It will ensure that each mortgage financed is to be residential, commercial, not owner occupied and within England, Scotland and Wales.

4.5 Each drawdown is not to exceed 80% loan to value.

4.6 That each drawdown request will be accompanied by a solicitors certificate of title in relation to each property to be financed by [the Specialist Partner] *in the prescribed form and un-amended without the consent of the* [Fund]*, in favour of* [the Specialist Partner] *and the* [Fund]*.*

4.7 A valuation on the property to be financed by [the Specialist Partner] *from a panel approved by the* [Fund]*.*

4.8 A secretary's certificate confirming the due execution of each sub mortgage by the Specialist Partner."

Termination Agreement, dated 23 September 2009, entered into by, among others CFM, the Replacement Operator, the Fund and the Fund Asset Manager

1.12 Pursuant to clause 1(c), from 25 September 2009 CFM was to:

> "*deliver to* [the Replacement Operator] *and use all reasonable endeavours to procure that its officers servants agents advisers or any person appointed by it in accordance with the terms of the Operator's Agreement shall deliver all records relating to the operator's business as are in the possession or under the control of* [CFM] *or any such appointees and shall do all such further acts and things as* [the Replacement Operator] *or* [the Fund's General Partner] *may reasonably require in consequence of such retirement*."

1.13 Pursuant to clause 2, CFM would

> "*cease to be responsible for issuing the information memorandum or any other financial promotions for the Fund" and that "the parties to the* [Termination Agreement] *undertake not to accept applications from new or existing investors which refer to* [CFM] *or which were prepared based on information memorandum or any other financial promotions referred to* [CFM] *(or any associated company* [CFM's group]*)*".

ANNEX D

Calculation of the payment

1. The required payment of up to £66,000,000 will include:

    a) the reasonable costs of distribution; and

    b) appropriate redress for each Fund Investor calculated by:

        i. taking the total amount of capital which that investor invested, both initially and then through any subsequent top-ups (but not including any income which that investor may have elected to have reinvested in the Fund);

        ii. deducting any income on their capital investment which that investor received from, as opposed to reinvested in, the Fund;

        iii. deducting any monies which were redeemed by that investor from the Fund;

        iv. deducting any previous distributions made to that investor in the period the Fund was suspended and immediately prior to the appointment of the liquidators of the Fund on 3 December 2012;

        v. deducting any dividend payments made by the liquidators of the Fund to that investor;

        vi. deducting any other compensation payments, including any FOS award, which has been paid to that investor in respect of any matters directly connected to the collapse of the Fund; and

        vii. applying simple interest at 0.52% on the capital invested (at (i) above) running from the date of each investor's initial capital investment in the Fund (and thereafter taking into account the timings and amounts of any subsequent top-ups of capital, and deductions in respect of any income received, redemptions, distributions, dividends or payments at (ii) to (vi) above) until the date on which those monies are paid to each Fund Investor.

Method of payment

2. CFM will make this payment to a sole entity which shall be nominated by the Authority.

Timing of the payment

3. As soon as is reasonably practicable, the Authority will inform CFM of the amount (up to £66,000,000) which it is to pay.

4. CFM may make this payment in tranches or in a single lump sum. All such payments should be made on or before 31 March 2018.