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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Takeaways From The Capita Financial Managers Sanction

By **Greg Lascelles**
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Greg Lascelles

On Nov. 10, 2017, the U.K.'s Financial Conduct Authority publicly censured Capita Financial Managers ("CFM") with respect to a collapsed unregulated collective investment scheme known as the Connaught Income Fund.

The collapse had caused the loss of around £118 million to investors. CFM's failings related to a period between 2008 and 2009 where it had been the fund's operator.

The FCA's final notice stated that, given the failures it identified, a £15 million fine against CFM would have been appropriate. However, no fine was imposed. This was because CFM, and its parent Capita PLC, had agreed to pay "up to" £66 million in compensation, and that the available money was best placed in the pockets of investors rather than in fines.

This result is identical to the FCA's November 2012 public censure of CFM in relation to the collapse of Arch-Cru funds. That collapse had caused the loss of around £125 million to investors. CFM's failings there related to a period between 2006 and 2009 where it had acted as those funds' authorised corporate director, another kind of fund administration service. In that case, the FCA stated that a circa £5 million fine would have been appropriate but would not be imposed because CFM, and its parent Capita PLC, would contribute £32 million to an investor compensation scheme of £54 million. There was much criticism at the time that: (i) the redress was not meaningful; and (ii) CFM should have received a financial penalty.

This recent Connaught-related decision, while substantially slower in outcome than the Arch-Cru one, addresses the first criticism that compensation to investors should be meaningful. The £66 million compensation does look meaningful, in particular coupled with a £18.5 million settlement CFM agreed with the fund's administrators in early 2016. It is likely that pressure brought to bear on the FCA to accelerate its investigation and provide what was termed "realistic compensation" to investors, by members of Parliament in December 2016, contributed significantly. It is also likely that Capita PLC's commercial imperatives contributed: it completed the sale of its asset services business, comprising CFM, in the week before the final notice, for over £800 million, and with substantial transaction costs. Related to commercial aspects, it is not known whether the fact that a regulatory fine cannot be insured against (see the General Provisions of the FCA Handbook, at GEN 6.1.5), but a contribution may be, played any part in the result.

The second criticism, that the Arch-Cru matters should have resulted in a fine, was not addressed by the Connaught decision; indeed, the fact that there was no fine is likely to exacerbate the criticism.

There is more of interest in this decision, including the lack of factual material as to why the fund collapsed (which may be a result of numerous other ongoing proceedings), a lack of causative connection between CFM's breaches of FCA principles and the losses suffered, and a lack of details as to the involvement of Capita PLC and the reasons for such a substantial compensation bill. There is evidently a large back story to this action which would provide context for the shortcomings identified. This article looks at these aspects, before discussing the sanction decision and any overarching lessons that might be extracted from the decision.

Factual Background

CFM was the operator of the fund for a large portion of the fund's existence. It did not directly manage the fund and did not hold itself out as competent to manage the fund's investments; a fund manager handled those functions. However, as the FCA-authorized entity, CFM retained the primary responsibility for managing the fund's investments.

The fund, which among other things marketed itself as a "Guaranteed Low Risk Income Fund," invested in high-risk loans. The fund had provided credit to a bridging loan firm which went into administration, and this appears to have been the catalyst for the collapse of the fund in 2012.

The FCA asserted a wide range of failures against CFM, including (i) due diligence failures; (ii) failures surrounding the original promotional materials; (iii) monitoring failures (among other things, breaches of loan-to-value guidelines, a lack of loan security checks and not identifying loan rollovers or the recycling of loans); (iv) inadequate record maintenance; and (v) a lack of follow-up on concerns that CFM itself had identified. In addition, in broad terms, it appears that CFM did not give a full handover to the operator that replaced it.

These failures translated into breaches of FCA Principle 2 relating to skill and care, and Principle 7, relating to communication with clients. However, despite CFM's systems and controls being criticized in the final notice, and account being taken of substantial investment in systems as a mitigating factor with regard to the sanction, no issues over Principle 3, relating to systems, are mentioned in the final notice.

Missing Information

As stated above, investigations continue as to the causes of the collapse and associated responsibility, and these include an FCA investigation into its own conduct and reaction time when concerns were first raised. There have been director-disqualification proceedings and there also seem to be ongoing associated legal proceedings, including a recent Supreme Court case involving the lending firm, Tiuta, that may have ultimately caused the collapse of the fund.

The FCA was under political pressure to find a means of compensation for investors and to speed up its investigation. This leaves a lacuna between the factual analysis that the FCA was able to reveal in this decision, and the cause of the collapse of the fund and of investor losses.

There appear to have been questions of how much investors knew or should have known, and claims that responsibility should be apportioned to intermediate independent financial advisers. A settlement was agreed by the liquidators of the fund and CFM in early 2016 in the amount of £18.5 million, but it appears to have been slow-going for investors. Ultimately the FCA assumed that (i) investments were made on the basis of materials promoting the fund that were materially misleading; and (ii) failings in the way the fund operated and abided by its investment guidelines (as set out in those same misleading materials) caused the collapse of the fund.

The FCA appears to have concluded that: (i) Capita had assumed overall responsibility for marketing materials and was thus liable in the event that their contents were misleading; and (ii) Capita had assumed a responsibility to identify, address and correct — or, alternatively, bring to the attention of investors — the failings, and was thus liable in the event that the failings were not identified, addressed and corrected, or brought to the attention of investors.

However, these failings are not tied to losses suffered. If the FCA argues that the failings would be worth a £15 million fine, and trigger liability for up to £66 million of compensation, one can plausibly argue that: (i) the failures identified, in particular the failure to tell investors this was high risk and the failures to ensure that the fund's practices were consistent with the documentation, should have been tied more closely to the losses; (ii) an examination should have been undertaken of what would have happened had things been done as they should have been done; and (iii) the actions of other actors should have been examined. This is particularly the case if, as stated in the final notice, only 25 percent of investors invested during CFM's tenure, because it does not properly explain why CFM should compensate the other 75 percent.

Further, there is no discussion of the basis for the parent's contribution to the compensation pot other than that it was voluntary. Given that there was a prior £18.5 million settlement with the fund liquidators, there is no reason not to think that CFM's view (and its parent's view) was that £18.5 million was a reasonable sum of what it would be held responsible for in a court. The commercial influences identified above, while guesswork, may provide a rationale, but a closer reasoning of the additional compensation bill of £66 million would have been useful for the parents of FCA-authorized fund administrators, operators, trustees, corporate directors and principals, and those providing outsourcing services generally.

One normally determines responsibility and then compensation — here it appears matters have been inverted. On the positive side, investors appear to have received substantial, if not total, compensation without recourse (or at least with limited recourse) to the Financial Services Compensation Scheme — albeit some of them would have waited almost 10 years for that. But the manner in which the result was achieved undoubtedly challenges market operators.

The Sanction

The rationale for the sanction imposed is limited. That CFM was not fined would be seen by most to amount to exceptional treatment, which may well be explained by circumstance, but is not justified by or consistent with the FCA's stated policies. It tends to show that the codification of rules and guidelines by the financial regulator has difficulty adapting to diversity of circumstance.

CFM's failings were identified as breaches of Principles 2 and 7 (but not Principle 3, which had been identified in the Arch-Cru decision), rather than any specific conduct rules, although conduct of business rules were referred to in the Annex, in particular those expanding on Principle 2 on clear information with regard to financial promotions.

For market participants and observers, the important point is why the FCA felt it was appropriate to impose a public censure rather than a financial penalty. In paragraph 6.9 of the final notice, the FCA gave its reasons for not imposing a financial penalty by reference to DEPP 6.4.2. These are brief, and some are questionable. For example, the fact that CFM did not make a profit and was not deliberate or reckless, is probably irrelevant when the nature of the business is taken into account but is, in any event, not backed up by an analysis of fee income as it was in the Arch-Cru decision. The prior Arch-Cru decision is not seen as an aggravating factor although it has generally been thought that a relevant prior disciplinary record is supposed to be an aggravating factor (although it is noted that the Connaught events occurred roughly at the same time as the Arch-Cru ones).

Given the references to CFM's inability to pay compensation without its parent's help, it is notable that the final notice does not address the point made in DEPP 6.2.4(8), in the context of financial hardship, that, "It would only be in an exceptional case that the FCA would be prepared to agree to issue a public censure rather than impose a financial penalty if a financial penalty would otherwise be the appropriate sanction." This then refers to DEPP 6.5D.4 which, when discussing that the FCA will consider reducing a penalty by reference to a firm's financial circumstances, states one such condition is where "... the FCA may consider it appropriate to allow a firm to … pay redress." That may have been an unstated reason for the public censure, but it is not clear that financial hardship was a factor here. Indeed, CFM was reported to have set aside £37 million for this matter, and while the final notice does say that CFM could not have afforded £66 million, it does not say that it could not have afforded £15 million.

Final Remarks

There is evident common sense in an outcome where investors are compensated, but the final notice is, in essence, a catalogue of imperfections that are not tied to factual outcomes, and a large bill but no fine without real justification. It looks, and quite probably is, an expedient outcome with little value as precedent or deterrent.

For all this, the final notice is a salutary reminder to those in the fund administration and outsourcing fields, that they take on a very high level of responsibility and liability in exchange for their relatively modest fees.

Greg Lascelles is a partner with Covington & Burling LLP in London.