
FINAL NOTICE

To: Capita Financial Managers Limited
FSA Reference Number: 119197
Address: Ibex House, 42-47 Minories, London EC3N 1DX
Dated: 13 November 2012

TAKE NOTICE: The Financial Services Authority (“the FSA”) of 25 The North Colonnade, Canary Wharf, London E14 5HS gives you, Capita Financial Managers Limited (“CFM”) final notice about the publication of a public censure of CFM:

1. ACTION

- 1.1. For the reasons listed below, and pursuant to section 205 of the Financial Services and Markets Act 2000 (the “Act”), the FSA has issued a public censure in relation to CFM. This is in respect of breaches of Principles 2 (skill, care and diligence) and 3 (management and control) of the FSA’s Principles for Businesses (the “Principles”) and Rules contained in the parts of the FSA Handbook relating to Collective Investment Schemes (“COLL”) which occurred between June 2006 and March 2009 (the “Relevant Period”).
- 1.2. CFM agreed to settle at an early stage of the FSA’s investigation. As part of the settlement reached between CFM and the FSA, CFM has agreed voluntarily to contribute, without admission of liability, £32 million towards a £54 million payment

scheme for investors who hold investments in the CF Arch cru Investment Funds (the “Investment Funds”) and in the CF Arch cru Diversified Funds (the “Diversified Funds”) (together the “Funds”).

- 1.3. The serious nature of the breaches identified in this Notice would ordinarily have led the FSA to impose a penalty of £4.025 million after the application of a 30% discount for early settlement. However, in light of the specific circumstances of this case and for the reasons set out more fully in section 6 below, the FSA has decided that it is not appropriate to impose a financial penalty on CFM.
- 1.4. The public censure will take the form of this Final Notice, which will be published on the FSA’s website on 26 November 2012.

2. REASONS FOR THE ACTION

Summary of conduct in issue

- 2.1. The FSA has issued a public censure to CFM for breaches of the Principles and COLL in relation to its role as Authorised Corporate Director (“ACD”) to the Funds, which are both Open Ended Investment Companies (“OEICs”) and which are investment companies with variable capital (“ICVC”). The Funds are non-UCITS retail schemes (“NURS”).
- 2.2. CFM delegated the investment management of the Funds to Arch Financial Products LLP (“AFP”), an investment firm authorised and regulated by the FSA. CFM remained primarily responsible for other aspects of its role as ACD.
- 2.3. The scheme property of the Funds was primarily invested in the shares of Guernsey incorporated cell companies (the “Arch ICs”) of Arch Guernsey ICC Limited (the “ICC”). The Arch ICs were listed on the Channel Islands Stock Exchange (“CISX”). The board of each of the Arch ICs appointed AFP as investment manager of the Arch ICs. AFP invested the sums invested in the Arch ICs (both by the Funds and by third party investors) in a variety of underlying assets. This investment activity was undertaken by AFP in its own right, in its capacity as investment adviser to the Arch ICs, and not in its capacity as CFM’s delegate.

2.4. CFM failed in aspects of its oversight of AFP and in aspects of the conduct of its other duties during the Relevant Period. CFM failed to adhere to Principle 2 in that it did not conduct its role as ACD with skill, care and diligence. Specifically CFM did not adequately:

- (1) identify and mitigate potential conflicts of interest that existed between the delegated investment manager of the Funds and the Funds themselves; and
- (2) monitor the performance and compliance of the investment manager of the Funds, having delegated this function. CFM did not, prior to October 2008, increase the intensity of its monitoring and oversight of AFP in response to indicators suggesting a potential need for enhanced monitoring.

2.5. CFM failed to adhere to Principle 3 in that it did not organise and control its affairs responsibly and effectively, with adequate risk management systems. Specifically CFM failed to:

- (1) ensure it had sufficient processes and procedures in relation to the appointment of its investment manager delegate to the Funds;
- (2) adequately monitor the liquidity of the Funds and consider what implications such liquidity might have on whether the Funds were being managed by AFP in a manner consistent with the requirement under COLL 5.6.3R to ensure that the scheme property aimed to provide a prudent spread of risk. CFM also did not adequately monitor what processes were in place at AFP to ensure compliance with the prudent spread of risk obligation; and
- (3) consider the application of an alternative fair value pricing methodology for the Funds at a sufficiently early stage and to have specific policies and procedures in place setting out when fair value pricing should be invoked, although it is not clear that the invocation of fair value pricing would have resulted in a different price being used.

2.6. CFM failed to adhere to COLL, specifically:

- (1) COLL 4.2.2R(2)(a) / COLL 4.2.5R(3)(g), due to its failure to include the CISX as an eligible market in the prospectuses for the Diversified Funds between October 2007 and April 2008 (although a party holding approximately 90% of the shares in the Diversified Funds as at November 2007 was informed of the investment in the CISX by other means);
- (2) COLL 6.3.3R and COLL 6.3.5R(1), through its failure adequately to consider whether or not the Arch ICs' share prices as quoted on the CISX represented a fair value price upon which to price the Funds' investments in those shares, given the liquidity of the shares and the Funds' status as majority shareholder of many of the Arch ICs. However, it is not clear that the invocation of fair value pricing would have resulted in a different price being used;
- (3) COLL 6.6.15R(2)(a)(ii), by delegating the investment management function for the Funds without adequately assessing whether AFP's interests could potentially conflict with those of the Funds, and without taking adequate steps to assess whether or not it could effectively monitor AFP; and
- (4) COLL 6.6.6R(1), through its failure to maintain and retain sufficient records of, *inter alia*, its compliance monitoring of AFP, its revision of the Funds' prospectuses and its evidencing of the matters it considered when conducting eligible market reviews.

2.7. The FSA views CFM's failings as particularly serious as:

- (1) CFM is the ACD or Authorised Fund Manager for 231 active UK funds, comprising assets under management of £19.9 billion as at 30 June 2011;
- (2) the ACD role carries important regulatory obligations in relation to the protection and fair treatment of investors. CFM's failings had a significant impact on CFM's ability to discharge its regulatory obligations to investors; and
- (3) there are approximately 6,400 investors in the Funds according to the share register and ISA plan register maintained by CFM. Many of the share register

holdings are nominee holdings for multiple underlying investors. In total, these investors invested £391 million into the Funds.

- 2.8. Trading in the Funds was suspended in March 2009 as a result of concerns that there was insufficient liquidity in one of the sub-funds of the Investment Funds to meet anticipated redemptions. Dealings in the other sub-fund of the Investment Funds and in the Diversified Funds were suspended because of their similar investor and asset profile.
- 2.9. Since the suspension of dealings, it has emerged that the Arch ICs were not worth as much as had been indicated by the CISX share prices that had been quoted for the Arch ICs, and on which CFM had relied when valuing the Funds. The Funds were therefore not worth as much as CFM and investors in the Funds had previously understood.
- 2.10. The FSA accepts that CFM has taken significant steps to address the issues identified, notably:
- (1) voluntarily contributing £32 million towards a £54 million payment scheme for investors in the Funds. CFM will establish and administer this scheme, which will be distributed to investors in the Funds;
 - (2) in December 2009, establishing a hardship scheme for those investors in the Funds who are experiencing financial difficulty. As at 30 June 2011, payments of approximately £660,000 had been made by CFM to investors;
 - (3) undertaking, from 2007, a programme of enhancements to CFM's systems and processes, including the strengthening of its control functions and improving the oversight of its delegated investment managers;
 - (4) funding, with the assistance of its ultimate parent, a series of investigations and reports, at a cost of over £2 million, into the existence, ownership and value of the assets held by the Arch ICs, although the documents and information regarding these issues were held by or for the Arch ICs rather than by CFM;

- (5) waiving its entitlement to £838,000 of fees from the Funds since April 2009; and
- (6) engaging an independent professional firm to assess whether any of the other funds for which CFM acts as ACD were impacted by the issues identified in relation to the Funds. The review did not identify any evidence that any other funds were impacted by issues giving rise to a material risk of customer loss or detriment.

3. RELEVANT STATUTORY AND REGULATORY PROVISIONS

- 3.1. The FSA's statutory objectives are set out in section 2(2) of the Act. The relevant objectives for the purposes of this case are maintaining confidence in the financial system and the protection of consumers.
- 3.2. Section 205 of the Act provides: "*If the Authority considers that an authorised person has contravened a requirement imposed on him by or under this Act, the Authority may publish a statement to that effect.*"
- 3.3. CFM is an authorised person for the purposes of section 205 of the Act. The FSA Principles, and Rules set out in COLL made under section 138 of the Act constitute requirements imposed under the Act.
- 3.4. The FSA Principles are a general statement of the fundamental obligations of firms under the regulatory system and reflect the FSA's regulatory objectives.
- 3.5. Principle 2 of the Principles states that: "*A firm must conduct its business with due skill, care and diligence*".
- 3.6. Principle 3 of the Principles states that: "*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*".
- 3.7. The FSA's Rules for authorised firms acting as authorised fund managers – a term that includes the ACD function – are set out in COLL, which came into force on 12 February 2007. Previously the Rules had been set out in the CIS Sourcebook of the FSA Handbook.

3.8. The general purpose of COLL (as set out in COLL 1.1.2G) is to provide a regime of product regulation for authorised funds.

4. FACTS AND MATTERS RELIED ON

Background

4.1. CFM is part of Capita Financial Group (“CFG”) which is a business unit within Capita Investor and Banking Services, which is in turn a division of The Capita Group Plc.

4.2. One of the services CFM provides is acting as ACD of authorised funds. An ACD is a corporate body and authorised person given powers and duties by the FSA to operate an OEIC. The ACD’s responsibilities include dealing with the day to day operation of the OEIC, managing the OEIC’s investments, buying and selling the OEIC’s shares on demand, and pricing the OEIC’s shares based on the value of the OEIC’s assets. These responsibilities (particularly responsibility for managing the OEIC’s investments) may be delegated, but overall responsibility for performance of the obligations remains with the ACD.

Launch of the Funds

4.3. In December 2005, CFM was approached by AFP in relation to a planned FSA authorised OEIC, the Investment Funds. This was the first time that AFP had been involved in establishing, or managing the investments of, an OEIC.

4.4. The Investment Funds was launched on 29 June 2006. It has two sub-funds, the CF Arch cru Investment Portfolio (the “Investment Portfolio”) and the CF Arch cru Specialist Portfolio (the “Specialist Portfolio”). CFM was appointed ACD and subsequently delegated the role of investment manager to AFP, pursuant to an agreement dated 5 July 2006.

4.5. From around 12 January 2007, AFP began to invest the assets of the Investment Funds primarily in the shares of the Arch ICs. The Arch ICs were predominantly invested in private equity, private finance (including asset-backed lending), hedge funds, real estate, fine wine, and other private market alternative assets.

- 4.6. The Arch ICs were incorporated in Guernsey and then listed on the CISX in January 2007. The Arch ICs were governed by a board of directors which appointed AFP as investment manager to each of the Arch ICs. AFP undertook this role in its own right, and not as CFM's delegate. The Arch ICs also appointed independent auditors and an independent administrator. The Arch ICs and their administrator are regulated by the Guernsey Financial Services Commission.
- 4.7. In September 2007, AFP agreed to take on the investment management responsibilities for a second OEIC, the Diversified Funds. CFM was appointed as the ACD and AFP as its investment manager delegate. The Diversified Funds had three sub-funds at the time, namely the CF Arch cru Balanced Fund (the "Balanced Fund"); the CF Arch cru Global Growth Fund (the "Global Growth Fund"); and the CF Arch cru Income Fund (the "Income Fund").
- 4.8. From October 2007, and upon being appointed as investment manager to the Diversified Funds, AFP began to invest the scheme property of these sub-funds in the Arch ICs. A further sub-fund of the Diversified Funds – the CF Arch Cru Finance Fund (the "Finance Fund") - was launched in October 2008, and from its launch, its scheme property was also invested by AFP in the Arch ICs.

Suspension of dealings in the Funds

- 4.9. By the date of suspension of the Funds, there were 22 Arch ICs listed on the CISX into which the Funds had invested in the Relevant Period. By the end of 2008, the Funds directly held all of the issued shares in seven of the Arch ICs and also directly held over 90% of the issued shares of a further seven of the Arch ICs. At the date of suspension of the Funds between 74% and 97% of the sub-funds' scheme property (and almost all of the non-cash scheme property) was invested in the shares of the Arch ICs.
- 4.10. Although the shares in the Arch ICs were "transferable securities" which could be traded with other market counterparties through the market maker, the liquidity of these securities was in fact very limited with trades undertaken by AFP between the sub-funds of the Funds far exceeding (in terms of volume and value) trades involving an independent third party. Up to the period of suspension, liquidity in the Funds had

been managed through the maintenance of sufficient cash balances within the scheme property of the sub-funds to meet all redemption requests up until that time. In December 2008, CFM also received assurances from AFP that in addition to liquidity in the Arch IC shares on the secondary market, further liquidity could be generated by the Arch ICs through buy-backs or tender offers of the Arch IC shares or through the sale or refinancing of the underlying assets of the Arch ICs to fund such buy-backs or tender offers.

- 4.11. This proved not to be the case when, following the financial crisis and the deterioration of the global markets, the cash balance in the Investment Portfolio was eroded, resulting in dealings in the Investment Portfolio being suspended on 13 March 2009 due to insufficient liquidity to meet anticipated redemption requests. Dealings in the other sub-funds of the Funds were suspended at the same time because of concerns that, due to the sub-funds' broadly similar underlying investments and investor profile, the suspension of one sub-fund might trigger a significant increase in redemption requests being made in relation to the other sub-funds which those other sub-funds would be unable to meet.
- 4.12. Since the suspension of dealings, it has emerged that the Arch ICs were not worth as much as had been indicated by the CISX share prices that had been quoted for the Arch ICs, and on which CFM had relied when valuing the Funds. Consequently, the Funds were therefore not worth as much as CFM and investors in the Funds had previously understood. Since suspension, the reductions announced by the Arch ICs in the values ascribed to them have led to the Funds suffering a 44% reduction in value equal to £160 million, from £363 million to £203 million.
- 4.13. Following the suspension of dealings and with the assistance of professional advisers, CFM, in consultation with the FSA and the depositaries, concluded that it was in the best interests of investors as a whole for the Funds (and in turn the Arch ICs) to be wound up on an orderly realisation basis. The orderly realisation commenced on 1 February 2010. As at the end of December 2011, £96.3 million has been returned to investors by way of interim distribution, with further distributions to be returned to investors as the assets of the Arch ICs are realised. The nature of the underlying

assets of the Arch ICs is such that the orderly realisation of the Funds is estimated by CFM to take five years from suspension.

Appointment of AFP as delegated investment manager to the Funds

- 4.14. Under COLL 6.6.15R(2), CFM was permitted to delegate to a third party to assist it in executing its powers and responsibilities as ACD, provided that a mandate in relation to managing investments of the scheme property was not given to any other person whose interests may conflict with those of the authorised fund manager or the unitholders, and provided that the authorised fund manager ensures that at all times it can monitor effectively the relevant activities of any person so retained.
- 4.15. COLL 6.6.15R(3) states that where certain activities are delegated under COLL 6.6.15R(2), *“the responsibility which the authorised fund manager had in respect of such services prior to that retention of services will remain unaffected”*.
- 4.16. In respect of the Investment Funds, CFM’s new business procedures in place at the time meant that limited due diligence was conducted; focusing on fund specific processes, such as preparing the required prospectus, agreeing fees and charges, and defining the fund objectives and policies. Due to the anticipated size of the Investment Funds, the launch of the fund was not subject to scrutiny by, and did not at that time require approval from, CFM’s internal risk and business development committees. CFM’s due diligence of AFP was limited to checking that AFP was authorised by the FSA.
- 4.17. CFM had recognised by July 2007 that its processes and controls for taking on new funds, making changes to existing funds and appointing investment manager delegates did not include sufficient in-depth scrutiny and due diligence. New procedures were therefore developed and introduced by CFM, but were not fully implemented until May 2008. As such, the Diversified Funds was not subjected to CFM’s new processes at the time. When the new procedures were fully implemented, CFM did not apply them retrospectively to pre-existing investment management delegates and funds but did undertake such a review in April 2009.

Conflicts of interest

- 4.18. As CFM's investment manager delegate, AFP earned a fee based on the total assets under management within the Funds. AFP also earned commissions out of the initial charges applied to investments in the Funds (the majority of which were passed on to a third party appointed by AFP, which marketed and distributed the Funds with AFP to investors). At Arch IC level, AFP earned an initial dealing charge (a percentage of the amount invested in the Arch IC), an annual management fee based on assets under management and a performance fee. AFP also earned fees from structuring some of the underlying investments of the Arch ICs. This gave rise to potential conflicts of interest for AFP, even if some of these potential conflicts also existed in some other fund structures.
- 4.19. AFP's role as investment manager of the Arch ICs would, however, have been known to those investors in the Funds who received the marketing literature used to market and distribute the Funds to investors, as this documentation explained AFP's role in relation to the Arch ICs. This information was also explained in the report and accounts for the Funds. Further, the fee structure applicable to AFP's roles as investment manager delegate to the Funds and as investment adviser to the Arch ICs was not unusual compared to similar fund structures, and the total level of fees at Arch IC and Fund level were within the reasonable range of expectations of fees charged for a NURS specialising in assets similar to those of the Funds.
- 4.20. Although AFP had its own responsibility to identify and manage its potential conflicts of interest, CFM's consideration and monitoring of those potential conflicts of interest was very limited prior to November 2008. As part of the take on processes, AFP's potential conflicts of interest were not identified or assessed. Prior to November 2008, CFM only sought to consider whether AFP's Procedures Manual covered conflicts of interest (and concluded that this was insufficient in September 2008). Prior to November 2008, CFM did not evaluate the efficacy of AFP's processes or procedures and did not identify specific conflicts of interest or examine how these were managed by AFP. This included CFM not seeking to obtain AFP's conflicts register, not reviewing the records of AFP's investment decision-making to see

whether or how potential conflicts had been identified and managed, and not requesting a copy of AFP's conflicts of interest policy prior to November 2008.

Record-keeping

4.21. COLL 6.6.6R(1) requires that CFM must make and retain for six years such records as enable the scheme and CFM to comply with the COLL Rules and to enable it to demonstrate at any time that such compliance has been achieved. CFM did not comply with COLL 6.6.R(1) in the following respects:

- (1) COLL 4.2.2R(1) requires that fund prospectuses are drawn up by the "authorised fund manager", and that all prospectuses are approved by the "Directors". As authorised fund manager (or ACD) and sole Director of the Funds, CFM was responsible for the prospectuses for the Funds. COLL 4.2.2R(2)(d) requires that the ACD must ensure that the prospectus is kept up to date, and that revisions are made whenever appropriate. Although during the Relevant Period only minor amendments were made to the Funds' prospectuses, CFM did not have adequate controls over the way in which Funds' prospectuses were reviewed and revised. A lack of adequate version control meant that CFM was unable to demonstrate when changes were made to the prospectuses and what the rationale for those changes was.
- (2) In order to assess a market which is not a regulated market or a market in an EEA state as eligible for investment or dealing in the scheme property of a fund, COLL 5.6.5R and 5.2.10R require the market first to have been assessed as appropriate by the ACD, in consultation with the depositaries to the fund. In the context of another fund wishing to invest on the CISX, CFM had assessed the CISX as eligible following a review undertaken on 16 May 2006. However, the records of the review undertaken were insufficient to evidence the matters which CFM considered when assessing the eligibility of the CISX as a market for investment.
- (3) As explained below, CFM did not maintain adequate records of its compliance monitoring visits to AFP.

Inclusion of CISX as an eligible market in Diversified Funds prospectus

- 4.22. Prior to investing the scheme property of the Funds in the shares of the Arch ICs, COLL 4.2.2R(2) and COLL 4.2.5R required CFM to have included the CISX in the list of eligible markets contained in the prospectus for the Funds.
- 4.23. The Balanced, Global Growth and Income sub-funds of the Diversified Funds began investing in the Arch ICs on 4 October 2007. However, the prospectus for the Diversified Funds was not updated to list the CISX as an eligible market until April 2008. Investors who relied solely on the prospectus may have been unaware for this six month period that the Diversified Funds could invest in transferable securities listed on the CISX. However, other material was sent to approximately 90% of investors in the Diversified Funds in early November 2007 which explained to those investors that the Diversified Funds would be investing in the Arch ICs. The investment in the Arch ICs was also subsequently disclosed in the report and accounts for the Diversified Funds.

Liquidity monitoring and prudent spread of risk

- 4.24. There were unusual liquidity risks associated with the Funds because of the assets in which they were invested (the shares in the Arch ICs, in respect of which there was limited external secondary market trading) and the underlying assets of the Arch ICs. These liquidity risks should have been identified and monitored.
- 4.25. During the Relevant Period, CFM's monitoring of the liquidity of the Funds was limited to checking the amount of un-invested cash within the Funds, and did not extend to assessing the liquidity of the non-cash assets of the Funds (such as the substantial investments in the Arch ICs' shares). CFM did not evaluate how the liquidity in the Arch ICs' shares quoted on the CISX might impact the liquidity of the Funds, and did not follow this up with AFP prior to October 2008.
- 4.26. Further, CFM did not consider what implications these liquidity issues might have on the obligation under COLL 5.6.3R(1) to ensure that: *“taking account of the investment objectives and policy of the non-UCITS retail scheme as stated in its most recently*

published prospectus, the scheme property of the non-UCITS retail scheme aims to provide a prudent spread of risk.”

- 4.27. Although CFM delegated responsibility to AFP for managing the investments, CFM retained overall responsibility for compliance with the requirement to ensure the Funds aimed to provide a prudent spread of risk. Although CFM monitored the Funds' compliance with the quantitative investment and borrowing power restrictions set out in COLL 5, CFM should also have considered whether AFP had appropriate controls in place to assess whether the Funds were being invested in a manner which aimed to provide a prudent spread of risk, particularly having regard to the overall liquidity profile of the Funds. These could have included, for example, understanding AFP's risk management and investment decision-making processes and what account was taken of the prudent spread of risk obligation in these processes. CFM did not have adequate processes and controls to ensure that this was the case.

Valuation Methodologies and the Valuation of the Funds

- 4.28. In accordance with the guidance set out in COLL 6.3.2G(2), CFM was responsible for valuing the Funds and for calculating the price of units in the Funds.
- 4.29. Under COLL 6.3.3R(1) and COLL 6.3.5R(1), in order to determine the price of units, CFM as ACD had to carry out a fair and accurate valuation of all the scheme property of the sub-funds, and to ensure that the price of a unit of any share class was calculated by reference to the net value of the scheme property. COLL 6.3.6G (the text of which is set out in the Annex to this notice) provides guidance on how authorised fund managers such as CFM should approach their valuation and pricing obligations under COLL 6.3.2G(2) and COLL 6.3.3R.
- 4.30. CFM was required under COLL to consider the reliability of the CISX quoted share prices used to value the investments of the Funds in the Arch ICs. In the event that CFM concluded, on reasonable grounds, that the CISX share prices for the Arch ICs were not reliable, or not reflective of its best estimate of the value of the Arch ICs at the time, CFM should have applied a value which in its opinion reflected a fair and reasonable price for the shares in the Arch ICs (i.e. a fair value price).

- 4.31. In pricing the Funds' investments in the Arch ICs, CFM used the share prices for the Arch ICs that were quoted on the CISX, based on information supplied to the CISX by an independent market maker. This is in accordance with standard industry practice for valuing transferable securities quoted on an exchange which is recognised by the FSA as a designated investment exchange. Further, on a monthly basis CFM required AFP to confirm its agreement with the valuations for the Funds on the basis of the CISX prices.
- 4.32. In addition to the daily share price, net asset values (NAVs) calculated by the Arch ICs' independent administrator were published, either on a monthly or quarterly basis, for each of the Arch ICs on the CISX's website. There would, however, be a delay of approximately three months between the NAV date and the date on which that NAV was published. The NAVs calculated by the Arch ICs' independent administrator were also subject to periodic external audit by an independent auditor.
- 4.33. Given the size of the Funds' shareholdings in the Arch ICs and of the independent trading volumes in the Arch ICs' shares as published on the CISX, CFM should have considered whether the CISX quoted share price was reliable and reflective of its best estimate of the value of the shares in the Arch ICs and, if not, whether an alternate fair value pricing basis needed to be invoked. However, during the Relevant Period, CFM did not have a fair value pricing policy, and this was identified to CFM in April 2008. CFM did not have adequate processes in place to identify the need to consider whether a fair value price should be used for the Arch ICs in place of the CISX quoted share prices. It was only from late 2008 that CFM began to investigate the valuation and pricing of the Arch ICs in further detail.
- 4.34. In relation to the Arch ICs, however, there were no readily identifiable alternative benchmarks or values to which regard could be had for the purposes of fair value pricing, other than the published NAVs of the Arch ICs. This was not a matter considered by CFM at the time. However, subsequent analysis shows that the CISX share prices closely tracked these NAVs. Given that the NAVs were produced by an independent administrator and also subject to periodic external audit (the first of which was published in October 2008), an ACD of the Funds may have concluded,

that at least for some period of time, it remained appropriate to rely on the CISX quoted share prices of the Arch ICs.

- 4.35. The substantial fall in the NAVs of the Arch ICs that occurred subsequent to suspension of the Funds was recognised after a detailed investigation by experts appointed by CFM into the existence, ownership and value of the assets held by the Arch ICs. CFM would not have been able to undertake this investigation on the basis of the information that CFM had available to it during the Relevant Period.
- 4.36. Subsequent to the suspension of dealings in the Funds, CFM has developed and implemented enhanced fair value pricing policies and procedures.

CFM's Oversight of AFP

- 4.37. Under COLL 6.6.15R(2), CFM was permitted to delegate to AFP to assist it in executing its powers and responsibilities as ACD, provided that CFM ensured that at all times it could monitor effectively the relevant activities of AFP.
- 4.38. Although AFP was authorised and regulated by the FSA, CFM should have taken appropriate steps to monitor AFP's management of the Funds, particularly given that CFM had a new relationship with AFP, that AFP had not previously managed an OEIC, that the structure and investment strategy of the Funds gave rise to potential conflicts of interest and given that the Funds appeared to be outperforming other funds in their Investment Management Association ("IMA") sectors. CFM did not identify or challenge AFP in relation to the potential conflicts of interest and outperformance until late 2008.
- 4.39. CFM's oversight of AFP and the Funds was undertaken through desk based compliance monitoring, and compliance monitoring visits to AFP in September 2007 and September 2008. Prior to the end of 2008, CFM's monitoring programme was not adequate in that:
- (1) CFM's 2007 visit did not identify important issues raised by CFM in the 2008 visit in relation to the adequacy of AFP's compliance manual, its compliance monitoring programme and its investment decision-making processes;

- (2) it failed to keep sufficient records of its visits. The 2007 visit records did not contain a comprehensive record of the visit. Important sections of the checklist used in the visit relating to how AFP ensured that illiquid assets were identified, monitored and priced, and how often AFP assessed the Funds' compliance with investment objectives were left blank. The checklist for the September 2008 visit was also incomplete as it did not properly record the content of the interviews undertaken or the testing carried out; and
- (3) it failed to follow up adequately on points identified in the visits. Following the September 2007 visit, CFM requested further important information and key documentation from AFP. CFM chased AFP for a response to these requests on five occasions during the next 11 months. However, it is not clear how much, if any, of the requested information / documentation was received from AFP, with the result that CFM never closed out these issues to produce a final report.

4.40. It was not until after October 2008 that CFM entered into significant discussions and correspondence with AFP, requesting detailed information on the management of the Funds, including AFP's investment strategy, the fact that some of the Arch ICs had purchased shares in other Arch ICs, conflicts of interest and liquidity, in order to address its concerns. CFM undertook an additional visit in October 2008 to discuss these issues with AFP, and followed up on these issues through detailed meetings and correspondence.

5. ANALYSIS OF BREACHES AND SANCTION

5.1. CFM failed to adhere to Principle 2 in that it did not conduct its role as ACD to the Funds with due skill, care and diligence. Specifically CFM did not adequately:

- (1) identify and mitigate potential conflicts of interest that existed between AFP, the delegated investment manager of the Funds, and the Funds themselves; and
- (2) monitor the performance and compliance of the investment manager of the Funds, having delegated this function. CFM did not, prior to October 2008,

increase the intensity of its monitoring and oversight of AFP in response to indicators suggesting a potential need for enhanced monitoring.

5.2. CFM failed to adhere to Principle 3 in that it did not organise and control its affairs responsibly and effectively, with adequate risk management systems. Specifically CFM failed to:

- (1) ensure it had sufficient processes and procedures in relation to the appointment of its investment manager delegate to the Funds;
- (2) adequately monitor the liquidity of the Funds and consider what implications such liquidity might have on whether the Funds were being managed by AFP in a manner consistent with the requirement under COLL 5.6.3R to ensure that the scheme property aimed to provide a prudent spread of risk. CFM also did not adequately monitor what processes were in place at AFP to ensure compliance with the prudent spread of risk obligation; and
- (3) consider the application of an alternative fair value pricing methodology for the Funds at a sufficiently early stage and to have specific policies and procedures in place setting out when fair value pricing should be invoked, although it is not clear that the invocation of fair value pricing would have resulted in a different price being used.

5.3. CFM failed to adhere to COLL, specifically:

- (1) COLL 4.2.2R(2)(a) / COLL 4.2.5R(3)(g), due to its failure to include the CISX as an eligible market in the prospectuses for the Diversified Funds between October 2007 and April 2008 (although a party holding approximately 90% of the shares in the Diversified Funds as at November 2007 was informed of the investment in the CISX by other means);
- (2) COLL 6.3.3R and COLL 6.3.5R(1), through its failure adequately to consider whether or not the Arch ICs' share prices as quoted on the CISX represented a fair value price upon which to price the Funds' investments in those shares, given the liquidity of the shares and the Funds' status as majority shareholder

of many of the Arch ICs. However, it is not clear that the invocation of fair value pricing would have resulted in a different price being used;

- (3) COLL 6.6.15R(2)(a)(ii), by delegating the investment management function for the Funds without adequately assessing whether AFP's interests could potentially conflict with those of the Funds, and without taking adequate steps to assess whether or not it could effectively monitor AFP; and
- (4) COLL 6.6.6R(1), through its failure to maintain and retain sufficient records of, *inter alia*, its compliance monitoring of AFP, its revision of the Funds' prospectuses and its evidencing of the matters it considered when conducting eligible market reviews.

6. SANCTION

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

Deterrence

- 6.4. The principal purpose of imposing a public censure is to promote high standards of regulatory conduct by deterring persons who have breached regulatory requirements from committing further contraventions, helping to deter other persons from committing contraventions, and demonstrating generally to persons the benefits of compliant behaviour.

The nature, seriousness and impact of the breach

- 6.5. In determining the appropriate sanction, the FSA has had regard to the seriousness of the contraventions, including the nature of the breaches, the number and duration of the breaches, and the number of investors who were exposed to risk of loss, and whether the breaches revealed serious and systemic weaknesses of the management systems or internal controls.
- (1) The ACD role carries important regulatory obligations in relation to the protection and fair treatment of investors. CFM's failings demonstrate weaknesses in its procedures and its internal controls, and had a significant impact on its ability to discharge its regulatory obligations to investors.
 - (2) There are approximately 6,400 investors in the Funds according to the share register and ISA plan register maintained by CFM. Many of the share register holdings are nominee holdings for multiple underlying investors. In total, these investors invested £391 million into the Funds.

The extent to which the breach was deliberate or reckless

- 6.6. The FSA has considered the extent to which CFM's actions were reckless or deliberate. CFM did not deliberately or recklessly contravene regulatory requirements.

Disciplinary record and compliance history

- 6.7. CFM has not previously been the subject of disciplinary action by the FSA.

Other action taken by the FSA

- 6.8. The FSA has taken into account action taken by the FSA in relation to other authorised persons for similar behaviour.

Conduct following the breach

- 6.9. CFM co-operated with the FSA throughout its investigation and agreed to settle at an early stage.

The size, financial resources and other circumstances of CFM

- 6.10. The FSA has taken into account the financial circumstances of CFM. This includes the fact that CFM did not profit from the breaches. CFM earned £1.2 million in fees from its role as ACD to the Funds. CFM has also waived its entitlement to £838,000 in fees from the Funds since April 2009. As at 31 December 2010, CFM had net assets of £12,371,031 and an annual turnover of £27,695,009.
- 6.11. Further, the FSA has taken account of the fact that CFM and its ultimate parent The Capita Group plc were already investing, and have continued to invest, in significant steps to address the issues identified, notably:
- (1) Investing, since 2007, 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;
 - (2) Ensuring that the position of the Funds was investigated and addressed following the suspension of dealings in March 2009. This included funding, with the assistance of its ultimate parent The Capita Group plc, a series of investigations and reports, at a cost of over £2 million, into the existence, ownership and value of the assets held by the Arch ICs, although the documents and information regarding these issues were held by or for the Arch ICs rather than by CFM; and
 - (3) In December 2009, establishing a hardship scheme for those investors in the Funds who are experiencing financial difficulty. As at 30 June 2011, payments of approximately £660,000 had been made by CFM to investors.
- 6.12. CFM also engaged an independent professional firm, at a cost of approximately £800,000 to assess whether any of the other funds for which CFM acts as ACD were impacted by the issues identified in relation to the Funds. The review did not identify

any evidence that any other funds were impacted by issues giving rise to a material risk of customer loss or detriment.

- 6.13. Importantly, CFM has agreed voluntarily to contribute, without admission of liability, £32 million towards a £54 million payment scheme for investors in the Funds. CFM will establish and administer this scheme, which will be distributed to eligible investors in the Funds.
- 6.14. The FSA has taken account of the fact that CFM itself would not have been able to fund such a significant contribution to the payment scheme, and that this has only been possible with the financial support given to CFM by its ultimate parent, The Capita Group plc.
- 6.15. The serious nature of the breaches identified in this Notice would ordinarily have led the FSA to impose a penalty of £4.025 million (after the application of a 30% discount for early settlement). However, after taking account of the factors set out above, the FSA has determined that it would not be appropriate in all the circumstances to require CFM to pay a financial penalty, and has issued a public censure in relation to CFM.

7. CONCLUSION

- 7.1. In light of the matters set out above, the FSA has concluded that between July 2006 and March 2009 CFM breached Principle 2 of the FSA's Principles for Businesses in relation to its failure to conduct its business with due skill, care and diligence, and Principle 3 of the Principles for Businesses in relation to its failure to organise and control its affairs responsibly and effectively, and certain Rules contained in the COLL sourcebook of the FSA's Handbook.

8. DECISION MAKERS

- 8.1. The decision which gave rise to the obligation to give this Final Notice was made by the Settlement Decision Makers on behalf of the FSA.

9. IMPORTANT

- 9.1. This Final Notice is given to you in accordance with section 390 of the Act.

Publicity

- 9.2. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.
- 9.3. The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

- 9.4. For more information concerning this matter generally, you should contact Stephen Robinson at the FSA (direct line: 020 7066 1338 / fax: 020 7066 1339).

.....

Georgina Philippou
FSA Enforcement and Financial Crime Division.

ANNEX

The COLL Rules and guidance that are relevant to CFM's conduct include:

COLL 4 (Investor Relations)

COLL 4.2.2R (Pre-sale notifications; Publishing the prospectus)

“(1) A prospectus must be drawn up in English and published as a document by the authorised fund manager and, for an ICVC, it must be approved by the directors.

(2) The authorised fund manager must ensure that the prospectus:

(a) contains the information required by COLL 4.2.5R (Table: contents of the prospectus);

(b) does not contain any provision which is unfairly prejudicial to the interests of unitholders generally or to the unitholders of any class of units;

(c) does not contain any provision that conflicts with any rule in this sourcebook;

(d) is kept up-to-date and that revisions are made to it, whenever appropriate...”

COLL 5 (Investment and borrowing powers)

COLL 5.2.10R (General investment powers and limits for UCITS schemes; Eligible markets: requirements)

“(1) A market is eligible for the purposes of the rules in this sourcebook if it is:

(a) a regulated market;

(b) a market in an EEA State which is regulated, operates regularly and is open to the public; or

(c) any market within (2)

(2) A market not falling within (1)(a) and (b) is eligible for the purposes of the rules in this sourcebook if:

(a) the authorised fund manager, after consultation with and notification to the depositary (and in the case of an ICVC, any other directors), decides that market is appropriate for investment of, or dealing in, the scheme property;

(b) the market is included in a list in the prospectus; and

(c) the depositary has taken reasonable care to determine that:

(i) adequate custody arrangements can be provided for the investment dealt in on that market; and

(ii) all reasonable steps have been taken by the authorised fund manager in deciding whether that market is eligible.

(3) in (2)(a), a market must not be considered appropriate unless it:

(a) is regulated;

(b) operates regularly;

- (c) is recognised as a market or exchange or as a self-regulating organisation by an overseas regulator;*
- (d) is open to the public;*
- (e) is adequately liquid; and*
- (f) has adequate arrangements for unimpeded transmission of income and capital to or to the order of investors.”*

COLL 5.6.3R (Investment powers and borrowing limits for non-UCITS retail schemes; Prudent Spread of Risk)

“(1) An authorised fund manager must ensure that, taking account of the investment objectives and policy of the non-UCITS retail scheme as stated in its most recently published prospectus, the scheme property of the non-UCITS retail scheme aims to provide a prudent spread of risk...”

COLL 5.6.5R (Investment powers and borrowing limits for non-UCITS retail schemes; Eligibility of transferable securities and money-market instruments for investment by an non-UCITS retail scheme)

“Transferable securities and money-market instruments held within a non-UCITS retail scheme must:

(1)

(a) be admitted to or dealt in on an eligible market within COLL 5.2.10R (Eligible markets: requirements); or

(b) be recently issued transferable securities which satisfy the requirements for investment by a UCITS scheme set out in COLL 5.2.8R (3)(e);

...

COLL 6 (Operating duties and responsibilities)

COLL 6.3.3R (Valuation and pricing; Valuation)

“(1) To determine the price of units the authorised fund manager must carry out a fair and accurate valuation of all the scheme property in accordance with the instrument constituting the scheme and the prospectus...”

COLL 6.3.5R (Valuation and pricing; Price of a unit)

“(1) An authorised fund manager must ensure that the price of a unit of any class is calculated:

(a) by reference to the net value of the scheme property; and

(b) in accordance with the provisions of both the instrument constituting the scheme and the prospectus...”

COLL 6.3.6G (Valuation and pricing; Valuation and pricing guidance)

“(1) The valuation of scheme property

(1) Where possible, investments should be valued using a reputable source. The reliability of the source should be kept under regular review.

...

(5) Where the authorised fund manager has reasonable grounds to believe that:

- (a) no reliable price exists for a security at a valuation point; or*
- (b) the most recent price available does not reflect the authorised fund manager's best estimate of the value of a security at the valuation point*

it should value an investment at a price which, in its opinion, reflects a fair and reasonable price for that investment (the fair value price).

(6) The circumstances which may give rise to a fair value price being used include:

- (a) no recent trade in the security concerned; or*
- (b) the occurrence of a significant event since the most recent closure of the market where the price of the security is taken.*

In (b), a significant event is one that means the most recent price of a security or a basket of securities is materially different to the price that it is reasonably believed would exist at the valuation point had the relevant market been open.

(7) In determining whether to use such a fair value price, the authorised fund manager should include in his consideration:

- (a) the type of authorised fund concerned;*
- (b) the securities involved;*
- (c) the basis and reliability of the alternative price used; and*
- (d) the authorised fund manager's policy on the valuation of scheme property as disclosed in the prospectus.*

(8) The authorised fund manager should document the basis of valuation (including any fair value pricing policy) and, where appropriate, the basis of any methodology and ensure that the procedures are applied consistently and fairly.

COLL 6.6.6R (Powers and duties of the scheme, the authorised fund manager, and the depositary; Maintenance of records)

“(1) The authorised fund manager must make and retain for six years such records as enable:
(a) the scheme and the authorised fund manager to comply with the rules in this sourcebook and the OEIC Regulations; and
(b) it to demonstrate at any time that such compliance has been achieved...”

COLL 6.6.15R (Powers and duties of the scheme, the authorised fund manager, and the depositary; Committees and delegation)

“(1) The directors of an ICVC may delegate to one or more of their number any of the directors' powers or duties but remain responsible for the acts or omissions of any such directors.

(2) The authorised fund manager of a scheme and the directors of an ICVC have the power to retain the services of anyone to assist in the performance of their respective functions, provided that:

(a) a mandate in relation to managing investments of the scheme property is not give to:

(i) the depositary; or

(ii) any other person whose interests may conflict with those of the authorised fund manager or the unitholders;

...

(b) the authorised fund manager ensures that at all times it can monitor effectively the relevant activities of any person so retained..."