[2015] UKUT 0013 (TCC)

Reference number: FS/2012/20

FINANCIAL SERVICES – investment management – management of conflicts of interest - compliance monitoring - separation of decision making within firm acting for different customers – whether property of open ended investment companies managed with the aim of providing a prudent spread of risk as regards liquidity – Principles 2, 3, 8 in respect of alleged breaches by firm and Statements of Principle 6 and 7 in respect of alleged breaches by individual Applicants

Management of conflicts of interest in respect of four specific transactions – whether Applicants acted without integrity – Principle 1 in respect of alleged breaches by firm and Statement of Principle 1 in respect of alleged breaches by individual Applicants

Financial penalty and public censure – whether action against individual Applicants prevented by limitation – s66(4), (5) FSMA – appropriate level of penalty – ss66(3), 205 FSMA

Fitness and properness of individuals – withdrawal of approvals – prohibition orders – ss56 and 63 FSMA

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER
FINANCIAL SERVICES

ARCH FINANCIAL PRODUCTS LLP (1) **Applicants**
ROBIN FARRELL (2)
ROBERT STEPHAN ADDISON (3)

- and -

THE FINANCIAL CONDUCT AUTHORITY **The Authority**

TRIBUNAL: JUDGE TIMOTHY HERRINGTON
SANDI O'NEILL (Tribunal member)
PETER FREEMAN (Tribunal member)

Sitting in public at 45 Bedford Square, London WC1 on 8 – 21 May 2014

Paul Stanley QC, instructed by King and Wood Mallesons LLP, for the Applicants

Monica Carss-Frisk QC and Iain Steele, instructed by the Financial Conduct Authority, for the Authority

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GLOSSARY

AAUK	Arch Advisors (UK) Limited
AGL	Arch Group (UK) Limited
ACD	Authorised Corporate Director
AFP	Arch Financial Products LLP
AGL Transaction	The transaction whereby in February and March 2007 certain Guernsey Cells invested in AGL
AIN	Arch Investment Nominees Limited
Applicants	AFP, Mr Addison and Mr Farrell
Arch Group	AFP and its holding and subsidiary companies from time to time
Authority	The Financial Conduct Authority, previously known as the Financial Services Authority
Bordeaux	Bordeaux Services (Guernsey) Limited
Capita	Capita Financial Managers Limited, ACD of the UK Funds
Cell IMA	An investment management agreement entered into between AFP and a Guernsey Cell
CISX	Channel Islands Stock Exchange
COB	That part of the Authority’s handbook in force prior to1 November 2007 relating to the conduct of business by persons regulated by the Authority
COLL	That part of the Authority’s handbook dealing with the regulation of collective investment schemes
Cru	Cru Investment Management Limited
Cru Transaction	The transaction whereby between February 2007 and March 2009 certain Guernsey Cells made investments in Cru

	Decision Notices	The Decision Notices issued by the Authority to the Applicants on 14 September 2012
	Distribution Agreement	the distribution agreement entered into between AFP and Cru
5	Diversified Funds	CF Arch Cru Diversified Funds, an OEIC in respect of which Capita is the ACD and AFP was the investment manager
10	Finance Fund	CF Arch Cru Finance Fund, a sub-fund of the Diversified Funds
	FSMA	Financial Services and Markets Act 2000
15	Guernsey Cells	The 22 cells incorporated by the ICC
	Guernsey Directors	Mr Neal Meader and Mr Peter Radford, directors of the ICC and the Guernsey Cells
20	Guernsey Proceedings	The legal proceedings brought by the Cells in Guernsey against, inter alia, Mr Radford and Mr Meader
	ICC	Arch Guernsey ICC Limited
25	ICP	a written investment proposal made to AFP's Investment Committee
	IFA	Independent Financial Adviser
30	IMA	an investment management agreement to which AFP is a party
35	Investment Funds	CF Arch Cru Investment Funds, an OEIC in respect of which Capita is the ACD and AFP was the investment manager
40	Investment Funds IMA	the investment management agreement entered into between AFP and Capita pursuant to which Capital delegated to AFP the investment management of the Investment Funds
	Lonscale Transaction	The loans made by certain Guernsey Cells in order to facilitate the acquisition of the Clubeasy group of companies by Lonscale Limited
45	Mr Addison	Mr Robert Addison, Compliance Officer of AFP during the Relevant Period

Mr Farrell	Mr Robin Farrell, Chief Executive of AFP during the Relevant Period
MiFid	Directive 2004/39/EC
Nice Transaction	The transaction in respect of which debt and equity investments were made by certain Guernsey Cells in Nice Group Limited and Nice Capital LLP
NURS	An OEIC authorised by the Authority as a non-UCITS retail scheme
OEIC	A UK incorporated investment company with variable capital (open ended investment company)
Principles	The Authority's Principles for Businesses
Property Advisory Agreement	The agreement dated 21 September 2007 relating to the initial steps of the Nice Transaction
Relevant Period	July 2006 to March 2009
Statements of Principle	The Authority's Statements of Principle for approved persons
Sub-Funds	The Sub-Funds of the UK Funds
SYSC	That part of the Authority's handbook setting out its rules relating to Senior Management Arrangements, Systems and Controls
The Four Transactions	The AGL Transaction, the Cru Transaction, the Lonscale Transaction and the Nice Transaction collectively
UK Funds	Diversified Funds and Investment Funds collectively
UK Funds IMA	An investment management agreement entered into between AFP and a UK Fund

DECISION

Introduction

1. The Applicants, Arch Financial Products LLP ("AFP") Robin Farrell ("Mr Farrell") and Robert Addison ("Mr Addison") have referred to this Tribunal Decision Notices issued by the Authority under its former name of the Financial Services Authority (the "Authority") on 14 September 2012 (the "Decision Notices").

2. In summary, the Decision Notices provide in respect of each of the Applicants as follows:

AFP

3. The Authority decided to issue a public censure in respect of alleged breaches of Principles 1, 2, 3 and 8 of the Authority's Principles for Businesses ("the Principles") and breaches of rules relating to Senior Management Arrangements, Systems and Controls ("SYSC") and Conduct of Business ("COB") which occurred between July 2006 and March 2009 ("the Relevant Period"). The Decision Notice stated that were it not for AFP's financial position, the Authority would have decided to impose on AFP a financial penalty of £9 million.

Mr Farrell

4. The Authority decided in respect of alleged breaches of Statements of Principle 1, 6 and 7 of the Authority's Statement of Principle for Approved Persons (the "Statements of Principle").

(1) to prohibit him, pursuant to section 56 of the Financial Services and Markets Act 2000 ("FSMA") from performing any function in relation to any regulated activity carried on by any authorised person, exempt person or exempt professional firm;

(2) to withdraw, pursuant to section 63 FSMA, the approval given to him under section 59 of FSMA to perform the CF3 (chief Executive), CF4 (Partner) and CF30 (Customer) controlled functions in relation to AFP; and

(3) to impose on him pursuant to section 66 of FSMA, a financial penalty of £650,000.

Mr Addison

5. The Authority decided in respect of alleged breaches of Statements of Principle 1 and 7:

(1) to prohibit him, pursuant to section 56 FSMA, from performing any function in relation to any regulated activity carried on by any authorised person, exempt person or exempt professional firm;

(2) to withdraw, pursuant to section 63 FSMA, the approval given to him under section 59 FSMA to perform the CF4 (Partner) and CF30 (Customer) controlled functions in relation to AFP; and

(3) to impose on him, pursuant to section 66 FSMA, a financial penalty of £200,000.

6. The Authority's case arises out of what it contends are regulatory failings arising out of AFP's role as investment manager of:

(1) two UK incorporated open-ended investment companies, the CF Arch cru Investment Funds and the CF Arch cru Diversified Funds; and

(2) 22 cells within the incorporated cell company Arch Guernsey ICC Limited into which the UK Funds invested.

7. Miss Carss-Frisk helpfully summarised the Authority's case by reference to five specific categories of alleged failings as follows:

(1) *Management of conflicts of interest:* AFP failed to manage conflicts of interest fairly by (a) identifying and taking appropriate steps to mitigate conflicts of interest between itself, its associates and/or its clients; and (b) adequately documenting and recording conflicts of interest that arose in its business and the steps it took to mitigate those conflicts. The Authority contends that AFP thereby breached Principle 8 and a number of COB and SYSC Rules, and Mr Farrell's and Mr Addison's respective roles and involvement constitute a breach by each of them of Statement of Principle 7.

(2) *Failure to manage specific conflicts*: AFP caused the Guernsey Cells to enter into a number of significant transactions, falling into four categories, by which AFP and related persons or entities stood to make gains at the expense of the Guernsey Cells; AFP also failed to manage fairly conflicts of interest arising between its clients (including different Guernsey Cells). The Authority contends that each of AFP, Mr Farrell and Mr Addison failed to take the requisite steps to ensure that the corresponding conflicts were managed fairly (in terms of their mitigation and/or recording). In the circumstances, the Authority contends AFP failed to conduct its business with integrity (on grounds of recklessness) in breach of Principle 1 and each of Mr Farrell and Mr Addison failed to act with integrity (on grounds of recklessness) in breach of Statement of Principle 1.

(3) *Compliance monitoring*: AFP did not have effective compliance monitoring procedures in place and failed to ensure that the results of compliance monitoring were adequately recorded and reported to senior management. In particular, the Authority contends, given the complexity of its business and the risks it faced, AFP should have implemented a formal compliance monitoring programme. The Authority contends that AFP thereby breached Principle 3 and a number of the SYSC Rules, and Mr Addison's role and involvement constitute a breach by him of Statement of Principle 7.

(4) *Separation of decision-making:* AFP failed to ensure that it had adequate systems for segregating and controlling its access to and use of non-public information about the Guernsey Cells. Prior to December 2008, the same individuals were in charge of making investment decisions not only at the Guernsey Cell level but also at the UK Fund level; persons who made investment decisions on behalf of the UK Funds had access to information that went further than the published net asset value ("NAV") of the Guernsey Cells (for example they had access to AFP's NAV model concerning the Guernsey cells and information that supported the NAV model). The Authority contends that this means that there was no effective safeguard against the risk of non-public information being shared between those involved in making investment decisions at UK Fund level and those involved in making investment decisions at Guernsey Cell level. The Authority contends that AFP thereby breached Principle 3, and Mr Farrell's and Mr Addison's respective roles and involvement constitute a breach by each of them of Statement of Principle 7.

(5) *Liquidity and spread of risk:* AFP failed to ensure that the scheme property of the Sub-Funds aimed to provide a prudent spread of risk due to its failure to maintain sufficient cash balances in the Sub-Funds (including to increase those balances) to mitigate the substantial investment of the Sub-Funds' property in the Guernsey Cells' shares, which had limited liquidity. The Authority contends that in increasing the Sub-Funds' exposure to Guernsey Cells' shares during a period of market turmoil and illiquidity (even when cash levels in the Sub-Funds were below stated target buffer levels), AFP's actions were not prudent. Investors were, the Authority contends, thereby exposed to the risk that the UK Funds would not be able to liquidate their holdings in the Guernsey Cells to meet redemption requests at times of net outflows from the UK Funds. Concerns as to this risk resulted in the suspension of the UK Funds in March 2009 by the ACD at the request of AFP. The Authority contends that AFP thereby breached Principle 2, and Mr Farrell's roles and involvement constitute a breach by him of Statement of Principle 6.

8. The Applicants dispute all of the allegations made by the Authority. Their reply to the contentions of the Authority as set out in paragraph 7 above can be summarised as follows:

(1) *Management of conflicts of interest:* The Applicants accept that conflicts of interest arose in respect of AFP's dual role as investment manager both of the UK Funds and of the Guernsey Cells, but they contend that AFP had appropriate policies to manage fairly any conflicts that arose.

(2) *Failure to manage specific conflicts:* The Applicants accept that AFP caused the Guernsey Cells to enter into the four specific transactions relied upon by the Authority and that conflicts of interest arose in that regard, but they contend that the conflicts concerned were managed fairly

and they deny they acted without integrity in the manner in which the conflicts were managed.

(3) *Compliance monitoring:* The Applicants contend that AFP maintained reasonable compliance monitoring procedures, appropriate to the size of the business at the relevant time, maintained records of breaches identified in the course of compliance monitoring and regularly reported compliance monitoring to senior management.

(4) *Separation of decision-making:* the Applicants accept that there was a risk that, as AFP was investment manager of both the UK Funds and the Guernsey Cells, those individuals at AFP making decisions on behalf of the UK Funds had access to more information about the Guernsey Cells and their underlying investments than that publicly available. However, the Applicants contend that when the business had grown to the point where it was justified, there was a division of responsibility for decision making amongst the investment teams within AFP, and policies and procedures in place to ensure that any non-public information about the Guernsey Cells was not used.

(5) *Liquidity and spread of risk*: The Applicants accept that AFP was obliged to take reasonable care to ensure that the Sub-Funds' scheme property aimed to provide a prudent spread of risk, but deny that it failed to do so. They contend that the evidence shows that AFP had liquidity constantly in mind and reached judgments about the level of liquidity to maintain which were perfectly reasonable under the circumstances in which they were taken.

Role of the Tribunal on a reference

9. Section 133(4) FSMA provides that, on a reference, the Tribunal may consider any evidence relating to the subject matter of the reference whether or not it was available to the decision-maker at the material time. This is not an appeal against the Authority's decisions but a complete rehearing of the issues which gave rise to the decisions.

10. Section 133(5) FSMA provides that, on a reference, the Tribunal must determine what (if any) is the appropriate action for the Authority to take in relation to the matter referred to it. Section 133(6) and (7) provide that the Tribunal must remit the matter to the Authority with such directions as the Tribunal considers appropriate for giving effect to its determination and the Authority must act accordingly.

Structure of this decision

11. For ease of reference we set out below the headings under which we have organised this decision, and the corresponding paragraph numbers:

Heading	Paragraphs
Relevant legislation and regulatory provisions	12 – 29
Issues to be determined	30 – 33
Evidence	34 – 40
Background findings of fact	41 – 102
Issue 1: Management of conflicts generally (AFP)	103 – 192
Issue 2: Management of conflicts generally (Mr Farrell and Mr Addison)	193 – 195
Issues 3 and 4: Management of conflicts in respect of The Four Transactions (AFP, Mr Farrell and Mr Addison)	
Introduction	196– 198
Integrity	199– 213
AGL Transaction	214 - 267
Cru Transaction	268- 313
Lonscale Transaction	314- 338
Nice Transaction	339- 374
Issues 5 and 6: Compliance Monitoring Procedures (AFP and Mr Addison)	375-389
Issues 7 and 8: Separation of Management (AFP, Mr Farrell and Mr Addison)	390-404
Issues 9 and 10: Prudent spread of risk (AFP and Mr Farrell)	405-449
Issue 11: Public Censure (AFP)	450-456
Issue 12: Limitation	457-472
Issue 13: Financial penalties (Mr Farrell and Mr Addison)	473-477
Issues 14 and 15 : Withdrawal of approvals and prohibition	478
Conclusions	479
Directions to the Authority	480-481

Relevant legislation and regulatory provisions

12. The Authority's regulatory objectives are set out in section 1B FSMA and include securing an appropriate degree of protection for consumers and protecting and enhancing the integrity of the UK financial system.

13. Section 205 FSMA provides that if an authorised person, which includes a person such as AFP who holds a permission from the Authority to carry on regulated activities, has contravened a requirement imposed on him by or under FSMA, the Authority may publish a statement to that effect. Section 206 also includes a power to impose a financial penalty in those circumstances but in view of AFP's financial position no financial penalty is sought by the Authority from AFP.

14. By virtue of sections 66(1) and (3) FSMA the Authority may take action to impose a penalty on an individual of such amount as it considers appropriate where it appears to the Authority that the individual is guilty of misconduct and it is satisfied that it is appropriate in all the circumstances to take action.

15. By virtue of section 66(2) FSMA misconduct includes failure, while an approved person, to comply with a statement of principle issued under section 64 FSMA or to have been knowingly concerned in a contravention by the relevant authorised person of a requirement imposed on that approved person by or under FSMA.

16. Section 66(4) FSMA now provides that the Authority may not take action under section 66 after the end of the period of three years beginning with the first day on which the Authority knew of the misconduct, unless proceedings in respect of the misconduct were begun against the relevant person before the end of that period. By virtue of section 12(1) and (4) of the Financial Services Act 2010 the period referred to in section 66(4) was increased from two years to three years on 8 June 2010 which was during the period that Mr Farrell and Mr Addison were under investigation by the Authority but prior to regulatory proceedings being issued. Mr Farrell and Mr Addison contend that the correct limitation period in their case is two years and on the basis that regulatory proceedings were not commenced against them by the issue of a Warning Notice within that period no financial penalty can be imposed on them under section 66.

17. Using its rule making powers, the Authority has issued the principles which it declares to be a general statement of the fundamental obligations of authorised persons (referred to as firms in the Principles) under the regulatory system. The Principles which are relevant to this reference are as follows:

Principle 1: A firm must conduct its business with integrity.

Principle 2:	A firm must conduct its business with due skill, care and diligence.
Principle 3:	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
Principle 8:	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

18. In addition to Principle 8 there are other regulatory provisions relevant to the question of the management of conflicts of interest. These rules changed significantly on 1 November 2007 to reflect the implementation in the United Kingdom of the requirements of the European Union's legislative provisions regarding Markets in Financial Instruments, in particular Directive 2004/39/EC, which imposes further organisational requirements and operating conditions for investment firms for the purpose of MiFID. It is therefore necessary for the purposes of this reference to have regard to the relevant rules in force during the Relevant Period both before and after 1 November 2007.

19. The relevant provisions are to be found in the Authority's COB and SYSC Rules, COB setting out conduct of business requirements (which were only in force prior to 1 November 2007) and SYSC setting out the relevant provisions concerning systems and controls.

20. We set out in full the relevant provisions in Part 1 of Appendix 1 to this Decision.

21. That part of the Authority's handbook known as APER sets out the Statements of Principle issued under section 64 FSMA as they relate to approved persons and descriptions of conduct which, in the opinion of the Authority, do not comply with a Statement of Principle. APER further describes factors which, in the opinion of the Authority, are to be taken into account in determining whether or not an approved person's conduct complies with a Statement of Principle. The Statements of Principle relevant to this reference are:

(1) Statement of Principle 1, which provides that an approved person must act with integrity in carrying out his controlled function;

(2) Statement of Principle 6, which provides that an approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function; and

(3) Statement of Principle 7, which provides that an approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with the relevant standards of the regulatory system.

22. APER 3.1.8G provides, in relation to applying Statements of Principle 5 and 7, that the nature, scale and complexity of the business under management and the role and responsibility of the individual performing a significant influence function within the firm will be relevant in assessing whether an approved person's conduct was reasonable.

23. APER 3.3.1E states that in determining whether or not the conduct of an approved person performing a significant influence function complies with Statements of Principle 5 to 7, the following are factors which, in the opinion of the Authority, are to be taken into account:

(1) whether he exercised reasonable care when considering the information available to him;

(2) whether he reached a reasonable conclusion which he acted on;

(3) the nature, scale and complexity of the firm's business;

(4) his role and responsibility as an approved person performing a significant influence function; and

(5) the knowledge he had, or should have had, of regulatory concerns, if any, arising in the business under his control.

Prohibition Orders and withdrawal of approvals

24. The power to make a Prohibition Order is contained in section 56 FSMA which is set out in full in Part 2 of Appendix 1 to this Decision.

25. The question of limitation does not arise in relation to the making of a Prohibition Order under s 56.

26. Guidance on the question whether an individual is a fit and proper person is given in FIT: The Fit and Proper Test for Approved Persons. According to FIT 1.3.1G, the Authority will have regard to a number of factors when assessing the fitness and propriety of a person to perform a particular controlled function. The most important considerations will be the person's:

(1) honesty, integrity and reputation;

(2) competence and capability; and

(3) financial soundness.

27. In this case, as appears from the Authority's statement of case, the focus is whether Mr Farrell and Mr Addison acted without integrity in managing conflicts in respect of the Four Transactions. We consider the relevant legal tests as regards integrity when considering those transactions.

28. Pursuant to section 63 FSMA, the Authority may withdraw an approval given to a person under section 59 FSMA if the Authority considers that the approved person is not a fit and proper person to perform the controlled function to which the approval relates.

29. That part of the Authority's handbook known as COLL makes provision for the regulation, *inter alia*, of authorised funds (including OEICs) and the authorised fund managers (ACDs) of those entities. The relevant provisions of COLL for this reference are as follows:

"5.5.3R(1) Cash and near cash must not be retained in the scheme property except to the extent that this may reasonably be regarded as necessary in order to enable:

(a) the pursuit of the scheme's investment objectives; or

(b) redemption of units; or

(c) efficient management of the authorised fund in accordance with its investment objectives; or

(d) other purposes which may reasonably be regarded as ancillary to the investment objectives of the authorised fund.

(2) During the period of the initial offer the scheme property may consist of cash and near cash without limitation.

5.6.3R(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 scheme aims to provide a prudent spread of risk

(2) The rules in this section relating to spread of investments do not apply during any period in which it is not reasonably practical to comply, provided that (1) is complied with during such period."

Issues to be determined

30. We can summarise the issues that we need to determine on this reference as follows:

(1) Whether AFP failed to manage conflicts fairly in breach of Principle 8 and associated SYSC and COB Rules by failing adequately to identify and take appropriate steps to mitigate conflicts of interests and failing adequately to document and record conflicts of interest that arose in its business and the steps it took to mitigate those conflicts;

(2) Whether Mr Farrell and Mr Addison in breach of Statement of Principle 7 failed to take reasonable steps to ensure that AFP complied with the relevant standards required by the provisions referred to in (1) above;

(3) Whether AFP failed in breach of Principle 1 to act with integrity in managing the conflicts arising in respect of four transactions, known as the AGL Transaction, the Cru Transaction, the Lonscale Transaction and the Nice Transaction;

(4) Whether Mr Farrell and Mr Addison failed in breach of Statement of Principle 1 to act with integrity in respect of the performance of their roles in relation to the Four Transactions;

(5) Whether AFP failed in breach of Principle 3 and associated SYSC Rules to take reasonable care to have effective compliance monitoring procedures in place and to ensure that the results of compliance monitoring were adequately recorded and reported to senior management;

(6) Whether Mr Addison in breach of Statement of Principle 7 failed to take reasonable steps to ensure that AFP complied with the relevant standards required by Principle 3 in relation to the matters referred to in (5) above;

(7) Whether AFP failed in breach of Principle 3 to take reasonable care to ensure that it had adequate systems for segregating and controlling its access to, and use of, non-public information concerning the Guernsey Cells;

(8) Whether Mr Farrell and Mr Addison in breach of statement of Principle 7 failed to take reasonable steps to ensure that AFP complied with the relevant standards required by Principle 3 in relation to the matters referred to in (7) above;

(9) Whether AFP failed in breach of Principle 2 to ensure that the Sub-Funds of the UK Funds aimed to provide a prudent spread of risk through its management of the liquidity of the property of the UK Funds in the light of the composition of their investment portfolios;

(10) Whether Mr Farrell in breach of Statement of Principle 6 failed to exercise due skill, care and diligence in performing his functions in relation to the matters referred to in (9) above;

(11) Whether any failings of AFP found to have occurred merit the imposition of a public censure;

(12) Whether the Authority is time barred from imposing a financial penalty upon Mr Farrell and Mr Addison pursuant to section 66 FSMA;

(13) Assuming issue (12) is determined in the negative, whether any failings of Mr Farrell and Mr Addison merit the imposition of a financial penalty, and if so, the appropriate amount of those penalties;

(14) Whether any failings of Mr Farrell and Mr Addison merit the withdrawal of their approvals under section 63 FSMA; and

(15) Whether any failings of Mr Farrell and Mr Addison found to have occurred merit the making of prohibition orders against either or both of them and if so, on what terms.

31. We shall determine the fifteen issues identified by reference to events occurring during the Relevant Period and by reference to the relevant statutory and regulatory provisions as in force from time to time during that period. As is well established in references of this nature, the burden of proof lies with the Authority and the standard

of proof to be applied is the ordinary civil standard on the balance of probability, namely whether the alleged conduct more probably occurred than not.

32. We do not understand it to be in dispute that, bearing in mind the roles of Mr Farrell and Mr Addison in relation to the matters in dispute, if we make findings that AFP was in breach of the relevant regulatory provision then it follows that the relevant individual will be in breach of his obligations under the relevant Statement of Principle.

33. After some general findings of fact we shall make separate findings of fact and conclusions in respect of each issue in the order set out above.

Evidence

34. We had witness statements from, and heard oral evidence of, a number of witnesses for the Authority. The Authority's witnesses of fact who gave oral evidence and were cross-examined were:

(1) *Nicholas Cook* – Mr Cook is currently employed by the Authority as a manager in the Authority's Policy Risk and Research Division. He formerly worked in the Authority's Enforcement and Financial Crime Division and was one of the appointed investigators in relation to the Authority's investigations into the Applicants. In that capacity Mr Cook was responsible for the majority of the calculations and analysis in respect of the steps taken by AFP in relation to the liquidity management of the UK Funds' investment portfolios. The most relevant evidence provided by Mr Cook was as to the levels of cash held within the UK Funds at particular times and the investments made by the Sub-Funds at particular times in the Guernsey Cells. We found Mr Cook to be a thorough and reliable witness; there was no significant challenge to his factual evidence although Mr Stanley challenged the inferences that Mr Cook drew from the facts he established.

(2) *Stephen Robinson* – Mr Robinson is a manager in the Authority's Enforcement and Financial Crime Division and is the Project Manager of the team working on the Authority's investigation into the Applicants. Mr Robinson's evidence related to the conduct of the investigation and the facts and matters arising from it. In relation to those matters, his evidence was unchallenged. Mr Stanley's cross-examination focused on the Authority's knowledge of the extent of the UK Funds investment in the Guernsey Cells as shown in their annual accounts filed with the Authority and the Authority's enquiries into whether there was any breach of the rules in COLL in respect of investment and borrowing powers, the conclusion being that no such breach occurred. Mr Robinson was of limited assistance on these issues and in any event, as explained in more detail later, we have not found these matters to be relevant to the issues we have to determine.

(3) *Damien Shanahan* – Mr Shanahan is a policy manager in the Authority's Markets Division, responsible, among other things, for policy issues relating to conflicts of interest. Mr Shanahan's evidence gave an overview of the regulatory requirements and standards expected of firms authorised by the Authority. Mr Stanley applied to exclude Mr Shanahan's evidence on the grounds that it was expert evidence for which permission was required and had not been sought. Alternatively, Mr Stanley submitted that the evidence was irrelevant to the issues the Tribunal had to decide. We decided that Mr Shanahan's evidence was on the borderline between factual evidence, namely as to the policy and expectations of the Authority which the Tribunal can find helpful in setting the regulatory context for the matters before it, and his opinion on what the regulatory provisions require of regulated persons, which is a matter for the Tribunal to determine. We decided on balance to admit the evidence but we have not found it to be of much assistance, other than to confirm the absence of any detailed guidance from the Authority to support Principle 8 and the relevant rules which might assist firms in understanding how to approach the management of conflicts.

(4) *Michael Derks* – Mr Derks was a partner at AFP from 8 September 2005. Initially he was employed as the Chief Investment Strategist reporting to Mr Farrell as Chief Executive Officer (CEO). In late 2008 Mr Derks became AFP's Chief Investment Officer, a function which he performed until shortly before he resigned and left AFP in May 2009. Mr Derks gave evidence regarding AFP's approach to the management of conflicts, liquidity management and the separation of decision making which was largely critical of the approaches taken. Mr Stanley characterised Mr Derks' evidence as highly unreliable. We would not share that assessment but whilst Mr Derks may have had concerns about the way conflicts of interest and liquidity management were dealt with at AFP, the evidence does not indicate that he expressed his concerns as forcefully as he suggested. We also accept that his role in achieving a separation of decision making may not have been as prominent as he suggested. In any event, we have not relied to any material extent on Mr Derks' evidence in making our determinations on the relevant issues, but we have found his evidence on the roles and responsibilities of the various individuals involved in AFP's investment management business to be of assistance.

35. Three further individuals provided witness statements to the Authority on a voluntary basis but did not offer themselves for cross-examination as follows:

(1) *Dominique Kateb* – Mr Kateb was a partner at AFP for some of the Relevant Period. His witness statement addresses the general roles and influence of Mr Farrell and Mr Addison within AFP. We received no submissions on this evidence which is in very general terms and have not found it of any assistance. We have therefore placed no weight on it.

(2) *Peter Radford and Neal Meader* – Mr Radford and Mr Meader were the non-AFP directors of the Guernsey Cells and their evidence is relevant to

the Four Transactions relied on by the Authority in relation to the conflict of interest issue. The evidence given is sketchy, consisting of very brief answers to a number of detailed questions about the Four Transactions together with an exhibit in the form of the defence filed by them in proceedings relating to these transactions brought against them by the Guernsey Cells in Guernsey. We have been cautious in attaching much weight to Mr Radford's and Mr Meader's evidence in the light of the fact that they were not available to be cross-examined and we were mindful of the risk that their evidence can be seen as self-serving in the context of the proceedings in Guernsey. Mr Meader and Mr Radford, as residents of Guernsey, are outside the jurisdiction of the Tribunal and could not be made the subject of a witness summons under the Tribunal's Rules. It is perhaps a matter of regret that they did not make themselves available to assist the Tribunal bearing in mind the close links between Guernsey and the UK and the benefits for that jurisdiction in its investment products being used as vehicles for investment by UK investors such as the UK Funds. We also noted in the hearing that the Authority had sought information directly from Mr Meader and Mr Radford rather than seeking the assistance of the Guernsey regulator under mutual co-operation arrangements.

36. The Applicants relied upon the evidence of Mr Farrell and Mr Addison who were cross-examined on their witness statements. We did not find their evidence to be entirely satisfactory; both from time to time gave answers that were evasive and they sought to defend rehearsed positions which the weight of the evidence showed, as they knew to be the case, to be untenable. For example, Mr Farrell was pressed a number of times before accepting that in the light of his position as CEO and controller of substantially all of the share capital of AFP's parent company, that he was a "reasonably dominant" member of AFP's Investment Committee and Mr Addison continued to deny that Mr Farrell was a particularly influential member of the Investment Committee. We have therefore treated their evidence with caution, seeking corroboration whenever possible.

37. The Applicants also sought to rely on witness statements given by Gary King and Peter Jeffs, two former AFP employees, in proceedings brought by the Guernsey Cells in the High Court in London against AFP and Mr Farrell. Neither Mr King nor Mr Jeffs attended for cross-examination and we have therefore, as with Mr Radford and Mr Meader, attached limited weight to their evidence.

38. Expert evidence was adduced on the liquidity issue. The Authority relied on an expert report from Andrew Shrimpton of Kinetic Partners LLP, while the Applicants relied on an expert report from Andrew Tyrtania of FM Consult. Each expert produced a supplemental report responding to the other's expert report and the experts produced a joint statement on matters agreed and not agreed.

39. Both Mr Shrimpton and Mr Tyrtania were cross-examined. We found them both to be competent and knowledgeable witnesses with substantial expertise on the matters on which they gave their opinions. Mr Tyrtania confined his evidence to

transactions relating to the Investment Funds, so his evidence was more limited than that of Mr Shrimpton. Mr Stanley sought to undermine our confidence in Mr Shrimpton by referring to some minor mistakes in his report and Mr Stanley also submitted that Mr Shrimpton lacked recent practical experience of managing investments and did not attempt to support his opinion by reference to the actual current practice of investment managers, but bearing in mind Mr Shrimpton's overall experience we did not find these criticisms to be justified.

40. In addition to the witness evidence we had a large number of bundles of documents provided by the parties, some of which was provided in electronic form.

Background findings of fact

Structure of the Arch Group

41. Mr Farrell established what became the Arch Group in late 2001, initially as a financial structuring and consultancy business.

42. Mr Farrell had at this stage extensive experience of working in major financial institutions in the City of London in senior positions, covering asset management, trading and risk management systems and marketing structured retail, tax and actuarial products, including insurance derivative backed products, his last position before establishing Arch being as Global Head of the Alternative Investments Group at Dresdner Kleinwort Wasserstein.

43. Mr Farrell established Arch Advisors (UK) Limited ("AAUK") in September 2002 as an alternative investment and structuring consultancy, focusing on structured transactions, intermediary services and some corporate finance work.

44. It does not appear that AAUK itself was ever authorised by the Authority but in November 2004 AFP was incorporated as a limited liability partnership. AFP sought authorisation from the Authority which was granted in March 2005. The firm's permission from the Authority was wide in scope and, as Mr Farrell's evidence shows, it was envisaged that the Arch Group would have a number of business lines; structuring deals for third parties, providing corporate advisory and research services and also, through AFP, intermediary services and investment management. Mr Farrell's evidence tended to suggest that AFP would focus purely on investment management with the implication that the other activities would be carried on elsewhere in the group, but it is clear that all regulated activities (which would cover, for example, corporate finance and other investment advice or arrangements) were carried out during the Relevant Period through AFP, and this is borne out by the role AFP played in respect of the Lonscale Transaction (one of the Four Transactions considered in detail below) where it received a fee for acting as corporate finance adviser at the same time as performing its role as an investment manager of the Guernsey Cells which invested in Lonscale.

45. It appears that at some point AAUK's role was confined to acting as the Arch Group's service company and it was also a member of AFP, holding a 1% interest. The corporate structure changed during the Relevant Period, but from March 2008 97% of the membership (or partnership) interest in AFP was held by a UK holding company, Arch Group (UK) Limited (AGL), which in turn was 100% owned by Arch International Group Holdings Limited a Guernsey registered company. The remaining interests in AFP were held by individual partners, with a very small interest held by another group company, Arch Real Estate Limited. The Arch Group was ultimately controlled by Mr Farrell and his wife throughout the Relevant Period. The intervening holding companies in place during that time changed but Mr and Mrs Farrell together held between 83% and 95% of the Group's ultimate holding company during the Relevant Period. Mr Farrell transferred half of his shareholding in this company to his wife on or around 23 January 2009.

46. There is one further Arch Group entity of relevance, Arch Investments Nominees Limited ("AIN"), which was the nominee holder of co-investments made by Arch Group entities.

47. After obtaining its authorisation, as Mr Farrell confirmed in his answer to a question from the Tribunal, AFP's business was initially confined to corporate finance advisory work. It was, however, envisaged that AFP would become involved in investment management, Mr Farrell's evidence being that the initial idea was an offshore incorporated fund of hedge funds marketed to non-retail investors. AFP started as a small entity, initially with a headcount of 8, growing to 12 in 2005 and 25 in February 2008.

48. At the outset of AFP's operations, with a small number of staff, decision making was informal. Individual roles were not clearly defined beyond the allocation of job titles. Mr Farrell was at all times the Chief Executive Officer (CEO) of AFP and had overall responsibility for AFP's business. He never held the title of Chief Investment Officer, but as we shall see later, he had a significant role with regard to the making of investments by the Arch Group and its investment management clients.

49. Mr Addison joined AFP in March 2006 and became Chief Operating Officer. A substantial part of his day to day work was taken up by his role as compliance officer and as such he was responsible for implementing compliance policies and undertaking compliance monitoring of AFP's business.

50. Prior to joining AFP, Mr Addison had a career of over fifteen years in the City of London, starting at NatWest Markets where he became an Associate Director specialising in equity derivatives. He joined UBS Investment Bank in 1997, acting as a Director of risk management products for approximately six years dealing principally with equities, equity derivatives and alternative investments. He then managed his own structuring and derivatives consultancy, where he oversaw the development and launch of a number of investment funds, before joining AFP.

51. Mr Derks was one of the early partners in AFP, joining in September 2005. Prior to that he had over twenty years' experience in researching and writing on

economic strategy. He was initially employed as Chief Investment Strategist, reporting to Mr Farrell, but it emerged during cross-examination that he performed a wider role than that, becoming a member of the investment management team and actively participating in investment management matters, with some participation in asset allocation, and a leading role in relation to liquidity management. Mr Derks resigned from a number of his responsibilities in November 2008 after expressing discomfort with some aspects of AFP's investment management operation, but remained as a partner in AFP and shortly thereafter agreed to resume an investment role, as Chief Investment Officer, following changes to the structure of AFP's UK and Guernsey investment management operations, as discussed in more detail below. He ultimately left AFP in March 2009.

Move into investment management

52. AFP started to move into investment management early in 2006. The strategy moved on from the original idea of focusing on alternative investments for the non-retail market to one of establishing retail funds.

53. AFP started discussions early in 2006 with Cru Investment Management Limited ("Cru"). Cru was established in 2005 as a marketing company with the focus of marketing investment funds to Independent Financial Advisers ("IFAs") on the basis of a model portfolio which it had designed, but it did not have its own managed funds. Cru wished to collaborate with a fund manager who would launch its own vehicle which Cru would then market to IFAs.

54. At the same time, AFP approached Capita to see if Capita would be interested in acting as ACD for a UK open ended investment company which would be the product offering of Arch's investment management business. An ACD of an OEIC has overall regulatory responsibility for the management of the OEIC and its compliance with COLL and other applicable regulations.

Establishment of the Investment Funds

55. Accordingly, on 29 June 2006 CF Arch Cru Investment Funds was authorised by the Authority as an umbrella OEIC with two sub-funds. Capita was the ACD of the Investment Funds but it delegated the role of investment management to AFP pursuant to an investment management agreement dated 5 July 2006. Under the Investment Funds IMA, AFP had complete discretion (without prior reference to Capita) to deal in investments, effect transactions and take all day to day decisions as AFP considered appropriate in relation to the management of the Investment Funds subject to any restrictions in its instrument of incorporation, prospectus, the Authority's rules and the regulations governing OEICs.

56. The Investment Funds was constituted as a non-UCITS retail scheme ("NURS") which meant that although it could be freely marketed to retail investors, its investment powers (particularly with regard to spread of investments) were wider than those of UCITS schemes, that is schemes which met the harmonised requirements of the European Union's UCITS directive.

57. The original prospectus of the Investment Funds drew up its investment policy in the widest possible terms as follows:

> "The fund will seek to achieve its objective by investing directly in a broad range of collective investment schemes, transferable securities, bonds, money market instruments, cash, derivative instruments, forward transactions and other instruments that the investment manager considers to be appropriate from time to time."

58. We observe that this disclosure gives an investor very little useful information as to the likely composition of the investment portfolio. The prospectus, which in accordance with COLL had to be filed with the Authority, would not therefore have given the Authority any meaningful information about the composition of the portfolio, and it meant that there was no need to change the prospectus when it was decided to invest predominantly in the Guernsey Cells, as described in more detail below.

Establishment of the Guernsey Cells

59. At around the time of the authorisation of the Investment Funds, AFP became aware of a new fund structure in Guernsey whereby under Guernsey law a Guernsey incorporated closed-ended company (that is one that generally has no obligation to redeem investors' shares) would be established with a number of sub-funds (known as cells) each of which would be a separate legal entity in its own right and which would have their own particular investment objectives. The shares of each cell could also be listed on the Channel Islands Stock Exchange ("CISX").

Investment Strategy

60. AFP at this time formed the view that it would like the Investment Funds to be invested in such a way that investors were predominantly exposed to alternative investments such as private equity investments, which of course are less liquid than transferable securities traded on a regulated securities market.

61. AFP was aware that the investment powers of a NURS prevented significant direct exposure to such assets. AFP realised that the cells of a Guernsey incorporated cell company could provide indirect exposure in the following manner.

62. The ICC would incorporate a number of cells each of which could have its own investment objectives. Under Guernsey regulations, as an investment fund that was not to be marketed directly to the public, the underlying assets into which the cells were to invest could be very widely drawn, with little restriction on spread of investments, so could without difficulty give exposure to alternative investments. As a closed ended vehicle, investors would not, unlike an OEIC, be able to redeem their shares on request so that there was no need to maintain any particular level of liquidity.

63. The shares of each cell could as mentioned above, be listed on the CISX. Although the CISX is not recognised as a regulated market by the Authority, if the prospectus of a UK authorised OEIC listed the CISX as an "eligible securities

market" in its prospectus, then the Cell's shares would become "transferable securities" which were eligible for investment by NURS subject to the rules in COLL regarding spread of investments.

64. The shares in the Guernsey Cells were "transferable securities" rather than interests in a collective investment scheme (in respect of which the investment powers of NURS are much more limited) because the Guernsey Cells are closed-ended. Subject to the spread rules of COLL it was therefore open to the OEICs to invest as widely as they liked in the shares of the Guernsey Cells; they effectively had the same status for investment purposes as any share listed on a major market such as the shares of a FTSE 100 company traded on the London Stock Exchange.

65. The spread rules prevented more than 10% of the value of the scheme property of a NURS from being invested in transferable securities of a single issuer, but as each of the Guernsey Cells was a separate legal entity, this limit was applied to each cell separately rather than the ICC as a whole, meaning that the spread rules could be complied with by spreading the investment of the NURS across a number of cells.

66. As there were no provisions in COLL imposing conditions on the composition of the portfolios of the closed-ended funds that a NURS may invest in, it was perfectly feasible for a NURS to invest in such number of cells that complied with the spread limits. Each of these cells could invest in alternative investments which could not be invested in directly by the NURS.

67. It is this portfolio model that AFP adopted. AFP therefore established Arch Guernsey ICC Limited as an incorporated cell company with a number of discrete cells in December 2006. The ICC was authorised by the Guernsey Financial Services Commission. AFP was appointed the investment manager of each of the separate cells then incorporated by the ICC. Ultimately there were 22 cells in respect of which AFP was appointed investment manager, under a separate agreement for each cell (each a "Cell IMA"). These agreements were materially the same as each other (except as to fees). AFP had complete discretion, *inter alia*, to deal in investments and other assets, effect transactions and make all day-to-day decisions as AFP considered appropriate in relation to the management of the assets of the cell. Although, surprisingly, no mention of it was made in the Cell IMA, as AFP was performing the investment management role from the UK, the services it provided to the Guernsey Cells would be subject to regulation under the Authority's rules, as was the case with its services under the Investment Funds IMA.

68. Bordeaux Services (Guernsey) Limited were appointed the administrator of the ICC on 28 December 2006. The services to be provided were not set out in any detail in the agreement, although it was understood that they included the valuation of the ICC's and the Guernsey Cells' assets which is usually the prime function of an offshore administrator of an investment fund. Two directors of Bordeaux (Mr Radford and Mr Meader) became directors of the ICC and each of the Guernsey Cells, along with Mr Addison.

69. From its launch in July 2006 the property of the Investment Funds was invested in cash and money market instruments, externally managed funds, equities futures and corporate bonds.

70. In January 2007 AFP started to implement an investment strategy for the Investment Funds which led these funds to invest predominantly in shares of the Guernsey Cells. The aim of the strategy was to offer the retail investors of the Investment Funds exposure to non-traditional asset classes, and private equity and private finance style investments, which as discussed above, could not to any significant extent be accessed directly by a UK authorised OEIC.

71. AFP explained the rationale for choosing the Guernsey Cells rather than any other vehicle to implement this strategy in a detailed response to questions raised by Capita in February 2009. AFP 's view was that in order to provide the desired risk return profile for the UK Funds it was essential to maintain a direct control over the investment decisions and ongoing monitoring over an investment. AFP stated that if it lent directly to a company or invested directly in private equity then it would have more control over the investment and would be able to assert more influence on the management of that business and therefore the potential returns. As they said to Capita, the decision was taken to create their own vehicles to obtain the specific type of exposure that they sought.

72. It is clear from this explanation that AFP made no distinction between the position of the UK Funds and the Guernsey Cells; the latter were seen as the means by which the UK Funds could obtain exposure to the desired asset class and in a manner which AFP, in its capacity as investment manager of both the UK and the Guernsey entities, could control. Although some of the Guernsey Cells did have investors other than the UK Funds, the investment strategy resulted in the UK Funds having majority or complete ownership of many of the Guernsey Cells.

Distribution Arrangements

73. On 13 February 2007 AFP entered into a distribution agreement with Cru whereby Cru was appointed on an exclusive basis to introduce both the UK Funds and the Guernsey Cells to IFAs and their prospective investors who satisfied the suitability and investment requirements of the offering documents for each fund. Cru was to be remunerated by a share of the fees earned by AFP from each UK Fund. On the same day three of the Guernsey Cells agreed to subscribe for new shares in Cru and provide it with a revolving note issuance facility, a transaction which is considered in more detail below.

Expansion of AFP's business

74. On the basis of Mr Farrell's evidence, which was not challenged on this point, AFP's funds under management grew from £20 million at the launch of the Investment Funds in July 2006 to £210 million by May 2007. There was a further substantial increase of £80 million in September 2007 when AFP took over the investment management of the Diversified Funds, the Fund being renamed as the CF

Arch Cru Diversified Funds at that time. This rapid growth was reflected in the Arch Group's headcount which rose from 11 in July 2006 to 61 by November 2008. The Group continued to carry on the other business lines in investment structuring and corporate finance as described above. The Diversified Funds began to invest in the Guernsey Cells shortly after AFP was appointed its investment manager, and by March 2008 its Sub-Funds were predominantly invested in the Guernsey Cells.

The Authority's Knowledge of the Structure

75. It is common ground that the structure used by AFP to give retail investors exposure to non-traditional investments was novel. The Authority became aware of the structure during the spring and summer of 2007. As we have observed, the prospectus itself gave no indications that the UK Funds would concentrate their investments on the Guernsey Cells. There were some concerns expressed within the Authority in July 2007 as to whether the UK Funds complied with the COLL Rules for a NURS, and in particular the restrictions on the amount that could be invested in other collective investment schemes. It appears that initially the Authority did not have full information as to the features of the Guernsey Cells. The Authority did not at first appreciate that as the Guernsey Cells were closed-ended vehicles they were not collective investment schemes and therefore they were subject to the less restrictive spread rules on transferable securities.

76. In November 2007, the Authority received details of the investments held by the UK Funds which clearly set out their holdings of the Guernsey Cells and it would appear that after that any concerns at that stage about the nature of the portfolio were allayed.

77. The question as to compliance with COLL was however raised again by the Authority in October 2008, in the context of the launch by the Diversified Funds of a new sub-fund, the CF Arch Cru Finance Fund. The Authority sought confirmation that the sub-fund's holdings would meet the requirements of COLL (which it received) and it also required the sub-fund's investment policy to state that it would invest predominantly in investment vehicles qualifying as transferable securities, including investment vehicles managed by AFP. This requirement was reflected in the prospectus for the Diversified Funds, but the prospectus was not changed in respect of the other Sub-Funds which continued to express their investment policy in very wide terms without specific reference to investment in vehicles managed by AFP.

Events as the financial crisis developed

78. In his Report Mr Shrimpton gave a helpful summary of the financial environment in which the UK Funds were operating between 2007 and 2009. As is well known and as Mr Shrimpton summarised, the disruption and downturn affecting the major economies of the world, commonly known as a "financial crisis," has manifested itself in, among other things, significant falls in investment markets and a reduction in the availability of capital, especially in the second half of 2008. Mr Shrimpton's view, which we accept, is that the "storm clouds" of the financial crisis

were building by the second half of 2007, manifested in such events as the Bear Stearns collapse in July 2007 and the bank run on Northern Rock in September of that year. This led to what Mr Shrimpton characterised as a period of heightened volatility until September and October 2008 when a number of major institutions either failed, were acquired or were subject to government takeover, the most significant being Lehman Brothers. Mr Shrimpton characterises the period after September 2008 to early 2009 as one of market breakdown, with a sharp decline in the S&P 500 Index during this period.

79. Unsurprisingly, against this background as public markets fell, large scale selling of investments took place. The UK Funds were affected with an increasing number of redemptions. As open ended funds the UK Funds were under an obligation to meet redemptions in cash within four business days of the request being made, which was clearly challenging where, as we will examine, the predominant assets, the shares in the Guernsey Cells, were largely illiquid as were the underlying assets of the Guernsey Cells.

80. Nevertheless, the UK Funds were able to deal with redemption requests until the suspension of dealings, assisted by the launch of the Finance Fund, whose launch was, as we find in paragraph 427 below, in response to AFP's view that exposure to a portfolio of private finance related investments (the stated objective of the Finance Fund) would offer less volatility than was then being experienced in the public markets. Money raised by the Finance Fund was invested in the Guernsey Cells and to an extent it invested in the shares of Guernsey Cells which other Sub-Funds wished to sell to fund redemptions that they were experiencing.

81. In February 2009 Capita raised concerns with AFP regarding the liquidity of the UK Funds which, after detailed discussions and correspondence, ultimately led to the suspension of dealings in the UK Funds. This was because Capita considered there was insufficient liquidity in one of the Sub-Funds of the Investment Funds and they considered that the suspension of those funds would lead to an increased likelihood of redemption requests in respect of the Diversified Funds, which Capita also stated had a significant lack of liquidity in their assets. AFP is highly critical of this decision, but it is not an issue that we are directly concerned with.

Related Litigation

82. For completeness, and because some of the material relating to them was before us as evidence in these proceedings, we should mention that there are various ongoing court proceedings which, *inter alia*, relate to the Four Transactions on which the Authority relies in these proceedings in respect of the conflict of interest issue.

83. Specifically, Mr Addison, Mr Meader, Mr Radford and Bordeaux are defendants in proceedings brought by the ICC and some of the Guernsey Cells before the Royal Court of Guernsey. In essence the claim is that in relation to the Four Transactions the defendants acted in breach of their respective duties as directors (in the case of the individuals) and as administrator (in respect of Bordeaux) in relation to

the investments made by the relevant Guernsey Cells in those transactions. These proceedings are being defended and the claims have not yet been heard.

84. AFP and Mr Farrell personally are defendants in proceedings brought by some of the Guernsey Cells in the High Court (Commercial Court). In essence the claim is in relation to the Four Transactions that AFP acted in breach of its duties as investment manager of the relevant Guernsey Cells in relation to those transactions and also failed to account for substantial secret profits. The claim against Mr Farrell is that in relation to the Lonscale transaction he procured a breach by AFP of its contractual duties and dishonestly assisted AFP in relation to its breach of its fiduciary duties, specifically in relation to the payment of fees to AFP in respect of the transaction. The proceedings are being defended. Walker J has heard the claim against Mr Farrell and AFP in respect of the Lonscale transaction. His judgment was handed down on 18 December 2014. He found that the claims against Mr Farrell and AFP succeeded. As this decision was drafted before Walker J's judgment was handed down we have not taken account of it in reaching our decision.

Governance arrangements during the relevant period

85. It is helpful by way of further background to describe in outline the governance arrangements which were maintained in the Arch Group during the Relevant Period.

86. It does not appear that there was any formal document setting out the responsibilities of the various bodies within the Arch Group responsible for decision making until November 2008. Whilst AGL and Arch UK Group Holdings Limited as corporate bodies each had a board of directors it appeared that they met infrequently and solely for the purpose of dealing with formalities and reviewing the business and decisions of the operating companies. Likewise the governing body of AFP, that is its members, met infrequently. This is borne out by Mr Derks' evidence and the other limited material we saw. We accept Mr Derks' evidence that decision-making at AFP was somewhat *ad hoc* and there was a flat management structure, with decision making at corporate level being driven by Mr Farrell who was CEO and controlling shareholder.

87. There were a number of committees which dealt with particular areas of operation and strategy but we have not seen any resolutions that formally established them and set out their terms of reference prior to November 2008. The functions of the most relevant are set out below.

Executive Committee

88. This was set up in the summer of 2008 and comprised a number of the partners, including Mr Farrell, Mr Addison, Mr Derks and two of the portfolio managers, Gary King and Adam Smith. Its responsibility was to report to the board of AGL about the day to day running of the business, and was also given the responsibility of focusing on risk management.

Commitments Committee

89. According to Mr Derks' evidence, which we accept, this was effectively the "money in, money out committee" which monitored upcoming or ongoing transactions, and fund inflows and outflows across the whole business.

Investment Committee

90. This committee was essentially the decision maker in relation to investments to be made by both the Guernsey Cells and the UK Funds, until separate UK and Guernsey Investment Committees were established towards the end of 2008.

91. An early set of minutes from this committee (relating to the meeting held on 23 January 2007) records that the committee was set up to review the investment activities of the seven Guernsey Cells that had at that stage been established. In that context the minutes record that recommendations were made regarding initial allocations to particular funds, including an investment in AGL which we consider in detail later. The minutes also record that the portfolio management team had been preparing the ground for investment into these various funds over recent weeks.

92. The minutes record that Mr Farrell, Mr Derks, Mr King, Mr Smith and another portfolio manager, Mr Peter Jeffs, were present at this meeting. There is no indication as to who chaired the meeting but in our view it is correct to assume that Mr Farrell as the senior person present did so. We reject Mr Addison's evidence that he did not know who chaired the investment committee as implausible.

93. The minutes of the meeting held on 24 January 2007 indicate that meetings of the committee were to be held on a fortnightly basis. We have not seen any formal minutes for this committee for periods after April 2007; this is consistent with Mr Derks' evidence that these more formal meetings ceased no later than April 2007 and that thereafter until the formal establishment of the Guernsey and UK Investment Committees in 2008 investment decisions were taken informally.

94. The tenor of these minutes, and others that we have seen, suggests that the way that investment decisions were made was that investments were brought to this committee, usually by members of the portfolio management team, and approved by the committee as a whole. Both and Mr Farrell and Mr Addison accepted this in their evidence.

95. We have seen a number of proposals made to the Investment Committee regarding specific investments which are generally very short, giving a brief description of the business of the target and a short "pros and cons" of an investment. They bear the initials of the investment analyst who is sponsoring the proposal.

96. The clear focus of the Investment Committee, on the basis of the minutes we have seen, was the portfolio allocation of the Guernsey Cells and investments made by them. There was also some discussion of performance, both of the UK Funds and

the Guernsey Cells. There appears to have been no separate consideration given to the position of the UK Funds as an investor in the Guernsey Cells when investment proposals came up for consideration.

97. The position of Mr Farrell on the Investment Committee was explored before us. Mr Farrell of course wore a number of hats in relation to the Arch Group. He was chief executive of the Group as a whole which, as we have seen, was involved in corporate finance transactions as well as investment management. Wearing his corporate finance hat, as we shall see when we look at the Four Transactions, he was responsible for bringing investment opportunities to the Guernsey Cells. As a participant on the Investment Committee, he was part of the decision making process that resulted in investments being chosen for the Guernsey Cells. Mr Farrell was also instrumental in decisions taken to establish new Guernsey Cells; in an email dated 9 February 2007 to the portfolio management group he set out details of the new cells shortly to be established. Although in formal terms these decisions would be a matter for the ICC's directors, in practice the proposals came from AFP in London.

98. We have found that Mr Farrell chaired the Investment Committee. Mr Addison denied under cross-examination that Mr Farrell, despite being Chief Executive of AFP was a particularly influential member of the Committee. We believe this to be a rehearsed line, because Mr Farrell in cross-examination after initially denying that he was more influential than other members of the Committee accepted that he was "reasonably dominant" because of his position as CEO. Mr Farrell accepted that he effectively had veto rights or was able to slow decisions down in relation to investments, and would, subject to due process, push forward a project if he had a particular interest in it. This is consistent with Mr Derks' evidence that once discussions of the Investment Committee became more informal after April 2007 and decisions were taken informally, Mr Farrell took the lead, sometimes following discussions with others.

99. It is also consistent with an answer that Mr King gave in interview to the Authority where he said that as "the managing partner, he [Mr Farrell] was, well basically he had a say in everything and the ultimate say in everything". Although we accept that there were discussions before decisions were made and there were occasions where investment proposals supported by Mr Farrell were not ultimately pursued, we conclude that Mr Farrell was the most influential member of the Investment Committee and a dominant figure when it came to investment decisions. Consequently, significant investments would most likely be approved if they had his support or were made on his initiative, and if he was not supportive generally they would not be approved. Bearing in mind the flat structure beneath Mr Farrell at that stage and his positions as CEO, chairman of the Investment Committee and majority owner of the Arch Group no other conclusion is plausible.

Arch Cru Investment Committee

100. This was not a committee of AFP as such, but a forum consisting of representatives of AFP (Mr Farrell, Mr Addison and Mr Derks) and representatives of Cru (Mr Jon Maguire and Mr Paul Evans). It was set up after the launch of the UK

Funds to review their operation and formulate investment strategy, although AFP as fund manager had the ultimate responsibility for making investment decisions. Later on, the committee seemed to be more of a forum for general discussion on the performance of the UK Funds and the Guernsey Cells and the economic situation generally. We do not believe that the proceedings in this committee have any significance in relation to the matters we have to determine so we do not consider it further.

UK and Guernsey Investment Committees

101. As we have observed above, initially investment decisions, whether relating to the UK Funds or the Guernsey Cells, were taken by the Investment Committee. Towards the end of 2008, steps were taken to separate investment decision making relating to the UK Funds from that relating to the Guernsey Cells. In effect, AFP created a Chinese Wall between those taking decisions in relation to the UK Funds and those responsible for investment decisions in relation to the Guernsey Cells. We consider this development when we determine the issue regarding separation of decision making below.

102. Against that background we now turn to deal with the fifteen issues we have identified for determination on this reference.

Issue 1: Whether AFP failed generally to manage conflicts fairly in breach of Principle 8 and the associated SYSC and COB Rules

Legal and regulatory background

103. We start our consideration of this issue with an analysis of the relevant legal and regulatory background.

104. We were referred to a number of well-known authorities from the general law dealing with the duties of a fiduciary who finds himself in a position where his own interest and that of his principal may conflict.

105. We agree with Mr Stanley (and we do not take Miss Carss-Frisk to disagree) that the principles established under the general law are of limited assistance to us in determining whether AFP was in breach of its duties under Principle 8. The other point we should make is that, as we shall see, the general law permits the scope of a fiduciary duty to be determined by contract, so that the terms of the contract may determine whether the door is open to enable the conflict to be managed by disclosure, as permitted by the regulatory rules in certain circumstances. We agree with Mr Stanley that the limited assistance that we can obtain from the general law is what is meant by a "conflict".

106. We start with an assumption that AFP, when agreeing to act as investment manager to the Guernsey Cells and the UK Funds, assumed fiduciary duties to those clients. The courts have not regarded the categories of fiduciary relationship to be closed. There are a number of relationships where it has been established that the nature of the relationship is inherently fiduciary, such as relationships between

trustees and their beneficiaries, agents and their principals, solicitors and their clients, companies and their directors, and partners and their co-partners. In addition, fiduciary relationships can be found to arise where the particular facts and circumstances of a relationship justify the imposition of fiduciary duties.

5 107. Often the factors that turn what might otherwise be a purely contractual relationship into a fiduciary one is the fact that the person on whom it is sought to impose fiduciary duties has a discretionary power to act and where the person to whom the duties may be owed is in a vulnerable position because of the degree of influence that can be brought to bear and the imbalance of knowledge and experience
10 between the two parties. That is certainly true of the inherent fiduciary relationships identified above.

108. Although there does not appear to be any authority directly on the point, the principles identified above would point to the conclusion that an investment manager with discretionary investment powers on his client's behalf is in a fiduciary position.
15 In any event, the investment manager/client relationship is but one example of a principal/agent relationship which it is well established gives rise to fiduciary duties.

109. When a fiduciary relationship is found to exist, its key feature is the duty of loyalty. In *Bristol and West Building Society v Mothew* [1998] Ch 1 Millett LJ summarised this duty at page 18 as follows:

20 > "The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without
25 > the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary."

110. We are concerned in this reference with what is commonly referred to as the "no conflict rule", that is the principle that a fiduciary must, unless he has been
30 properly authorised, avoid acting where there is a conflict between his duty to a client and his own personal interest, or where there is a conflict between duties owed to multiple clients.

111. The central question to be answered so as to determine whether a conflict of the type specified above exists was identified by Lord Upjohn in the House of Lords case
35 of *Boardman v Phipps* [1967] 2 AC 46, where in considering the judgment of Lord Herschell in *Bray v Ford* [1896] AC 44, who stated at page 51 that a person in a fiduciary position was not, unless otherwise provided, allowed to "put himself in a position where his interest and duty conflict", stated at page 124C:

> "The phrase "possibly may conflict" requires consideration. In my
40 > view it means that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict; not that you could imagine some situation arising which might, in some conceivable possibility in events

> not contemplated as real sensible possibilities by any reasonable person, result in a conflict."

112. This follows from the classic exposition of the principle in *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 where Lord Cranworth noted at page 471:

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> "A corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal and it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interest of those whom he is bound to protect.
>
> So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into."

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113. It is clear from these authorities, that because the no conflict rule is breached where there is a real sensible possibility of conflict regardless of whether the conflict has actually materialised, there is no distinction to be made, as the Applicants sought to do in their Reply but did not pursue at the hearing, between an actual and a potential conflict.

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114. That latter point was considered in the regulatory context in the recent Upper Tribunal case of *First Financial Advisers Ltd v FSA (2012)* where the Tribunal was considering whether Mr Danner, coincidentally a director of Cru, had dealt with conflicts properly when he recommended investments in the UK Funds when acting as an IFA and he then stood personally to gain. The Tribunal said at paragraphs 64 to 66:

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> "64. We accept that the benefits that Mr Danner personally received from his interest in CruIM were not solely related to the introduction of funds into the CF Arch cru Funds from SDAM investors. The marketing allowance that CruIM received was a percentage based on the total of new investment received by the Funds, the vast majority of which was obtained from sources outside SDAM. Mr Danner, and on his behalf Mr Davies, sought to characterise the conflict of interest as a "potential" conflict, as the introductions of the funds of the SDAM clients had not themselves resulted in any financial benefit to Mr Danner. The argument was that, since the majority of SDAM clients would have transferred funds from the Cru Portfolio to the Funds in 2006 (a year in which no salary and dividends were paid to Mr Danner), any marketing commission derived from the introduction of those monies into the Funds would have been exhausted in the costs of setting up, and so would not have qualified for dividends.
>
> 65. We do not accept the argument of Mr Danner and Mr Davies in this respect. The mere fact that actual benefits received by Mr Danner cannot be traced to particular investments made by SDAM clients does not mean that there was no conflict of interest. Nor do we accept that for this purpose there can be any distinction between a conflict of interest and a potential conflict of interest. If the use of "potential" is intended to denote a circumstance where a person may become entitled to receive benefit from an interest that could be in conflict with a duty, but at the material time

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there has been no such receipt, then that in our judgment is a real and present conflict, notwithstanding that the benefit has not crystallised, or indeed may never do so.

66. Our conclusion in this regard is supported, to the extent that it needs to be, by the guidance of types of conflicts in that part of the FSA Handbook dealing with systems and controls, in particular SYSC 10.1.4. Point (2) of that section refers to whether the firm or a relevant person has an interest in the outcome of a service provided by the client, or of a transaction carried out on behalf of a client, which is distinct from the client's interest in that outcome. It is only necessary that there be an interest in the outcome, not that the interest has crystallised. Accordingly, once something can be described as a potential conflict, it is already an actual conflict of interest."

115. It is clear from this passage that the Tribunal was in effect applying the same test as is derived from the general law in deciding what amounted to a conflict.

116. Principle 8 has been in force both pre and post MiFID in the same terms. The relevant provisions of SYSC derived from MiFID which refer to conflicts provide no further definition of the term. As those provisions are derived from a European Directive, we should have regard to any different meaning that the term might bear as a matter of European jurisprudence but we have not been referred to any such meaning and neither counsel was able to refer to any European authority to assist us. We therefore proceed on the basis that in considering whether conflicts are present in relation to any of the matters we have to consider on this reference, the question should be determined by reference to the principles we have identified above.

117. The reason why we agree with Mr Stanley that the general law will not assist us in deciding whether AFP put appropriate policies and procedure in place to deal with conflicts and whether it managed specific conflicts in accordance with the relevant regulatory provisions is because the general law and the regulatory provisions take different paths when it comes to managing conflicts. Without contractual modification, the general law duties can be extremely harsh. For example, as Mr Stanley pointed out, they have generally been adopted in relation to the duties that lawyers owe to their clients in respect of conflicts with the result that if there is a significant risk of a conflict the lawyer may not act at all. As we have also seen, whether the terms of a transaction are fair or not is an irrelevant factor in considering whether a conflict exists or not. The regulatory rules are not so harsh; they focus on whether the conflict has been managed fairly and the firm may employ a number of different tools to achieve that, including disclosure and Chinese Walls.

118. However, where the regulatory rules are stricter than the general law is in relation to the freedom to define the duty that is owed. A number of cases have established that a duty defining clause in a contract will be effective so as to modify the extent of a fiduciary duty or even remove it where it would otherwise exist.

119. This is illustrated by the Privy Council case of *Kelly v Cooper* [1993] AC 205 concerning the duties of an estate agent. The facts were that the claimant instructed an estate agent to sell his house. The owner of the adjacent house also instructed the same estate agent. The agent received an offer for both houses, but did not inform the claimants that their purchaser was also interested in buying the house next door. The

claimant argued that he could have obtained a higher price for his house if he had known the purchaser was interested in both houses, and that the defendants had put themselves in a position where their duty to the claimant to disclose all relevant information pertaining to the sale conflicted with their personal interest in obtaining commission on both sales. Lord Browne-Wilkinson held that the terms of the contract prevailed.

He stated at pages 213 to 214:

> "First, agency is a contract made between principal and agent; second, like every other contract, the rights and duties of the principal and agent are dependent upon the terms of the contract between them, whether express or implied. It is not possible to say that all agents owe the same duties to their principals: it is always necessary to have regard to the express or implied terms of the contract."

120. Such a contractual term would not in itself have helped the estate agent if he was under a regulatory duty to act fairly; the terms of his contract could not override those duties. In relation to this reference, the investment management agreements between AFP and the Guernsey Cells each contain a section dealing with conflict of interest. For example, that relating to Arch Private Finance IC Limited (defined as the "Company" in this agreement) provides:

> "The Investment Manager may without prior reference to the Company, effect transactions in which or provide services in circumstances where the Investment Manager has, directly or indirectly, a material interest or a relationship of any description with another party which may involve a potential conflict with the Investment Manager's duty to the Company. The Investment Manager shall not be liable to account to the Company for any profit, commission or any connected transactions and the Investment Manager's fee shall not, unless otherwise provided, be abated thereby. For example, such potential conflicting interests or duties may arise because:
>
> (a) the Investment Manager undertakes investment business for other clients;
>
> (b) any of the Investment Manager's directors or employees is a director of, holds or deals in securities of or is otherwise interested in any company whose securities are held or dealt in on the Company's behalf
>
> …
>
> (d) the Investment Manager may act as agent for the Company in relation to transactions in which it is also acting as agent for the account of other clients;
>
> (e) the Investment Manager may have regard, in exercising its management discretion, to the relative performance of other funds under its management;
>
> However, the Investment Manager shall at all times have due regard to its duties owed to the Company and the Company [sic] and where a conflict arises it will endeavour to ensure that it is resolved fairly."

121. This clause appears to have confined the duties of AFP when a conflict arose to a duty to "endeavour" to act fairly. This may not be sufficient for regulatory purposes because the terms of the contract cannot prevail over the regulatory duty to take whatever steps were necessary to ensure fair treatment for the customer. The

investment management agreement between AFP and Capita in relation to the Investment Funds contained a similar term, although it did not bind AFP contractually to act fairly in resolving conflicts, merely requiring it to ensure that all transactions were effected on terms which were no less favourable than if the potential conflict had not existed.

122. For these reasons, we place little weight on the terms of the various investment management agreements as a tool for managing conflicts fairly in accordance with AFP's regulatory obligations. The only respect in which AFP is able to derive assistance from the contractual provisions is that they enable the strict duties which arise under the general law to be managed by disclosure and informed consent. As disclosure is one of the tools to manage conflicts under the regulatory rules, the contractual provisions enable that tool to come into play.

123. Before turning to the requirements under the regulatory provisions it is helpful, applying the definition of conflict specified above, to identify the general nature of the conflicts that were likely to arise as a result of the structure of AFP's business and the manner in which it was managed.

124. As we have identified above AFP had three main strands to its business:

(1) A corporate finance advisory business pursuant to which it would be involved in structuring and advising on corporate transactions, transactions which as we shall see in particular cases, came to involve the Guernsey Cells directly, and where shares in the Guernsey Cell concerned were owned by a Sub-Fund, the UK Funds;

(2) The investment management of the Guernsey Cells, closed-ended entities whose shares were listed on the CISX and therefore available for purchase on the market or through placements by external investors, as well as the UK Funds, the UK Funds being predominantly invested in the Guernsey Cells and most of the Guernsey Cells being wholly or mainly owned by the UK Funds; and

(3) The investment management of the UK Funds, the underlying investors in which were predominantly retail investors.

125. It can be seen immediately that there are conflicts inherent in that business model which can be summarised as follows:

(1) The Investment Committee of AFP may be asked to approve an investment in relation to a transaction where AFP is acting as corporate finance advisor and may have a financial interest in the transaction, such as its advisory fees being dependent on the successful completion of the transaction. Where its fees are calculated by reference to the value of the transaction it is in AFP's interest that investments are made at the highest possible price, whereas the Guernsey Cells have an interest in acquiring its investments at the lowest price possible. A corporate finance advisor's interests are generally short term; its objective is to realise the transaction at the best possible price for its corporate finance client. The investment

fund's interests are long term, seeking an increase in value of the investment as the business develops. Furthermore, in relation to illiquid assets, a long term view is usually essential.

(2) AFP would maximise its fees as manager of the Guernsey Cells the greater the net asset value of those entities, so there was a clear incentive to exercise its discretion as manager of the UK Funds to invest in the Guernsey Cells and a risk therefore that investments in those cells would be made when it was not necessarily in the interest of the UK Funds.

(3) The UK Funds were fully open ended; redemption requests ordinarily had to be settled in cash within 4 days. Although the Guernsey Cells' shares were listed on the CISX and there was a market maker for the shares, Winterflood, there was no obligation on Winterflood to deal in large sizes and no evidence that there was an active secondary market in the Guernsey Cells' shares beyond demand from the UK Funds, as we find in paragraph 429 below. There may therefore be pressure to realise investments within the Guernsey Cells to generate cash which could either be distributed to the UK Funds or used to fund share buy backs in order to assist with redemptions. Such realisations may be difficult to achieve at a good price bearing in mind the general illiquidity of the Guernsey Cells' investments and in any event the interests of any external investor in the Guernsey Cells may be better served by the retention of its investments for the long term; it may not be in such an investor's interest for the investment to be realised to help meet redemption requests from other investors.

(4) Whilst as we shall see, there was some independent scrutiny of investments made by the Guernsey Cells where there was a conflict, there was no such scrutiny on behalf of the UK Funds where those funds made an investment in the Guernsey Cells. Capita delegated the entirety of the investment management of the UK Funds to AFP and exercised no oversight or approval role in relation to the particular investments being made. There was therefore no person independent of AFP specifically charged with considering the interests of the retail investors in the UK Funds in relation to investments made in transactions where a conflict existed, or until the separation of Guernsey and UK investment management any separation within AFP, which we deal with in paragraphs 390 to 404 below.

(5) Where there was an investment opportunity that would be in the interests of a number of different Sub-Funds, there was a risk that one or more Sub-Funds might be favoured to the detriment of the others.

(6) A further conflict arose as a result of the decision taken that the Guernsey Cells should in effect help fund AFP's infrastructure by investing in AGL's shares and AFP's main distributor, Cru. There was a risk here that the interests of AFP in obtaining sufficient funding for its business and that of its distributors at the best possible price would conflict with the interests of the Guernsey Cells in investing on the best possible terms.

126. In our view all of the situations identified above would lead a reasonable person looking at the relevant facts and circumstances of the case to think there was a real sensible possibility of conflict; each of those situations would therefore have to be managed in such a way to ensure fair treatment for both the Guernsey Cells and the UK Funds.

127. In that context we understand Mr Derks' comment in his evidence that conflicts "had become deeply embedded in the DNA of the firm". We accept that description, not in the sense that there was no recognition that conflicts existed, but that the structure of the business was such that there were conflicts inherent in the business which required to be managed and in respect of which policies and procedures needed to put in place in order that they could be managed fairly.

128. In terms of policies and procedures required by the regulatory rules, in respect of the period prior to the implementation of MiFID in November 2007, the Applicants dispute the Authority's contention that AFP was required to have a formal conflict procedure, and that there was any specific requirement to make a record of conflicts and how they had been managed, although they accepted that it would be best practice to do so. Mr Stanley also pointed out, and we agree with him on this, that there is no comprehensive guidance that the Authority has issued on how to identify conflicts. COB Rule 7.1.5 sets out some examples but they are limited.

129. We agree with Mr Stanley that there was no specific requirement to adopt a formal conflict procedure or maintain records of conflicts prior to November 2007. We do note however that the general provisions of SYSC, which were in force throughout the Relevant Period, impose the following requirements of general application:

(1) Rule 3.2.6 which requires a firm to take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements under the regulatory system;

(2) Rule 3.2.20(1) which requires a firm to take reasonable care to make and retain adequate records of matters and dealings which are the subject of requirements and standards under the regulatory system; and

(3) Rule 6.1.1 which requires a common platform firm (a description which we understand applies to AFP) to establish, implement and maintain adequate policies and procedures sufficient to ensure compliance with the firm's obligations under the regulatory system.

130. Moreover, as Mr Shanahan observed in his evidence, it is difficult to reconcile the overarching requirement to manage conflicts fairly, as set out in Principle 8, without having established a conflicts of interest policy that identifies the type of conflict that the firm is likely to come across in its business and the measures that it has in place to manage those conflicts of interest. In our view such a policy could not hope to list every single situation that might arise that could generate a conflict but it could provide guidance for employees as to the typical situations that were likely to arise, how they should be managed to ensure fair treatment, and how a record could be kept to demonstrate compliance. The policy could also indicate how specific

guidance could be obtained in respect of matters not specifically covered by the policy.

131. As regards record keeping, we have referred to SYSC 3.2.20(1), and in any event we see the maintenance of records of how a conflict has been identified and managed as essential if a firm is to be able to demonstrate that it has complied with its obligation to manage conflicts fairly. As Mr Shanahan points out, such a record is a useful tool to help identify how conflicts evolve and emerge in practice, so that the firm's approach is updated as its business develops.

132. In any event, it appears that AFP did in fact take the view that it should have a written conflicts policy and record of conflicts regardless of the specific requirements and it pleaded in its Reply that the procedures it put in place were adequate.

133. There is no doubt, however, as to what was required after 1 November 2007. The requirements were helpfully summarised by Miss Carss-Frisk as follows:

(1) to keep and regularly update a record of the kinds of activity carried out by AFP in which a conflict of interest entailing a material risk of damage to one or more clients may arise or had arisen (SYSC 10.1.6R);

(2) to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its clients (SYSC 10.1.7R);

(3) to have an appropriate written conflicts of interest policy in place (SYSC 10.1.10R); and

(4) to maintain records in a medium that allows the storage of information in a way accessible for future reference by the Authority and so that (*inter alia*) the Authority must be able to access them readily and to reconstitute each key stage of the processing of each transaction (SYSC 9.1.3R).

General principles

134. Mr Stanley helpfully set out a number of general principles as to how to approach the management of conflicts which he submits can be extracted from the regulatory provisions as follows:

Identification of and understanding the conflict

(1) One size does not fit all: conflicts are different from each other, clients are different, firms are different and the appropriate approach in various circumstances is going to be context dependent.

We agree with this principle; it accords with our view that the policy and procedures to be put in place must reflect the nature of the various business lines carried on by the firm and the typical conflict situations that are likely to result from that.

(2) As a consequence, it is necessary to identify what the conflict in question consists of in any particular case and why it amounts to a conflict. Mr Stanley identified four categories of conflict, which are not exhaustive, as follows:

5 (i) Direct conflicts of interest between the firm and its client, where the firm is incentivised by self-interest to act contrary to the interests of its client, in whose best interests it is obliged to act. An obvious example is where the client deals as a counterparty to the firm or one of the firm's associates.

10 (ii) Indirect conflicts of interest and duty between the firm and its client, where some more or less remote incentive presents the risk that the firm might be encouraged to act contrary to the interests of its clients. An example is where the client deals as a counterparty to an entity in whose success the firm has a material interest.

15 (iii) Direct conflicts of interest between clients, where although the firm's own interests are not affected the firm is involved in acting for clients whose interests conflict. An example from this reference is where one Sub-Fund sells its Guernsey Cell shares to another Sub-Fund.

20 (iv) A combination of the above, for example where a direct conflict between clients also presents an indirect conflict of interest between a client and the firm.

(3) Whether there is a risk that a client will be disadvantaged if the transaction proceeds and, if so, the extent of the damage that will result.
25 In our view this is a relevant factor, bearing in mind the requirements of SYSC 10.1.7 that the firm's systems must address conflicts that give rise to a material risk of damage to the interests of the firm's clients. In that context the following situations by way of example pose a risk of loss:

(i) In a counterparty conflict, where the risk is the client would pay
30 more than he would if the transaction were at arm's length and therefore subject to a negotiated price. If the terms of the transaction have clearly been established to be those available between parties dealing at arm's length it can be said that the risk of loss has been minimised.

35 (ii) In a co-investment conflict, where the firm obtains terms that are more favourable than those obtained for the client, for example if the firm obtains a "sweetheart" deal. This is the "parity of treatment" principle which as we shall see, is a principle on which AFP relies in relation to the Four Transactions we consider later. In
40 our view in considering co-investments, it is necessary to consider whether there is a true alignment of interests between the firm and its client and if there is, we agree that it minimises the risk of material damage to the client, assuming the transaction is appropriate for the client generally.

(iii) In an indirect conflict, where although the conflict is more remote, the same issue arises as with counterparty conflicts, namely whether the transaction is on terms comparable to terms that would be agreed on an arm's length transaction.

5 (4) The seriousness of the conflict. In that regard the following factors are relevant:

(i) The value of the transaction: We place less significance on this factor and do not see that laxer standards are appropriate simply because of the low value of the transaction, although we accept that 10 the rules, at least after November 2007, focus on material damage to clients.

(ii) Whether there is an alignment of interest: Mr Stanley submitted that an investment manager who commits his client to a disadvantageous transaction will know that performance will be adversely affected 15 and he has a strong incentive to avoid that. We disagree with Mr Stanley. The investment manager may perceive that the disadvantage to the relevant client's portfolio as a whole may be relatively small compared to the benefit to the firm in achieving a transaction in its own interest such that the firm considers that the 20 risk to the client's overall portfolio performance is worth taking. In our view there has to be a complete alignment of interest. The investment manager must not be able to obtain an advantage or benefit that is also not made available to his client;

(iii) How direct the conflict is: the more remote the conflict the less 25 likely it is to be problematic;

(iv) The complexity of the transaction: in general risks are likely to be higher in more complex or "non-standard" transactions; and

(v) The duration of the conflict: an ongoing conflict requires more management than a conflict which ends on completion of the 30 transaction.

Mitigating factors

(5) Whether the transaction can be justified on a defensible objective basis.

(6) The quality of the internal review and assessment: Mr Stanley accepts the higher the degree of independence or insulation of the decision-maker the 35 better.

(7) Any external review and assessment: this may or may not be necessary depending on the circumstances. The role of Mr Meader and Mr Radford as the non-AFP directors of the Guernsey Cells is relevant in that regard.

(8) Continuing review: where there is an ongoing conflict the matter should 40 be kept under review, for example to make any adjustment according to change of circumstances or to correct an error that was made at the time it was concluded.

Disclosure and Consent

(9) Disclosure and consent can be used to manage conflict in a variety of ways. For example:

(i) Generalised disclosure and consent: As we have observed the investment management agreements concerned in this reference contained generalised consents and disclosures. Mr Stanley submits these are of some value in that they demonstrate that the client has agreed to his manager being conflicted. For the reasons mentioned above, we do not believe generalised disclosures of this type have any significant value in a regulatory context; the fact that a client knows that a conflict may arise from time to time does not dilute the need to deal with it fairly according to the standards laid down in the rules. In any event, none of the agreements concerned were negotiated on an arm's length basis so the clients concerned were effectively bound by whatever AFP proposed without there having been any challenge by any person specifically representing their interests.

(ii) Specific disclosure and consent which may be a useful step, although its value depends on the experience, competence and position of the persons to whom the disclosure is made and whether they have been given sufficient information to give an informed consent so that they are in a position to assess the fairness of the transaction concerned;

(iii) Ex post facto disclosure, which is insufficient in itself, but would be of value if the client then retrospectively agreed to the transaction; and

(iv) Prevailing market practices can be a relevant factor, for example the acceptance for many years that general insurance brokers can be remunerated by commission from the underwriters, thus incentivising higher premiums.

Record keeping

(10) A record of the steps taken to manage a conflict establishes an audit trail and gives a "corporate memory" so the firm can see how to handle conflicts in a particular situation. We accept Mr Stanley's submission that records do not have to be in any particular form and can be in a series of different documents, although their value will be much diminished if they are not easily accessible, coherent and comprehensible and made soon after the event. They also need to be accurate. If they are made much later they are less likely to be accurate.

(11) Mr Stanley suggested what may need to be recorded without accepting (contrary to our view) that there was a regulatory requirement to make a record. He suggested the following matters, which we regard as sensible:

(i) The basic facts about the transaction, setting out the parties to the transaction and its terms;

(ii) The commercial rationale for the transaction, including how it was valued, priced and why was it thought to be in the best interests of the client;

(iii) The decision-making process for the transaction, stating who participated in the decision-making process, who carried out the analysis and on the basis of what material;

(iv) Any specific analysis of the conflict that was carried out by the decision-makers (or by those who supervised them) concerning the nature of the conflict and its management, how significant the risks associated with the conflict were thought to be and the key mitigating factors;

(v) Any relevant independent advice received;

(vi) If disclosure was made to the client or a representative of the client, what disclosure was made, to whom and when; and

(vii) Any subsequent review

Findings of fact regarding AFP's policies and procedures

135. Against these principles we turn to make findings of fact as to the policies and procedures that AFP put in place during the Relevant Period to manage conflicts.

136. It is clear that both Mr Farrell and Mr Addison recognised the need to identify, manage and record conflicts.

137. Mr Derks recognised in his evidence that Mr Addison chased portfolio managers for conflict notes, which as we shall see were often prepared long after the transaction concerned had been concluded. Mr Addison is recorded in the minutes of one particular AGL Board meeting as having said that conflicts of interest kept him awake at night. Mr Addison specifically recognised that AFP's record keeping on conflicts could have been better. Mr Derks accepted that Mr Farrell "agonised" over the AGL transaction and whether it could be justified. The effect of the conflict arising because of the fees earned by AFP as manager of both the Guernsey Cells and the UK Funds was lessened by the rebating to the Guernsey Cells of a significant amount of the fees earned.

138. In terms of the operational and administrative arrangements that Mr Addison said he put in place during the time he was responsible for compliance our attention was drawn to a number of relevant documents as follows.

139. In March 2006, shortly before Mr Addison assumed the position of Compliance Officer, a revised compliance manual was issued. The compliance manual gave staff a good summary of the requirements of the relevant regulatory provisions they were likely to need to consider in practice but is completely lacking in practical guidance on how to identify conflicts and how to manage them. The relevant section, under the heading "material interests", does little more than repeat the examples given in the COB Rule 7.1 and state that conflict management can take place in a number of specified ways, again repeating what is said in COB Rule 7.1.3. There is no attempt to

give guidance as to what conflicts are likely to arise as a result of the specific circumstances of AFP's business model and what particular tools should be used to manage the specific conflicts identified.

140. We do however, note the following provisions in the manual:

> "As noted above, conflicts of interest may also arise in relation to members of AFP partners and staff. In such circumstances, the individual concerned should ensure that they have no involvement in the transaction which gives rise to the conflict.
>
> Due to the practical difficulty of notifying clients of material interests, AFP will rely on its policy of independence (a copy of AFP's Independence Policy is Appendix 9 to the Manual)."

We address the first paragraph mentioned above in relation to the Four Transactions where Mr Farrell himself had a personal interest.

141. The independence policy, having noted that where there was a conflict AFP could only advise if the client was treated fairly, in essence required AFP partners and staff to disregard any material interest or conflict of interest when giving advice to clients. The second paragraph quoted in paragraph 140 above in essence amounts to a statement that the primary tool for managing conflicts is the policy of independence, but the policy does not give any guidance as to what "disregarding" a conflict of interest means in practice.

142. In May 2006 Mr Addison circulated an annual report on AFP's senior management arrangements, systems and controls to AFP's partners which contained the following statement:

> "As of 5th July 2006 Arch will have its first fund's [sic] under management. This opens Arch up to new areas of risk which are captured in the latest SYSC including dealing procedures and the potential for reputational risk as a result of the higher exposure of Arch to a wider audience that includes retail individuals."

We observe that although this refers to the reputational risk associated with dealing with retail investors, no mention is made of any consideration of whether the position on conflicts needed to be revisited in the light of the expansion of AFP's business. Mr Farrell confirmed in an answer to a question from the Tribunal that no such consideration was given when the UK Funds were established and thus AFP became investment manager to both these Funds and the Guernsey Cells.

143. In January 2007 a specific conflicts and insider policy was produced. Its primary focus was on the handling of material non-public information; the document also set out the Authority's Principles for Business in full including Principle 8, which along with Principle 6 (treating customers fairly) were in bold type, which we accept indicates that AFP regarded these principles as being of particular importance. There was however, no further reference in the document to conflicts of interest or the policy adopted to manage them in practice.

144. On 2 February 2007 Mr Addison emailed to Mr Jeffs a copy of the draft Annual SYSC Risk Assessment and Report to the partners for his comment. Although the report refers, under the heading SYSC, to the fact that the introduction of new funds and the increase in the size of the team makes it appropriate to review and enhance the existing SYSC Risk Assessment to accommodate the additional risks to the business, no mention is made of any need to assess conflict procedures as a result. In relation to the specific risks to the business identified, no mention of conflicts is made at all. The final version of this document was adopted in May 2007.

145. On 15 August 2007 Mr Addison circulated to all relevant AFP employees a Compliance Update. Mr Addison commented that "given the rapid expansion of the Arch Group and its funds under management it seems a good time to provide a refresher to everyone of the key compliance issues that we face on a day to day basis".

146. The Compliance Update reminded staff to refresh themselves as to the content of the March 2006 Compliance Manual. The only specific mention of conflicts of interest was in a section at the end giving an update on MiFID where it highlighted that a properly articulated conflicts of interest policy will be required for all firms.

147. On 23 August 2007 a file note records a meeting to discuss conflicts of interest at which Mr Farrell and Mr Addison were present along with a solicitor, Mr Charles Douglas, and Mr Richard Symington of Methuen Consulting. The note records the purpose of the meeting being to provide AFP with advice on how to correctly manage conflicts of interest that are likely to occur between investment funds where AFP is the investment manager, including funds where Arch shareholders have a beneficial interest. The advice was given in the context of a specific proposal to establish a new unlisted Guernsey Cell, Arch Treasury, in which shareholders of Arch were also to become investors. Mr Symington is recorded as advising four possible techniques of managing the conflicts concerned, namely, disclosure, independence policy, internal arrangements and declining to act. He noted that disclosure on its own was not enough, and a policy of independence was of little assistance in this situation. As far as internal arrangements were concerned, Mr Symington advised that the reasons for undertaking a transaction via Arch Treasury should be documented to show fair treatment and it was noted that a different fund manager would represent Arch Treasury in the consideration of investment opportunities. A Chinese Wall was discounted as not being practicable because of the size and ownership structure of AFP, and declining to act was considered unnecessary.

148. This is the first evidence we have seen as to consideration being given as to how to approach the management of particular conflicts as a matter of policy.

149. Mr Addison circulated this note to AFP's portfolio management team on 15 September 2007. His covering email indicates clearly the approach taken to date by AFP in relation to conflicts as follows:

(1) Mr Addison states that by 1 November (when MiFID came into force) AFP will require to have a "full conflicts of interest policy";

(2) He states that under the pre-MiFID Rules a firm could deal with conflicts simply through disclosure and, with client consent, it could then continue to do business and that this had been dealt with through the prospectuses for the relevant funds and the investment management agreements; and

(3) He states that the pre-MiFID Rules did not require firms to prepare a conflicts of interest policy.

The email goes on to indicate what will be necessary to manage conflicts arising between funds, and that it will be the responsibility of the fund managers to have a paper trail indicating how conflicts have been identified and managed. It also explained that the deal ticket would be amended to have a space for recording conflicts.

150. In October 2007 AFP produced its conflicts of interest policy. However, rather than providing detailed guidance as how to identify and manage particular conflicts, its introduction stated that it set out "high level standards" to be applied.

151. The policy makes it clear that it is the responsibility of each group entity to maintain its own procedures to identify and manage conflicts. Some guidance is given, mainly by reference to the Authority's Rules, as to how entities might take steps to manage conflicts, such as internal separation arrangements and measures to limit exercise of inappropriate influence but it gives no guidance as to what AFP's overall policy is in relation to such matters and how in practical terms it is suggested such arrangements should be structured. The policy contains no description of Arch's particular business lines and the potential conflicts that are likely to arise because of business and ownership structure.

152. In summary, this is a framework document which envisages the creation of more detailed practical written statements as to how conflicts are to be managed rather than a comprehensive and definitive document in its own right.

153. In February 2008 a revised Compliance Manual was prepared. It was far more extensive than that produced in 2006; in fact it extends to over 300 pages and is somewhat unwieldy as a practical document for the guidance of AFP's employees. It contains three pages referring to the conflict of interest requirements set out in SYSC 10 which amount to little more than a description of the relevant rules. It does however refer to AFP's conflicts of interest policy as being provided in Appendix G to the manual, although this was not in fact attached. Mr Addison sought to explain this in his oral evidence by saying this was an accidental omission and that when it was brought to his attention the policy was emailed around to all staff. Mr Addison was evasive in his answers as to what was emailed round and when. However, at that stage the only policy in existence was the one produced in October 2007 and Mr Addison did not explicitly state that on the omission being noticed that document was re-circulated. He made reference to the updated policy of August 2008, which we consider below, but of course in February 2008 when the compliance manual was updated that document did not exist. We can therefore only conclude that it was intended that a revised policy be circulated as part of the compliance manual but it had not been prepared at that point and was not prepared until August 2008. This is consistent with an email that Mr Bruce Lockwood of AFP sent to Mr Addison on 29

July 2008, in which he observed that the written conflict of interest procedures were absent from the compliance manual and that it might make sense to get outside consultants to help on it. Mr Addison's evidence in stating that the policy was circulated is misleading and we reject it, so that we find that no further conflicts of interest policy was circulated until August 2008.

154. A further annual report to AFP's partners on its senior management arrangements, systems and controls was produced for the year ended 28 February 2008. Its only reference to conflicts was that a written conflicts policy was in place (presumably the October 2007 document) and that work on the new deal ticket and investment committee procedures will incorporate elements of conflicts resolution.

155. It seems that a further revised Compliance Manual was circulated on 30 June 2008; Mr Addison was recorded in minutes of a meeting of AFP partners on that day as reiterating the importance of the conflicts policy and reminding staff that conflicts should be resolved before a transaction is undertaken. It would appear that record keeping with regard to the recording of conflicts was behind at this time because Mr Addison offered to assist with completing these.

156. In August 2008 a document described as a conflicts of interest policy statement was produced. Again, its introduction referred to it being a document setting out "high level standards". It was more detailed than the October 2007 document but still operates on the basis that it was for group entities to develop procedures to identify and manage conflicts. Specifically, the last paragraph of the document states that individual entities must maintain a written statement as to how they manage conflicts arising in the course of their business.

157. Mr Addison in cross-examination sought to defend the January and October 2007 and February 2008 documents as appropriate written policies for the identification and management of conflicts, but ultimately he accepted that although deal tickets and investment committee proposals were documents used to a degree to identify conflicts and described how they were to be managed there was no comprehensive policy document drawing the various standards together. He accepted that the documentation could have been better.

158. The question as to how to manage conflicts that can arise where there are trades between funds managed by AFP seems to have first been specifically raised in an email that Mr Farrell sent to Mr Addison and others on 27 August 2008, where he referred to the need to have formal separation of roles.

159. On 2 September 2008 a document was produced headed "Review of Activist Positions and Related Conflicts of Interest". This document included details of three of the Four Transactions. Its information is historic, but is useful to an extent in describing the steps taken to manage the specific positions concerned but we observe that it is not produced pursuant to any comprehensive written procedure regarding the recording and review of conflicts.

160. On 15 September 2008 Mr Farrell and Mr Smith met with Mr Symington of Methuen to obtain advice regarding AFP's management of conflicts of interest in relation to situations where funds that AFP managed made investments where there was also an exposure taken by persons associated with AFP. There was some helpful advice in the note as to how steps could be taken to mitigate the conflicts of interest involved, particularly the need to ensure that investment decisions could be taken independently by portfolio managers without any real or perceived pressure to invest from Arch Management. Mr Symington also emphasised the need for potential conflicts to be formally documented and managed to ensure that they are appropriately handled.

161. In November 2008 Mr Alex Hartley joined AFP and took over from Mr Addison as compliance officer. Mr Hartley prepared a new compliance manual in January 2009. Our impression of this document is that it gave much more detailed and practical advice to investment managers which was more focused on AFP's specific activities than previous versions, and in relation to conflicts of interest, it gave specific examples of the type of conflict that could arise in the course of AFP's business. It specifically indicated that disclosure was not the primary tool to be used to manage conflicts and that a conflict could be so acute that AFP should decline to act.

162. A revised conflict management and confidentiality policy prepared by Mr Hartley was produced in February 2009. Whilst repeating some of the content of the August 2008 document, it goes into further detail about the actual organisational steps taken to manage conflicts including the Chinese Wall that by then AFP had put in place between its corporate finance and investment management businesses and its Guernsey and UK investment management businesses. There was also a description of specific conflict of interest situations that could arise because of the way AFP was structured and operated. There is also more detail as to how particular conflicts should be managed, emphasising that under MiFID disclosure is to be used as a last resort.

163. AFP rely on further approaches and documents beyond those specified above as an appropriate process for identifying and managing conflicts.

164. It is clear that the primary factor that AFP relied on throughout the Relevant Period to mitigate conflicts of interest was that there was a "community" of interests or "alignment" of interests between the UK Funds and the Guernsey Cells and between the Cells and AFP and its associates where there were co-investments with those entities.

165. As Mr Farrell said in his witness statement, AFP's fundamental view was that the ultimate interests of the UK Funds and the Guernsey Cells were aligned and any benefit to the Cells would be a benefit to the UK Funds and therefore a benefit to the ultimate investors in the UK Funds. That was AFP's starting point for its contention that it managed conflicts fairly. In his view therefore there was no actual conflict at all if the investment was appropriate and fair for the investor, because there is a clear alignment of interests with mutual potential benefit. Mr Addison agreed; his

philosophy was that at the outset the Guernsey Cells were a "natural extension" of the UK Funds. In other words, AFP approached the issue as if the UK Funds were investing directly in the underlying assets of the Guernsey Cells.

166. In our view this theory is inherently flawed. We have described above when considering the general principles set out by Mr Stanley how a fund manager may still be willing to take the risk of a long term disadvantage to a fund if there is a short term benefit for the conflicted party. Furthermore, a total alignment of interest between a UK Fund and a Guernsey Cell was only possible where at all times the Guernsey Cell was 100% owned by the UK Fund; as we have explained above when describing the structure, as the Cells were listed on the CISX they could always have external investors whose interests were different to those of the UK Funds and shares in some Guernsey Cells were placed directly with external investors. Mr Cook's evidence does in fact show that at all times during the Relevant Period a majority of the Guernsey Cells had some external investors and in a small minority external investors held more than 50% of the shares of the relevant Guernsey Cell. Furthermore, as we shall see later, some buying and selling of shares between some of the UK Funds took place to assist in the meeting of redemption requests and it does not appear that any regard was had to the fact that the underlying investors in each UK Fund would or could be different.

167. In addition, if the theory was that the UK Funds and Guernsey Cells could in effect be regarded as a single entity, then we observe that there was no effective independent scrutiny of the investment from the UK Funds' point of view. AFP had complete discretion to manage the UK Funds as the delegate of Capita who did not, as found in the Final Notice given to it by the Authority, effectively monitor the conflicts of interest arising between AFP and the UK Funds.

168. We examine the issue of alignment of interest in further detail when considering the Four Transactions.

169. Disclosure is a tool that AFP used, as we shall see, as a means of managing conflicts in relation to some of the Four Transactions. We accept Miss Carss-Frisk's submission that where disclosure is used as a tool there should be a clear record of the rationale for using it and the information provided to enable an informed consent to be given. None of the written policies we have examined prior to February 2009 gave any guidance as to when disclosure was an appropriate tool and how it should be documented.

170. AFP also placed some reliance on the fact that deal tickets (issued after a transaction had been approved) were expected to record relevant conflicts and that proposals made to the Investment Committee (ICPs) were expected to contain details of conflicts where appropriate. However, as Mr Derks' evidence demonstrates and as shown by some of the underlying documentation that we have seen, the relevant information was often missing from these documents. ICPs were also often prepared after the event; for example that for the Nice transaction. In those circumstances the ICP could not be regarded as an effective tool to enable the Investment Committee to identify and manage conflicts.

171. As Mr Stanley recognised in the principles he identified for managing conflicts a proper record of conflicts should be expected. The evidence shows that there were no specific procedures laid down for how a record was to be prepared and what should be contained in it and Mr Addison was often chasing portfolio managers for conflict notes well after the event. Their value diminishes in those circumstances. We have seen no evidence of a centralised system for recording conflicts, although aggregate records seemed to be prepared on an *ad hoc* basis and often well after the event: see for example the review of Activist Positions produced in 2 September 2008 and referred to in paragraph 159 above. Again, Mr Addison accepted in his evidence that AFP's record keeping in relation to its management of conflicts could have been better.

Conclusions

172. We can now come to our conclusion as to whether AFP failed to manage conflicts fairly in breach of Principle 8 and associated SYSC and COB Rules by failing adequately to identify and take appropriate steps to mitigate conflict of interest and failing adequately to document and record such conflicts that arose in its business and the steps it took to mitigate these conflicts.

173. As we have found in paragraphs 124 and 125 above, AFP had from very early on in its operations three main business strands which gave rise to inherent conflicts of interest that would require careful and structured management. Although AFP was a small firm at the outset which later grew rapidly, if a firm has such structural conflicts however small the firm is it needs to have well defined policies and procedures in place in order to manage conflicts fairly, rather than seek to do so informally. We accept Mr Stanley's submission that formal Chinese Walls were unrealistic at the outset, but that did not preclude separation of decision-making between those who were conflicted and those who were not.

174. Mr Farrell accepted in answer to questions from the Tribunal that no thought was given to whether the novel structure put in place for retail investors to gain exposure to private equity and other non-publicly traded investments, and in particular where some of those investments could involve conflicts between the interests of investors and AFP or persons associated with it, gave rise to a need to give careful consideration to the approach to be taken to conflicts of interest.

175. In our view it was necessary in the circumstances in which AFP found itself to give that careful consideration and develop policies and procedures to manage them in practice. As we stated in paragraph 130 above, it is difficult to meet the overarching requirements of Principle 8 without having established such policies and procedures.

176. We therefore do not believe that the introduction of the new provisions in SYSC 10 in November 2007 to implement MiFID should have represented a step change as far as a multi-functional firm such as AFP was concerned. The risks inherent in its business model clearly called for a structured approach before that time and in any event as we identified in paragraph 129 above, there were more general provisions relating to systems and controls which would have underpinned Principle 8 in any

event. There may have been more specific detail required in policies and procedures as a result of the implementation of MiFID, but we do not believe that for a well organised multi-functional firm the advent of MiFID called for a fundamentally different approach.

177. In our view when AFP established its multi-functional business model it should have brought into effect a comprehensive conflict management policy which in effect addressed all the issues identified by Mr Stanley in his exposition of the general principles that we discussed in paragraph 134 above.

178. Had AFP developed such an approach, it could have prepared a template to enable investment proposals that were put to the Investment Committee to have properly identified the nature of the conflict that had arisen, the potential disadvantage that the client may suffer as a result of the conflict and the seriousness of the conflict. In light of all of those factors the template would enable the decision-maker to identify the appropriate steps that should be taken to manage the conflict, namely how it was to be assessed, and approved internally, whether external review and assessment was necessary, the extent to which disclosure could be used appropriately and the steps that needed to be taken to ensure informed consent and, by way of conclusion in the light of all of those factors, whether it was appropriate to act in relation to the transaction in question. Finally, in order to demonstrate compliance an adequate record along the lines suggested by Mr Stanley would be kept of the decisions made in the light of the factors present which would be available in an easily accessible form to those having to deal with conflicts in the future as a useful precedent.

179. It is clear to us that until Mr Hartley prepared the compliance manual and revised conflicts of interest policy that we have referred to in paragraphs 161 and 162 above that AFP's approach was seriously inadequate.

180. AFP by its unstructured approach effectively sleepwalked into a situation where there was a serious risk that individual conflicts would not be managed fairly. This was not because of ignorance on the part of Mr Farrell and Mr Addison of the need to identify and manage conflicts. As we have found, both have long experience of working in multi-functional financial services firms and will understand that conflicts are endemic to the financial services industry; particularly in firms that carry out multiple functions. They simply did not give conflicts management the in-depth consideration that was necessary once the decision had been made to market the UK Funds to retail investors in the context of the novel structure using the Guernsey Cells. This is despite the recognition in AFP's SYSC report of May 2006 referred to in paragraph 142 above that the exposure to retail investors gave rise to reputational risk; no consideration was given to the risk of not managing conflicts adequately at the same time.

181. Matters went off on the wrong foot with the manner in which the Investment Committee operated from the outset. No consideration was given as to how investment decisions should be managed so as to minimise the inherent conflicts. In particular Mr Farrell's position as effectively chair of that committee and, as we have

found, a dominant member of the committee put him in an impossible situation where the committee considered investments in which he or Arch through its corporate finance business had a personal interest. As we shall see when we consider the AGL Transaction in more detail, Mr Farrell sourced the transaction, presented it to the Directors of the Guernsey Cells as a good investment (effectively wearing his AGL hat) when he had also led the investment committee that had approved it. There was no attempt to separate out decision making and ensure that those with an interest did not participate in the making of the decision. Nor, as is common in the fund management industry, was any experienced independent non-executive co-opted on to the Investment Committee or Board to assist in ensuring that conflicts were properly identified and dealt with fairly.

182. As we have also found, there was no structure in place before late 2008 to separate out investment decision-making between the Guernsey Cells and the UK Funds. We deal with this issue in further detail below in the context of the access to unpublished price sensitive information that was thereby afforded, but as we have observed, there was no separate consideration of the interests of the UK Funds when investment decisions were made, giving rise to the risk of the conflicts described in paragraph 125(2) to (4) above. Neither was consideration given as to developing a procedure to establish how investment opportunities might be fairly allocated across Sub-Funds or Guernsey Cells; we have been shown no evidence that discussions regularly took place on that issue when investment proposals were considered. The position might have been improved had Capita, as the ACD of the UK Funds, performed a meaningful role in practice in reviewing the investment decisions made by AFP in relation to the UK Funds, but AFP did not in practice seek to involve Capita and, as was found in the Final Notice, Capital failed to supervise AFP adequately.

183. The problem was further compounded because of the lack of a structured approach to the preparation of ICPs and deal tickets. As we have found, no template was developed initially as to what should be contained in an ICP to enable the Investment Committee to decide how to manage the conflict. Although subsequently some ICPs did contain sections on conflicts, they were not prepared to a consistent standard. Some ICPs were prepared after the event so could not be a useful tool in the investment decision-making process and the management of conflicts of interest. The same is true of deal tickets which could have been a useful tool to record conflicts if prepared to a consistent standard. As a result of these failings, no centralised system for recording conflicts to a consistent standard was put in place.

184. There appeared to be no consistent thinking on when the use of disclosure and informed consent would be used as a tool to manage a conflict. As we shall see when we examine the Four Transactions, in some cases consent was sought and others it was not. A comprehensive procedure to guide decision-makers as to the necessary ingredients of an informed consent and the circumstances in which it would be appropriate to use disclosure as a tool to manage conflicts should have been built into the process. AFP sought to downplay the role of informed consent by referring to the fact that the IMAs allowed them full discretion to proceed without consent so that when they did seek consent they were doing more than they were obliged to. That

approach is seen to be misconceived in the light of our finding that notwithstanding the contractual position, the regulatory position may call for a higher standard so that if the correct approach to manage the conflict was through disclosures and consent, it should have been pursued regardless of the contractual position.

5 185. It therefore appears that during the Relevant Period AFP relied heavily on its assumption that there was an alignment of interest between the Guernsey Cells and the UK Funds and between those entities and conflicted parties such as AFP and its associates when dealing with co-investment situations, and on its policy of independence.

10 186. As we observed in paragraphs 166 to 167 above, we regard that assumption as flawed. As far as the policy of independence is concerned, in our view undue reliance was placed on it. The passage we have quoted from AFP's 2006 Compliance Manual in paragraph 140 above shows that it was relied on in lieu of notifying clients of material interests which, for reasons that are not apparent to us, was stated in that 15 document as giving rise to practical difficulties, but we do not see the two approaches as being alternatives. A policy of independence on its own is inherently weak, and it is hard to see how the Investment Committee, structured and operated the way it was, could operate effectively on the basis that its decisions were taken in disregard of any conflict of interest that existed.

20 187. In any event, the ability to rely on a policy of independence was removed when COB Rule 7.1 ceased to have effect in November 2007 and is therefore not relevant to conflicts managed after that time.

188. Neither do we find that what were described by AFP, and Mr Addison in particular, as conflicts policies materially improved the position. As we have found, 25 none of the policies adopted in January 2007, October 2007 and February 2008 contained a comprehensive and practical guide to identifying, managing and recording conflicts as opposed to setting out high level standards. Consequently, as at 1 November 2007 when on any view a full written procedure dealing with such issues should have been in place, none was in existence and that position did not change 30 until early in 2009 following Mr Hartley's appointment as Compliance Officer. In particular by October 2007 as we found in paragraph 147 above, AFP had recently received specific advice on conflicts management from Methuen but none of this advice was reflected in the conflicts policy adopted shortly thereafter.

189. Our overall impression up to the point that the documents referred to in 35 paragraph 188 were circulated was that conflicts were managed and recorded on an *ad hoc* basis and decisions were not made and recorded within a tailored framework of systems and controls as required by the relevant regulatory provisions. AFP's approach to conflicts is encapsulated in the response it gave to Capita on the subject on 20 February 2009 as follows:

40 > "The original written Conflicts of Interest policy was put in place following implementation of MiFID in November 2007. Prior to this general conflict principles were followed as laid out in the Compliance Manual and a Conflicts and Insider policy note originally dated January 2007, Conflicts Notes were

made on an ongoing basis following referral to compliance and senior management. In cases of uncertainty external advice would be sought. Since the appointment of a dedicated Head of Compliance in November 2008, the Conflicts of Interest policy has been updated, and there is a continual process of review and improvement.

…

Senior management have taken on board the need to address conflicts of interest. The nature of Arch's business has become more complex over time, which has resulted in an increase in the number of potential conflicts. The Compliance Officer is working with senior management on an ongoing basis to ensure conflicts of interest are adequately monitored and mitigated. A full Conflict Management Review has been undertaken, with the result that we have fully revised the Conflict Management policy of the regulated entity Arch Financial Products and the wider Arch Group.

In terms of evidencing the management of these conflicts, a number of significant initiatives have been undertaken: 1) A clear demarcation/ separation is in place between the UK Open Ended and Guernsey Closed End fund personnel. This can be demonstrated by the physical separation of staff, separate investment committees, and separated fund management processes and systems. 2) When a potential conflict arises, front office personnel are required to record the potential conflict on the relevant deal ticket. 3) The Head of Compliance has also insisted that any potential conflicts of interest need to be reported to him as soon as they are known. 4) The Head of Compliance maintains a Conflicts Register. 5) The Corporate Department is located in a completely separate section to the Portfolio Management Department."

These passages reflect AFP's thinking that a formal conflict policy was not required at all until November 2007, which as we have found, was not the case in relation to a multi-functional business such as AFP. It captures the essential *ad hoc* approach to management that was taken.

190. We accept that conflicts management should evolve over time and not all possible conflict situations can be identified in advance. We are not suggesting that a conflicts policy covering all the situations that AFP faced during the Relevant Period could have been prepared at the outset but we do believe that a policy could have and should have been prepared that would have given practical guidance as to how to approach the conflicts arising in respect of the Four Transactions that we consider later, all of which were foreseeable from AFP's business model and the different activities it carried on. A much more robust framework could have and should have been developed at the outset and we see no reason why all of the measures that AFP identifies in the passages quoted above as having evolved over time could not have been in place to some degree from the beginning, or evolved over a much shorter timescale.

191. All AFP and Mr Addison in particular were prepared to admit to was that their documentation could have been better. Our analysis of the situation leads us to conclude that the malaise went much further than that. In our view AFP failed to

meet the requirements of Principle 8 and the associated SYSC and COB Rules by failing to have in place appropriate policies and procedures to manage conflicts fairly and to record them. This practice continued throughout the Relevant Period until February 2009.

Issue 2: Whether Mr Farrell and Mr Addison in breach of Statement of Principle 7 failed to take reasonable steps to ensure that AFP complied with the relevant standards required by Principle 8 and the associated SYSC and COB Rules.

192. We had no argument to the effect that if we found AFP to have failed to meet the requisite standard it was the case that either Mr Farrell or Mr Addison nevertheless complied with their personal obligations under Statement of Principle 7.

193. A corporate failing in itself does not mean that individuals will automatically be culpable. In a large firm it can be sometimes difficult to pin responsibility on individuals where a firm's decision-making processes are obtuse and responsibilities not clearly allocated.

194. There is no such difficulty in this case; although the management structure was flat there was no doubt that Mr Farrell had overall responsibility as CEO for AFP's systems and controls. He was fully aware of what processes were or were not in place and fully involved as issues were identified. He did not take the lead in ensuring that processes were put in place to manage the conflicts that were inherent in the business model that he had responsibility for establishing. We therefore find that Mr Farrell failed to comply with the provisions of Statement of Principle 7 in this respect.

195. We reach the same conclusion in relation to Mr Addison. As the member of AFP's senior management responsible for compliance he had responsibility, subject to Mr Farrell's supervision, to implement the necessary systems and controls so that AFP could meet its regulatory obligations with regard to the identification and management of conflicts. Mr Addison failed to appreciate what was required of AFP and consequently failed to meet the requisite standard. We therefore find that Mr Addison failed to comply with the provisions of Statement of Principle 7 in this respect.

Issues 3 and 4: Whether AFP failed in breach of Principle 1 to act with integrity in managing the conflicts arising in respect of the AGL Transaction, the Cru Transaction, the Lonscale Transaction and the Nice Transaction and whether Mr Farrell and Mr Addison so acted in breach of Statement of Principle 1

Introduction

196. This issue needs to be broken down into its constituent parts. We need to consider first, in relation to each transaction, whether in managing the particular conflicts arising in respect of the transaction AFP complied with the standards required by Principle 8 and the associated COB and SYSC Rules. Secondly, if we decide that those standards were not met, then we need to consider the level of culpability on the part of AFP: was it solely a case of them failing to take the

necessary steps with the degree of competence that would be expected or did its failings go further than that and amount to a failure to act with integrity in the manner in which the conflicts concerned were managed.

197. The Authority's case on this issue is based entirely on the acts and omissions of Mr Farrell and Mr Addison in relation to the Four Transactions and their close involvement in each transaction. It therefore follows that if we were to find that the relevant standards had not been met that would be because we had found that either Mr Farrell or Mr Addison or both of them had caused AFP to be in breach of the relevant regulatory provisions. In other words, the acts and omissions of the relevant individuals would be attributed to AFP because of the seniority of the individuals concerned and the level of their involvement.

198. We did not take Mr Stanley to dispute this analysis. It therefore follows that by determining the issue in relation to AFP in respect of each transaction we are also determining the issue in relation to Mr Farrell and Mr Addison. That would be so on the basis that they acted in breach of Statements of Principle 6 or 7 if AFP had failed to act with the requisite level of competence in managing the conflicts in question, or on the basis that either or both of them acted in breach of Statement of Principle 1 if we find that AFP acted without integrity in that regard.

Integrity

199. It is therefore necessary to identify the correct legal test to apply in determining whether the Applicants acted without integrity in managing the conflicts in question.

200. The question as to whether in particular circumstances a person has acted without integrity has been considered on many occasions in this Tribunal and its predecessors. The Tribunal has recently summarised the principles to be applied in *Batra v The Financial Conduct Authority* [2014] UKUT 0214 (TCC). We do not believe we can improve on this summary (as set out in paragraphs 13 to 15 of the Decision) so we quote it in full as follows:

> "13. The meaning of integrity was considered by the Tribunal in *Hoodless and Blackwell v FSA* (2003). The Tribunal observed at [19]:
>
> > "In our view "integrity" connotes moral soundness, rectitude and steady adherence to an ethical code. A person lacks integrity if unable to appreciate the distinction between what is honest or dishonest by ordinary standards. (This presupposes, of course, circumstances where ordinary standards are clear. Where there are genuinely grey areas, a finding of lack of integrity would not be appropriate.)"
>
> 14. While the passage quoted above is useful guidance as to the meaning of the concept, the second sentence is clearly not the only circumstance in which a person can be said to lack integrity. In the subsequent cases of *Vukelic v FSA* (2009) at [23] and *Atlantic Law LLP and Greystoke v FSA* [2010] UKUT B30 (TCC) at [96], the Tribunal has cautioned against attempting to formulate a comprehensive definition of integrity. As the Tribunal in *Vukelic* observed, integrity

> remains a concept "elusive to define in a vacuum but still readily recognisable by those with specialist knowledge and/or experience in a particular market."
>
> 15. The Tribunal in *First Financial Advisors Limited v FSA* [2012] UKUT B16 (TCC) agreed with the observation in *Vukelic* and endorsed the guidance in *Hoodless* and *Atlantic Law*. At [119], the Tribunal observed:
>
> > "Even though a person might not have been dishonest, if they either lack an ethical compass, or their ethical compass to a material extent points them in the wrong direction, that person will lack integrity."
>
> We agree. A lack of integrity does not necessarily equate to dishonesty. While a person who acts dishonestly is obviously also acting without integrity, a person may lack integrity without being dishonest. One example of a lack of integrity not involving dishonesty is recklessness as to the truth of statements made to others who will or may rely on them or wilful disregard of information contradicting the truth of such statements. Such behaviour was found to be evidence of a lack of integrity by the Tribunal in *Vukelic* at [119]:
>
> > "It may be that Mr Vukelic was not dishonest on this transaction in the sense of deliberately participating in a scheme to deceive and we are prepared to accept that he was not. But he turned a blind eye to what was obvious and failed to follow up obviously suspicious signs. We do not believe that an educated professional in a senior position could have been oblivious to the signs that the transaction depended on concealment for its success. It is possible, but unlikely, that Mr Vukelic simply failed to spot what should have been obvious to a person in his position. But if that had been so it would have resulted from an inexcusable failure to ask obvious questions."

201. It is clear from the above passages that acting recklessly is one example of acting without integrity. The passage from Vukelic referred to above indicates that a person acts recklessly when he turns a blind eye to what was obvious to a person in his position.

202. In our view such a formulation results from no more than an application of the authoritative formulation of the concept of recklessness by Lord Bingham of Cornhill at page 1057 of the opinion of the House of Lords in *R v G* [2004] AC 1034 where he stated that a person acts recklessly when he acts with respect to (i) a circumstance when he is aware of a risk that exists or will exist and (ii) a result when he is aware of a risk that it will occur; and it is in the circumstances known to him, unreasonable to take the risk. This formulation was recently adopted by this Tribunal in *Amir Khan v The Financial Conduct Authority* FS 2013/002 (January 2014).

203. The Authority in this case relies on reckless behaviour on the part of Mr Farrell and Mr Addison as making out its case that they, and consequently AFP, acted without integrity in relation to each of the Four Transactions. The Authority contends

that each of the Applicants was reckless as to the risk that the conflicts of interest concerned would not be managed fairly. In order to establish that, the Authority contends, what must be established is that the Applicants (i) were subjectively aware (that is within their own knowledge) of a risk that conflicts of interest would not be managed fairly and (ii) that it was objectively unreasonable for them to take the risk (by proceeding with the transactions without taking further steps to mitigate the risk) in the circumstances known to them. In Miss Carss-Frisk's submission it is sufficient that the Tribunal is satisfied that the risk concerned was a real risk, that is a material and not *de minimis* risk: having identified (subjectively) a material risk that a conflict may not be managed fairly by the mitigation measure already in place, when (objectively) it would be unreasonable not to take further measures to mitigate the risk.

204. It is clear from this formulation that Miss Carss-Frisk does not apply an objective test to the nature of the risk other than to accept that the risk must be a material risk. On her formulation once the person concerned is aware of a material risk it follows that it is unreasonable for that risk to be taken without further mitigating steps.

205. Mr Stanley interprets Lord Bingham's formulation differently. He points out that the facts on which the case was based were that two children made a small bonfire in some premises not thinking it would be a problem to leave the fire without putting it out whereas in fact the fire caused serious damage to the premises. In the case there was no argument about the risk the children took being an unreasonable risk; in objective terms it was clearly inappropriate. The question was whether they were aware of the risk in question.

206. Mr Stanley therefore submits that before applying the subjective knowledge of the person concerned regarding the risk in question, it is first necessary to establish whether the risk was an unreasonable one to take. In order to establish the test of unreasonableness, he refers to paragraph 32 of Lord Bingham's speech where he sets out what he regarded as the policy behind the concept of "recklessness" as used in the Criminal Damage Act 1971. Lord Bingham stated:

> "The most obviously culpable state of mind is no doubt an intention to cause the injurious result, but knowing disregard of an appreciated and unacceptable risk of causing an injurious result or a deliberate closing of the mind to such risk would be readily accepted as culpable also. It is clearly blameworthy to take an obvious and significant risk of causing injury to another. But it is not clearly blameworthy to do something involving a risk of injury to another if … one genuinely does not perceive the risk."

207. Lord Bingham here was clearly conflating the two elements of the test he subsequently set out definitively in paragraph 41 of his speech as quoted above when he refers to the policy being to impose liability where there is a "knowing disregard of an appreciated and unacceptable risk". Whether the person had a "knowing disregard" and "appreciated" the risk reflects the subjective element and whether the risk was "unacceptable" reflects the objective element.

208. Mr Stanley draws support for his analysis of this paragraph from the decision of the Competition Appeal Tribunal in *Travel Group Plc v Cardiff City Transport Services Limited* [2012] CAT 19. Although that case was considering the question of what level of culpability is required in order to justify an award of exemplary damages, the Tribunal referred to the fact that the minimum threshold was reckless behaviour: see paragraph 477 of the decision. The Tribunal then referred in paragraph 483 of the decision to the fact that many business decisions will be taken in the knowledge that there is a risk that the company's actions will be found to breach competition rules. It then in paragraph 486 of its decision referred to Lord Bingham's passage at paragraph 32 of his speech in *R v G* and stated:

> "It is only where a risk is "unacceptable" but is nevertheless consciously disregarded that conduct becomes "reckless". The conscious disregard of an acceptable risk is not recklessness."

209. Miss Carss-Frisk is critical of the Competition Tribunal's reliance on paragraph 32 of Lord Bingham's opinion rather than paragraph 41 where he sets out the definitive test. In her submission Lord Bingham was merely setting out examples of what amounted to reckless behaviour, and he was careful not to say that the risk concerned had to be of any particular magnitude. Nevertheless, perhaps inconsistently with that submission, she accepted that it had to be a real or material risk.

210. We reject Miss Carss-Frisk's submissions on this point. She herself recognises that Lord Bingham's words when looked at in a practical fashion have to be qualified to some degree. We accept that, but in our view Lord Bingham has clearly set out in paragraph 32 of his speech what level of risk was unreasonable to take; his answer was that it was an "unacceptable" risk. The objective limb of his formulation in paragraph 41 of his speech is to be tested by reference to whether the person concerned is aware of an unacceptable risk and nevertheless chooses to take it. Whether the risk is unacceptable is of course to be assessed objectively, but the starting position is that what a reasonable person in the position of the person concerned would regard as an acceptable risk is not reckless. We therefore agree with the reasoning of the Competition Appeal Tribunal in paragraph 486 of its decision.

211. In our view this approach is consistent with the Tribunal's approach to the question of integrity generally; as we have observed recklessness is only one example of a lack of integrity and just as Lord Bingham was interpreting the concept of recklessness in the context of statutory definition we should look at his words in the context of the concept of integrity as developed in this Tribunal. In a regulatory context, the concept of lacking integrity embraces only behaviour of a serious nature which demonstrates the lack of an ethical compass, and where as stated in *Hoodless v Blackwell* there are genuinely grey areas there is no place for a finding of a lack of integrity. A finding of a lack of integrity cannot be made in a situation where there has been a conscious decision to take an acceptable risk.

212. Consequently, and following the approach taken in *Vukelic*, in our view the correct approach to take in relation to each Applicants' behaviour in respect of the

Four Transactions is to consider whether he was aware that there was an unacceptable risk that the conflict in question would not be managed fairly if he failed to take further steps to mitigate it, that risk being one that would have been obvious to a person in his position and having his level of experience. If those conditions are satisfied then in our view it will lead to a finding of acting without integrity.

213. It is against that legal background we turn to consider the Four Transactions, taking each in turn.

The AGL Transaction

214. In brief, as one of the first investments that AFP made on behalf of the Guernsey Cells, three Guernsey Cells made debt and equity investments of £1.17 million in AGL, AFP's parent company and at the time the ultimate holding company for the Arch Group. The valuation of the shares acquired was carried out by Mr Farrell and not verified independently. Shortly after the initial equity and debt investment, the Guernsey Cells purchased further shares in AGL from Mr Farrell personally for £500,121 at the same price per share as they subscribed on the initial investment.

215. We set out in Part 1 of Appendix 2 details of the chronology of this transaction, and the steps taken to implement and record it. This Appendix does not deal with the material facts in dispute, which we address below.

216. As we have recorded above, Mr Farrell owned between 83% and 95% of the share capital of AFP's holding company throughout the Relevant Period until January 2009 when he transferred one half of his holding to his wife. Consequently, he controlled both AGL and AFP. AGL was the ultimate holding company at the time of the AGL Transaction.

217. It was common ground that this transaction created a conflict. It involved a direct conflict of interest between AFP and its associates (AGL and Mr Farrell) and the Guernsey Cells as the Guernsey Cells were to be counterparties to transactions in which associates of their investment manager were interested. There was a clear risk of disadvantage to the Guernsey Cells in that both AGL and Mr Farrell had an interest in maximising the price they receive for their shares whereas the Guernsey Cells have an interest in making its investment at the lowest possible price. There was therefore a clear risk, as Mr Stanley accepted, that the Guernsey Cells might enter into a transaction that was not in their interest, or on terms which were less favourable to them than would have been achieved in an arm's length transaction.

218. The conflict is heightened by the fact that, as is clear from the declared purpose of the fund raising exercise being to assist in AGL's expansion plans, the Guernsey Cells were being asked to fund AGL's infrastructure. No information was available as to whether other traditional sources of funding such as bank lending had been considered, and if they had, why they had not been progressed or made available. One concern is that it would have been possible to have obtained finance on commercial terms from third party lenders or financial institutions on terms commensurate with

AGL's then financial position and prospects, but those terms were more expensive than those provided by the Guernsey Cells. In our view in the absence of independent scrutiny there is the risk that the Guernsey Cells would be regarded as a readily available source of finance on terms that had the risk of being advantageous to AGL and Mr Farrell but disadvantageous to the Guernsey Cells and their investors. A more serious concern is that other sources of funding had been sought and not made available on reasonable terms so that the Guernsey Cells were in effect a lender of last resort.

219. The conflict in relation to Mr Farrell is even more acute. With a subscription for new shares, in what is effectively still a start up business in February 2007, the benefit of the Guernsey Cells' subscription monies go to funding directly the development of AGL, whereas on a sale of existing shares by Mr Farrell AGL receives no direct benefit while the Chief Executive receives a significant personal benefit. Therefore, from the Guernsey Cells' perspective a subscription for new shares is preferable to an acquisition of existing shares as it increases the capital available to AGL.

220. In our view therefore these are very serious conflicts which under the regulatory standards prevailing at the time required rigorous challenge and robust management so as to ensure the Guernsey Cells, and as a consequence, the UK Funds were not disadvantaged.

221. Mr Stanley sought to downplay the seriousness of the conflict on the following basis:

(1) The transaction was relatively small;

(2) The incentive for AFP to disadvantage the Guernsey Cells was relatively weak;

(3) There was no suggestion that AGL was desperate for money or that the Guernsey Cells were the only possible source of it, nor any evidence that Mr Farrell was anxious to sell AGL shares; and

(4) The transaction was simple and routine, involving as it did a straightforward valuation.

222. We reject all of those submissions. We do not think that the seriousness of a conflict is diminished simply because of its relative size, unless the investment is insignificant. In this case, the evidence from the Investment Committee minutes shows the Guernsey Cells had raised approximately $100 million at the time the investment was approved. The investment was therefore not insignificant in the context of the available assets for investment at that time. As we have indicated, in our discussion of management of conflicts generally, we do not accept that the incentive to disadvantage a client will necessarily be weak and do not see this as a significant mitigating factor. As regards the financial position of AGL and Mr Farrell and other sources of finance, we have seen no evidence either way on this so cannot see this as a positive factor. If anything the lack of evidence, bearing in mind what we said about the risk of the Guernsey Cells being a lender of last resort or a lender on uncommercial terms, might be seen as a negative rather than purely neutral factor. Mr

Stanley's submissions also do not address the issue as to whether the allocation of the investment across the three Guernsey Cells properly took account of the risk profile of each individual Guernsey Cell. Finally, we do not believe that any transaction of this nature involving a direct conflict between an investment manager's client and the manager's associates, one of which is the Chief Executive and controlling shareholder, in relation to a private rather than publicly traded investment could ever be regarded as routine and not creating a serious conflict of interest.

223. If the transaction had been at arm's length it would be expected that the documentation would have been much more complex. We observe the lack of a formal subscription agreement containing detailed warranties and indemnities common in transactions of this type or any kind of due diligence process carried out by independent professionals.

224. It is against that background that we need to measure the quality of the conflict management process that AFP undertook.

225. Such management of the conflict that occurred took place against AFP's underlying philosophy that "self-investment" was an acceptable form of investment, subject to proper consideration. AFP believed, as Mr Farrell stated in his witness statement, that provided the investment is appropriate and fair for the investor then there is a clear alignment of interests with mutual potential benefit and therefore not an actual conflict of interest. Mr Farrell justified this by reference to the fact that other fund managers had self-invested, often on much higher multiples of earnings than was the case in relation to the AGL Transaction.

226. AFP contended that despite the fact that Mr Farrell had prepared the valuation on which the price for the AGL shares was based, there was no need for an independent valuation, contrary to the Authority's strong contentions. In Mr Farrell's view, as the valuation was compiled in accordance with recognised guidelines from the British Venture Capital Association ("BVCA"), and private firms do not typically instruct external independent valuers when they are dealing in shares in their companies, especially if they are high growth companies. His view was that instead there would be a price setting by the firm and price negotiation.

227. We observe that the BVCA guidelines that we were shown give the valuer a large degree of flexibility when calculating the earnings of a firm to be used as the basis of the valuation and the appropriate multiples to be used. There is a fair degree of discretion given to the valuer in this regard. Indeed, as shown in the details of the transaction set out in Part 1 of Appendix 2 to this decision, the multiplier was changed from a multiple of 12.5 on forecast gross earnings to one of 9.3, albeit on a higher forecast (in Mr Farrell's view so as to give rise to a more conservative valuation). Mr Addison was challenged regarding an email that he sent to Mr Bullerwell of Nice Group in September 2007 in which he stated that in AFP's experience of running private equity funds small to mid cap firms (such as AGL itself) sell for approximately 7 to 8 times earnings. Mr Addison was pressed to accept that as a more realistic multiplier for AGL but Mr Addison accepted, rightly in our view, that there are a variety of approaches under the BVCA guidelines that can be taken to the

valuation of private equity investments. We should also emphasise that the Authority has not pleaded that the valuation of AGL (or of any of the other investments which were the subject of the Four Transactions) was in fact unrealistic or inappropriate and accordingly we express no view on whether that was the case.

228. In the light of the variety of approaches that could have been taken to valuation, in our view there is an unacceptable risk that the conflict in respect of the AGL Transaction was not being managed fairly if the valuation relied upon was one prepared by the firm itself, particularly where the individual who prepared the valuation has a strong personal interest as the controlling shareholder. That in our view takes the transaction concerned out of the routine situation, which we accept is the case in relation to private equity investments, that independent valuations are not prepared. In these circumstances the fact that other investment managers self-invested on the basis of much higher multiples is of no comfort.

229. Moreover, the absence of an independent valuation is tempered in the usual situation that applies when private equity investments are made. This is because the terms of the transaction, including its price, are negotiated on an arm's length basis, following the preparation of a valuation by the firm using, for example, the BVCA guidelines.

230. Consequently, the absence of an independent valuation may not be material if it can be demonstrated that other steps were taken to protect the investors' interests, such as an arm's length negotiation between AGL and appropriate persons representing the Guernsey Cells and UK Funds' interests and a fully informed consent to the terms of the transaction by such persons.

231. In that context, the only persons involved in the decision making process which led to the investment in AGL by the Guernsey Cells and were independent of AFP were Mr Meader and Mr Radford. It is therefore necessary to examine in some detail the role that they assumed in relation to the transaction and the information that was available to them.

232. We only have limited information regarding Mr Meader and Mr Radford's experience and expertise with regard to the valuation of private equity investments. Their brief biographies that are to be found in the ICC's Scheme Particulars (or prospectus) published in January 2007 suggest that their expertise lies in fund administration and does not suggest any specialist expertise beyond that. Mr Farrell, in answer to questions from the Tribunal, stated that Bordeaux were chosen because of their experience as administrators and that Mr Meader and Mr Radford were regarded as highly experienced "professional directors". There was no suggestion that Bordeaux, or Mr Meader and Mr Radford in particular, had any significant experience in structuring or negotiating private equity investments such as the investment in AGL, although we accept that as administrators dealing with private equity investments they may well have been aware of the terms on which such investments were commonly structured.

233. The inference we draw from these facts is that the reason that Mr Meader and Mr Radford were chosen as directors was because of the need for the ICC and the Guernsey Cells to have directors who were experienced as acting as directors of Guernsey companies through their roles as administrators (hence Mr Farrell's reference to them as being "professional directors") and they were not expected to perform any in depth role in assessing the quality of investments made by the funds they administered or the terms on which they were acquired.

234. This limitation in their roles is consistent with what Mr Meader and Mr Radford stated in their defence in the Guernsey Proceedings, which was that in approving the transaction they focused on the information that was provided to them in the business plan and in particular whether the price was conservative compared to comparable investments.

235. Mr Meader and Mr Radford's review was therefore at a very high level, which was necessarily the case considering that they were only alerted to the transaction a few days before it was entered into and the documents they reviewed (notably the business plan) were only provided to them at the meeting on 15 February 2007 during which the consent to the transaction was given.

236. Furthermore, in no sense could the role that Mr Meader and Mr Radford performed be considered as negotiating on behalf of the Guernsey Cells as regards the terms of the investment. Mr Farrell accepted this in his evidence, but stated that it was open to Mr Meader and Mr Radford to have sought to negotiate the price but they chose not to. He suggested that the price was negotiated between AGL and the fund managers representing the Guernsey Cells and then approved by the Guernsey Directors. In our view none of that process resulted in an arm's length negotiation that could plausibly be regarded as a substitute for an independent valuation. Bearing in mind Mr Farrell's position as majority shareholder of AGL a negotiation between himself and the fund managers could not in any sense be regarded as being at arm's length or independent. We find that Mr Farrell knew, bearing in mind the roles that Bordeaux and Mr Meader and Mr Radford had been employed to perform, that they would not have been expected to negotiate the terms of investments to be made by the Guernsey Cells. We therefore reject Mr Farrell's evidence on that point.

237. Aside from the limited nature of the review that Mr Meader and Mr Radford undertook in relation to the transaction, in our view the consent given at the meeting on 15 February 2007 was not fully informed. As described in paragraph 10 of Part 1 of Appendix 2, a further valuation was prepared which resulted in a higher price being paid than was envisaged in the business plan presented to the Guernsey Directors. Mr Farrell justified the increased price because of the update in AFP's earnings figures and that the price paid was still calculated on the same basis as the valuation indicated in the business plan presented to the Guernsey Directors.

238. It would normally be expected that once a price had been agreed for a transaction of this type, the transaction would be effected on those terms, regardless of any subsequent change in the earnings on which the price was based, unless it was made specifically clear that the price would be revised once new earnings figures

became available. A particular date for the calculation of the relevant earnings would be chosen and it would be unusual to change that date after the price had been agreed. Mr Meader and Mr Radford would have been entitled to assume that the earnings figures used for the calculation set out in the business plan that they saw would be used to calculate the price and that if there was any change to the figure to be used then they would be informed so they could consider whether the fact that an increased price was to be paid affected their decision to approve the transaction. In the absence of any disclosure of the updated figures and the fact that they were to be used as the basis of the price calculation, the Guernsey Directors' consent cannot be regarded as having been fully informed.

239. Having considered the process for the Guernsey Cells' subscription for new AGL shares, we turn now to the position regarding Mr Farrell's sale of his own shares to the Guernsey Cells. There are two matters on which we need to make findings of fact in this context. First, as to what led to Mr Farrell selling his own shares to the Guernsey Cells and secondly as to whether Mr Meader and Mr Radford were aware of the sale and gave their consent to it.

240. With regard to the first issue, the business plan given to Mr Meader and Mr Radford in February 2007 disclosed that AGL was seeking to raise £1.5 million through the issue of loan notes and new shares and the Guernsey Directors' consent to the transaction was given on this basis. A further business plan summary prepared in March 2007 stated that the amount sought for AGL by way of capital raising was £1.6 million.

241. However, on 28 February 2007, when resolving to allot the new shares in AGL that were subscribed by the Guernsey Cells, AGL also resolved to approve a transfer of 5,166 existing shares from Mr Farrell to the Guernsey Cells for a consideration of £500,121. It therefore appears that by this time the original plan as presented to the Guernsey Directors, that the Guernsey Cells would acquire an investment valued at approximately £1.5 million through subscription of new shares and the commitment to a revolving note facility, had been modified. The end result was a total commitment of approximately £1.67 million, comprised of a revolving discounted note facility of £0.66 million, a share subscription of £0.5 million and a purchase of existing shares of a similar amount, Thus the Guernsey Cells had a greater exposure to equity capital than was presented to the Guernsey Directors. The transfer of Mr Farrell's shares was completed on 15 March 2007.

242. Neither Mr Farrell nor Mr Addison was able to explain how this change came about when a document had been prepared in March 2007 indicating that AGL's funding needs were for £1.6 million. Mr Farrell simply stated that AGL did not require any further funding at this stage, but that was clearly inconsistent with the March 2007 document and Mr Addison merely reiterated that AGL did not require any further funding. The note prepared by Mr Farrell recording the conflict indicates that AGL did not wish to issue more shares than those subscribed and that Mr Farrell was prepared to make up the difference through the sale of some of his shares. Mr Farrell contended that the portfolio managers were keen to invest up to £1.6 million in

AGL and the initiative came from them that Mr Farrell make available some of his existing shares.

243. We find that explanation unlikely. In our view it was more likely than not that the impetus for the Guernsey Cells' investment in AGL came from Mr Farrell, driven by him in his capacity as Chairman of AGL and CEO of AFP in order to meet its funding requirements. In that capacity we find that he brought the proposal to the Investment Committee which subsequently approved it with him in the chair. This is consistent with Mr Farrell's explanation in his oral evidence that he presented the proposal to the Guernsey Directors on behalf of AGL; none of the portfolio managers were involved in explaining the merits of the transaction from their perspective as investment managers of the Guernsey Cells. There is no evidence of any discussion between Mr Farrell and the portfolio managers along the lines that AGL indicated that its funding needs were complete with a capital raising of £1.1 million and the portfolio managers then pressed for an investment of £1.6 million whereupon Mr Farrell agreed to sell some of his shares. In our view it is more likely than not that the proposal to sell his shares, like the proposal to make the subscription, was initiated by Mr Farrell himself. In the light of the Guernsey Cells' appetite for an investment of £1.6 million in AGL there was an opportunity for Mr Farrell to realise his investment, resulting in a gain of just under £500,000 and Mr Farrell decided to take advantage of that opportunity by proposing the sale himself, some time during February 2007.

244. With regard to the second issue, it is common ground that the Guernsey Directors were not told of the possibility that Mr Farrell would sell some of his shares to the Guernsey Cells at the meeting on 15 February 2007.

245. Mr Farrell and Mr Addison both gave evidence to the effect that a phone call took place after 15 February 2007 between Mr Addison and Mr Meader during which the proposed sale was disclosed. Mr Addison's evidence was that the call was made sometime between 15 February and 15 March 2007, probably in the latter half of that period. However, he was unable to recall any details of the conversation other than to say that he told Mr Meader that Mr Farrell was going to sell some of his shares to the Guernsey Cells. He could not recall explaining to Mr Meader the rationale for the change of position from that presented on 15 February, but he said that Mr Meader indicated his acceptance of the proposal. Mr Addison made no note of the conversation and there is no evidence that it was minuted in any fashion by Mr Meader on behalf of the Guernsey Cells.

246. Mr Farrell had no direct knowledge as to whether the call between Mr Addison and Mr Meader took place and if so, when. In his witness statement he said that he "believed Mr Addison told [the Guernsey Directors]". In his oral evidence he said this belief came from a conversation with Mr Addison but he could not remember when that conversation took place, and in particular whether it took place around the time of the alleged conversation between Mr Addison and Mr Meader. This explanation differs from previous accounts given to the Authority. In its response to the Authority's Preliminary Investigation Report (PIR), which Mr Addison confirmed he had been involved in producing, AFP stated that Mr Farrell had disclosed the transaction to the Guernsey Directors, without being specific as to the form of that

disclosure, other than to say that it was evidenced when the stock transfer forms transferring the shares were presented to Bordeaux in its capacity as administrator so as to register the Guernsey Cells' ownership and enable the relevant stamp duty to be paid. Furthermore, in his oral representations to the RDC on his Warning Notice, Mr Farrell is recorded as making a response to Mr Radford's statement that he was unaware of the sale of shares by Mr Farrell. Mr Farrell stated that the Guernsey Directors would have been aware from "certain emails and information that was created at the time".

247. Mr Addison's oral evidence was that the reference in the response to the PIR to Mr Farrell making the disclosure was a mistake; AFP had been under tremendous pressure to complete its response to the PIR within 28 days of receiving it and the Authority refused to allow an extension of time for the response so it was inevitable that some mistakes would be made. In relation to the RDC proceedings, Mr Addison said he did not correct Mr Farrell's statement, there being limited time in these proceedings to get the key points across. Mr Farrell was feeling ill during the RDC proceedings (having missed the first day of the RDC meeting) and he made his comment without knowing how Mr Addison had communicated the fact of the transaction to the Guernsey Directors.

248. The alleged conversation with Mr Meader was not referred to anywhere in the note for the Investment Committee prepared in 21 March 2007, which as we shall see, is relied on by the Applicants as a record of the steps taken to manage the conflicts arising in respect of the AGL transaction. This document was prepared by Mr Farrell with Mr Addison's assistance. Mr Addison expressed regret that the conversation was not recorded in the note, Mr Farrell suggested he might not have been aware of the conversation at the time he wrote the note.

249. Finally, neither Mr Meader nor Mr Radford in their witness statements recall the conversation with Mr Addison; Mr Meader states that although he recalls the investment in AGL and giving consent to it he does not recall whether it was mentioned from whom the shares were to be acquired. He makes no reference to any phone call with Mr Addison after the meeting on 15 February 2007. Mr Radford states that he was not aware that the Guernsey Cells were purchasing shares from Mr Farrell.

250. As we have previously indicated, we place little weight on Mr Meader's and Mr Radford's evidence as they were not available for cross-examination. Bearing in mind the Guernsey Proceedings are ongoing, their answer that they were unaware of the sale by Mr Farrell may be said to be self-serving.

251. Nevertheless, in our view the weight of the evidence leads us to conclude that the alleged conversation did not take place and the consent of the Guernsey Directors for the sale of Mr Farrell's shares was not given prior to the transaction occurring. The following facts lead us to that conclusion:

(1) We think it unlikely that if such a conversation took place that Mr Addison would not have made a record of it. We cannot accept that he

would have regarded the change to the position represented to the Guernsey Directors on 15 February 2007 as being not materially different to the position already approved so that recording it was unnecessary. If that was his view, it would have been unlikely that he thought it was necessary to make the call in the first place.

(2) Even if the recording of the conversation shortly after it took place was an oversight, we think it unlikely that there would have been a further oversight in failing to ensure that the record of the conflict arising out of the AGL Transaction made on 21 March 2007 mentioned it. On Mr Addison's evidence, the conversation had taken place by the time that note was prepared.

(3) Bearing in mind the importance of the conversation, despite the time pressures of preparing the PIR response and the stress of the RDC meeting, we think it is unlikely that its existence had been overlooked both when preparing the PIR response and when preparing for the RDC meeting, and we think it more likely than not that if the conversation had taken place then Mr Addison would have corrected Mr Farrell's account when he gave it to the RDC.

252. In conclusion, there were too many missed opportunities to record the correct position to reach a conclusion that there was a repeated oversight to mention the conversation when the opportunity presented itself. We think that it is inherently unlikely that if the conversation did take place, bearing in mind its importance, that it would not have been mentioned or recorded at some stage prior to these proceedings. We therefore reject the evidence of Mr Addison and Mr Farrell on this issue and find it to be untruthful.

253. We now turn to the question as to the adequacy of the record made by AFP of the conflict and the measures taken to manage it.

254. AFP relies on two documents in that regard. Both these documents were prepared by Mr Farrell with Mr Addison's assistance. First, it relies on the "Note for the Investment Committee and Senior Management", completed in March 2007. This note records the following steps taken with regard to conflicts:

(1) The structure of the transaction was in the best interests of the clients concerned and the investment was of an appropriate size;

(2) Senior Management were consulted and approved the transaction;

(3) The approval of the Guernsey Directors to the transaction following presentation of the detailed business plan with cash flow projections and SWOT analysis, it being noted that the Guernsey Directors were principally concerned with whether "the investment would prove worthwhile for the funds and raised no objections to the investment or its rationale";

(4) Mr Farrell sold his shares on the same terms as the new shares issued; and

(5) The £17.4 million valuation was conservative and the earnings multiplier used was very favourable to the Guernsey Cells when compared to the basis on which the shares of listed funds managers were currently trading.

255. Secondly, it relied on the note of 2 September 2008 headed "Review of Activist Positions and related Conflicts of Interest". This note records little specific information regarding the AGL Transaction other than to record that the conflict was managed by being disclosed to the Guernsey Directors and to the "external Arch Cru Investment Committee". No mention was made of the fact that the transaction involved a purchase of shares from Mr Farrell. Under a heading entitled "Experience to date ("proof of the pudding")" it was recorded that the investment had performed very well.

256. In our view these documents, either separately or taken together, cannot be regarded as an adequate record of the conflicts of interest arising out of the AGL Transaction and the steps taken to mitigate them. By reference to the matters suggested by Mr Stanley to be included in a properly drafted conflicts record (as set out in paragraph 134(11) above) the notes failed to deal with the decision making process for the transaction, any specific detailed analysis of the conflict and the significance of the risks associated and the key mitigating factors, or whether independent advice had been received. Neither did the documents disclose that Mr Farrell had been responsible for the valuation and consequently the setting of the price to be paid for the shares. As discussed above, the notes failed to deal with the question of the disclosure to the Guernsey Directors of the fact that Mr Farrell was selling his shares (on the basis of our findings that no such disclosure was made and that fact should have been recorded).

257. We can therefore set out our conclusions on whether the steps taken to manage and record the conflicts arising in respect of the AGL transaction were adequate as follows:

(1) The decision making process was seriously flawed. Mr Farrell participated as chairman of the Investment Committee and was its most influential member in the decision to make the investment, notwithstanding his personal interest in the transaction and the fact that he brought the investment proposal to the Committee on behalf of AGL. This was clearly contrary to the provisions of AFP's compliance manual, as referred to in paragraph 140 above. He later presented the merits of the investment to the Guernsey Directors, representing AGL, and there was no-one to represent the views of the portfolio managers on the merits of the transaction for the Guernsey Cells;

(2) There was no separate scrutiny of the transaction from the perspective of the UK Funds;

(3) There was no detailed and formal proposal document presented to the Investment Committee setting out the conflict, why it amounted to a conflict, and its seriousness and how it was to be managed;

(4) There was no independent valuation of the investment. Whilst we accept that such a process is not usual in respect of private equity investments, we regard it as essential where the circumstances are such that the valuation is prepared by someone who has as serious a conflict as is possible in relation to the transaction, namely that he has fixed the price at which those to whom his firm owes a fiduciary duty are to acquire shares from him personally, unless there has been a robust negotiation on behalf of those investors, which we have found, did not take place in this instance;

(5) The limited roles assumed by Mr Meader and Mr Radford in their capacity as Guernsey Directors and the fact that they were given very little time to assess the investment and develop and ask probing questions about the terms of the investment and the price to be paid for the shares meant that their consent could not be considered as fully informed. In addition, they were not informed of the upward revision in the valuation and the consequent increase in the price paid for the shares, the increase of the amount of equity acquired and, as we have found, of the fact that some of the shares to be acquired were to be sold by Mr Farrell;

(6) These serious deficiencies were not outweighed by AFP's arguments that the price paid was favourable and that there was an alignment of interest between AFP and the Guernsey Cells in the success of the investment. There was a serious risk in the circumstances that the Guernsey Cells overpaid for the investment, whether or not that turned out actually to be the case; and

(7) The recording of the conflicts and manner in which the conflicts were managed were both seriously inadequate.

258. We therefore conclude that the manner in which AFP managed this conflict was in breach of Principle 8 and the associated COB and SYSC Rules. We now turn to consider whether AFP acted without integrity in respect of its conduct in that regard.

259. As we analysed in paragraph 197 and 198 above, if we were to find that Mr Farrell and Mr Addison failed to act with integrity in relation to the steps they took in managing the conflicts arising in respect of the AGL Transaction, then it follows that AFP also failed to act with integrity in that regard.

260. We have identified in paragraph 212 above that the correct approach to take in determining this issue is to consider whether Mr Farrell and Mr Addison were aware that there was an unacceptable risk that the conflicts arising in respect of the AGL Transaction would not be managed fairly if they failed to take further steps to mitigate it, that risk being obvious to someone in their position and having their level of experience.

261. We have found that the conflicts arising in this case between the interests of the Guernsey Cells and the UK Funds on the one hand and AFP and its associates, namely AGL and Mr Farrell, on the other hand were very serious conflicts, involving in respect of the subscription for new shares and the revolving note facility, a significant investment in AFP's infrastructure and an even more acute conflict in the case of the sale of AGL shares by Mr Farrell based on a valuation that he prepared.

262. As a result of our conclusions on the inadequacy of the steps taken to manage the conflicts arising in our view there was an unacceptable risk that the Guernsey Cells and the UK Funds would be disadvantaged by the AGL Transaction and accordingly that the risk had not been managed fairly.

263. Mr Farrell and Mr Addison are both highly experienced investment professionals. They were both fully aware that the AGL Transaction gave rise to conflicts that required appropriate management. Consequently, in our view it would have been obvious to both of them that neither Mr Meader nor Mr Radford were, through their brief review of the transaction, undertaking a meaningful negotiation of the transaction on behalf of the Guernsey Cells and indeed there was no evidence that their experience and expertise equipped them to do so.

264. It would also have been obvious to Mr Farrell and Mr Addison that such consent as was given at the meeting on 15 February 2007 was not fully informed; Mr Meader was not told about the subsequent change in the valuation on which the price was based as a result of the use of updated figures. It must have been obvious to Mr Farrell and Mr Addison that the consent was given on the basis of the earnings figures contained in the business plan disclosed to the Guernsey Directors; there was no suggestion that the figures were subject to change.

265. Both Mr Farrell and Mr Addison knew that full disclosure of the fact that Mr Farrell would be selling some of his AGL shares to the Guernsey Cells needed to be made to the Guernsey Directors, but we have found that they did not make this disclosure. That in itself demonstrates a lack of integrity.

266. Mr Stanley submits that the fact that AFP was fully open about the transaction, with no attempt to conceal any of its terms on the conflicts concerns is inconsistent with a finding of a lack of integrity. We reject that submission. Whilst the factors identified by Mr Stanley are clearly relevant in considering all the facts and circumstances as a whole and do amount to positive factors against a finding of a lack of integrity, we think they are less significant in a case where, as is the situation here, there is no allegation that there was deliberate dishonesty and in our view these factors are strongly outweighed by the overwhelming evidence of the failure to take the necessary steps to manage the conflict by persons to whom the risks concerned would have been obvious.

267. In our view the only right course of action to take to manage the conflict fairly in the light of the serious nature of the conflict, the lack of adequate disclosure and the lack of an independent valuation (which was not tempered by an arm's length negotiation of the terms of the transaction) was to decline to enter into the transaction.

In failing to take this course of action Mr Farrell and Mr Addison failed to act with integrity and consequently so did AFP.

The Cru Transaction

268. Alongside the AGL Transaction, as one of the first investments that AFP made on behalf of the Guernsey Cells, between February 2007 and March 2009 three Guernsey Cells made debt and equity investments in Cru. Two additional Guernsey Cells also made debt finance available in May 2007. AFP also entered into a distribution agreement with Cru at the time of the initial investment for Cru's network of IFAs to introduce investors to AFP's products The Guernsey Cells subscribed for new shares in Cru three months after Cru's directors acquired the initial shares in the company, the price paid for the shares subscribed by the Guernsey Cells being many times greater than that paid by the Cru directors.

269. We set out in Part 2 of Appendix 2 details of the chronology of this transaction.

270. It was common ground that this transaction created a conflict. Mr Farrell said the reason AFP wished to obtain consent for the transaction from the Guernsey Directors was because it was "close to home" bearing in mind the commercial relationship between AFP and Cru. Mr Stanley described the conflict as an indirect conflict; AFP had no direct interest in it but it did have an indirect interest because it had a relationship with Cru. The risk identified by Mr Stanley is that AFP could, consciously or unconsciously, disadvantage the Guernsey Cells (and the UK Funds) in order to improve the terms of its own contractual arrangements with Cru. In our view the conflict goes deeper than that. The Distribution Agreement was the only significant asset that Cru had at the time it was entered into. Mr Addison confirmed that to be the case in an answer to a question from the Tribunal. Mr Addison also explained that Cru was not a "funds manufacturer"; its expertise lay in distribution so the attraction of the arrangements with AFP was that Cru had the ability to market what it regarded as suitable funds, namely the structures designed by AFP through the UK Funds and the Guernsey Cells. AFP for its part now had an outlet for its funds. It was therefore apparent that the two organisations were mutually dependent; the success of both depended on the success of the Distribution Agreement and it was a very significant asset of both businesses. This is demonstrated by the fact that once dealings in the UK funds were suspended in 2009 Cru's business failed very shortly afterwards.

271. Consequently, as we found to be the case with the AGL Transaction, the Guernsey Cells were providing the necessary capital to enable AFP's business to grow through the medium of the Distribution Agreement, and, as we found in relation to the AGL Transaction, the Guernsey Cells were effectively being asked to invest in AFP's infrastructure. We therefore have the same concerns about the Guernsey Cells in effect being a lender of last resort or a lender on generous terms as we expressed in relation to the AGL Transaction in paragraph 218 above. AFP also of course stood to gain from increased management fees through Cru performing its obligations under the Distribution Agreement.

272. In our view in effect the conflict should be regarded as a direct conflict. The conflict was a serious conflict which, like the AGL Transaction, under the regulatory standards prevailing at the time required rigorous challenge and robust management so as to ensure that the Guernsey Cells, and as a consequence, the UK Funds (and any external investors in the Guernsey Cells) were not disadvantaged.

273. Mr Stanley, as with the AGL Transaction, sought to downplay the seriousness of the conflict on the following basis:

(1) The transaction was relatively small;

(2) The incentive for AFP to disadvantage the Guernsey Cells was small because AFP already had a distribution arrangement with Cru and its terms were not renegotiated in the light of the investment made in Cru. AFP had its own interest in ensuring that the Guernsey Cells' performance was good; and

(3) The transaction was simple and routine.

274. We reject all of those submissions. As with the AGL Transaction, the investment was not insignificant in the context of the available assets for investment at that time. As we also explained in relation to the AGL Transaction in paragraph 223 above, the incentive not to disadvantage is necessarily weak. Finally, we do not believe that a transaction of this type, being in effect an investment in AFP's infrastructure, could be regarded as routine, regardless of the complexity of the documentation. As with the AGL Transaction, the transaction does not appear to have been negotiated at arm's length; the documentation is relatively simple because of the absence of the detailed warranties and indemnities common in transactions of this type.

275. It is against that background that we need to measure the quality of the conflict management process that AFP undertook.

276. In the Note for the Investment Committee and Senior Management prepared in March 2007 ("the Note"), it is recorded that AFP relied on the pricing and valuation of the securities being in line with applicable market standards and that fair treatment for the investors had been achieved because of the conservative nature of the valuation. A business plan prepared by Cru in February 2007 to support what it described as its "application for financial assistance" to AFP showed that the proposed share price had been calculated using EBITDA of between 12 and 15 times the 2006 earnings, giving a price of 90p per share, although in fact the Guernsey Cells subscribed at a price of £1 per share, as reflected in a later valuation prepared by AFP The Note makes a comparison with the price/earnings multiples of a number of investment management firms.

277. AFP accepted this valuation as the basis of the subscription arrangements. We have no evidence as to whether that price was the subject of an arm's length negotiation, but if it was in any event it would have been a negotiation with a conflicted party. Therefore, as we identified in paragraph 230 above in relation to the AGL Transaction, in the absence of an independent valuation it would be expected

that other steps would be taken to protect the investors' interests, such as an arm's length negotiation with appropriate persons representing the Guernsey Cells and the UK Funds' interests and a fully informed consent to the terms of the transaction by such persons.

5 278. We should at this point deal with the Authority's contention that the terms of the equity investment were inappropriate because the Guernsey Cells had paid £480,000 to subscribe for A shares in Cru at £1 per share, a sum which represented 99.8% of the nominal share capital and share premium account of Cru, yet the number of shares subscribed (because of their very low nominal value) represented just 6.78% 10 of the voting and dividend rights. Obviously this situation arose because the existing shareholders had subscribed for their shares at par rather than at a premium resulting in 5,600,000 A shares being in the hands of the existing shareholders (for a total consideration of £560) and 480,000 shares being in the hands of the Guernsey Cells. The bulk of the shares held by the existing shareholders (5,600,000) were according 15 to Cru's audited accounts for the year ended 30 April 2007 issued during that financial year.

279. We think the Authority has failed to appreciate that such a disparity can be justified if the underlying value of the company has increased to such an extent that the subscription of new shares at such a large premium compared to the price paid by 20 the existing shareholders can be justified. We accept Mr Addison's explanation in his oral evidence that due account must be taken of the value that the existing shareholders had put into the company through their efforts in building it up and taking on the risks involved.

280. The appropriate way therefore at looking at the disparity is to examine whether 25 in fact the value has increased as a result of the existing shareholders' efforts and why that had occurred.

281. Where Mr Addison's evidence is not convincing is when he maintained that the existing shareholders had owned the company for some time and had created the value in the business since their subscriptions at par which justified the Guernsey 30 Cells paying a large premium for the shares they subscribed.

282. It is clear that the period between the existing shareholders subscribing for their new shares at par and the Guernsey Cells doing so at a large premium was very short, the existing shareholders' new shares being issued some time between 1 May 2006 and 13 February 2007. In that short period, and from the audited accounts for Cru for 35 the period ended 30 April 2006 and the year ended 30 April 2007, it is hard to see how the efforts of the existing shareholders alone had resulted in the large increase in value that justified the premium paid by the Guernsey Cells. Appendix II of Cru's business plan sets out its business targets for each year up to 2012. They show a rapid expansion in funds under management in respect of which Cru was expected to earn 40 commission income from initial and annual charges rebated by the managers concerned from £60 million in 2006 (representing the embryonic UK Funds before the Guernsey Cells were established) to £1.65 billion in 2012.

283. As the business plan makes it clear, that rapid expansion is expected to occur as a result of the perceived attractiveness of the UK Funds, managed by AFP, to potential investors to whom they will be marketed. It is therefore clear that the increase in value is largely attributable to the distribution arrangements with Arch rather than the efforts of the founders of the business. The Guernsey Cells are therefore paying for the value of an agreement that AFP created in partnership with Cru. The valuation effectively results in the Guernsey Cells providing the working capital necessary to generate the growth that is expected to come from the Distribution Agreement, so that the price paid is arguably very generous to Cru and its directors. We also observe that the earnings multiple was benchmarked against those for fund managers, whereas Cru was not a fund management company but a distributor.

284. It is not for the Tribunal to determine whether the price was in fact appropriate, but the important issue is whether the Guernsey Directors were aware of all the relevant features of the transaction when giving their consent to it. In that regard, aside from the valuation of the shares, the business plan gave no consideration as to the exit strategy for the Guernsey Cells or the risks arising in relation to the income and capital cover on the debt facility.

285. As with the AGL Transaction, the only persons involved in the decision making process who were independent of AFP were Mr Meader and Mr Radford. As we found in relation to the AGL Transaction, which was approved by the Investment Committee at the same time, Mr Farrell was the most influential Investment Committee member in driving forward the transaction and he was responsible (wearing an AFP hat) for presenting the proposal to the Guernsey Directors alongside Mr Addison. Mr Addison was fully aware of the transaction, and, as Compliance Officer, responsible for considering compliance with all relevant regulatory obligations in relation to the transaction.

286. We therefore turn to consider what information was made available to Mr Meader and Mr Radford when they considered the transaction. Both Mr Addison and Mr Farrell refer to the Cru Transaction having been discussed "in detail" with the Guernsey Directors, initially during a telephone call on or around 9 February 2007 and then a further call on 14 February. The plan had been to visit Guernsey to discuss the transaction on 8 February but due to cancellation of flights because of fog that visit did not take place. It is clear that the Guernsey Directors had no documentation relating to the transaction prior to the meeting which did take place on 15 February. Mr Farrell sent an email to the portfolio management team on 9 February asking for the "Cru funding pack of docs" to be sent to Bordeaux and referring to the fact that the transaction should be "properly considered/written up and minuted. Valuation policy to be described". There is no evidence, however, that any documentation was sent before Mr Addison's email of 14 February 2007, referred to in paragraph 8 of Part 2 to Appendix 1.

287. We have no evidence of what was discussed in the telephone conversations before 15 February. Mr Farrell stated that AFP "certainly gave them [the Guernsey Directors] a lot of information" but we have no evidence as to the detail. We accept

Miss Carss-Frisk's submission that it is likely that the matter was only discussed in principle in very general terms during these conversations and as a result it was felt necessary to explain the transaction in greater detail at a meeting.

288. It is therefore necessary to focus on what was contained in the documents emailed on 14 February and what was discussed at the meeting the next day.

289. Mr Addison's email refers to the attachments as being the Distribution Agreement, various documents relating to the facility for the Revolving Discounted Note Issuance Facility, the Subscription Agreement for the shares and various resolutions and documents for filing at Companies House in respect of the subscription, and finally the business plan.

290. It appears that the principal transaction documents (showing the signatures of the various parties) were sent. We are not satisfied that the business plan was in fact sent although it is referred to as one of the attachments. What appears to have been sent was an extract from Cru's audited accounts for the year ended 30 April 2006. These accounts form one of the Appendices to the business plan so it is possible that due to a copying error the rest of the document was not attached.

291. Thus by the morning of the meeting on 15 February even if Mr Meader and Mr Radford had had time to absorb the information in the documents that were sent (and that must be regarded as questionable since they were only sent at 16.39 the day before) they would not have been able to ascertain on what basis the subscription price for the shares had been fixed. If they had read the documents carefully (particularly the return of allotments to be filed at Companies House) they would have seen that the shares were issued at a very large premium. They would however, have not been aware that the existing shareholders had subscribed for new shares at par only a few months before.

292. Mr Meader's email of 8.28 on 15 February (referred to in paragraph 9 of Part 2 of Appendix 1) suggests that the Guernsey Directors were primarily focused on ensuring that the necessary formalities of approval had been complied with rather than being concerned with the substance of the investment. This is consistent with our earlier finding in the context of the AGL Transaction that the Guernsey Directors were not expected to perform any in depth role in assessing the qualities of investments made by the funds they administered or the terms on which they were acquired.

293. Mr Stanley suggested that the business plan was taken to the meeting. We have no direct evidence of that, but even if it was there would have been little time for the Guernsey Directors to consider it in any detail. There is no evidence that the valuation of the shares was discussed or why equity warrants or options were not taken then as was the case when other Guernsey Cells extended finance later, when the rationale was that the equity acted as a "kicker" for the debt facility. In his cross-examination Mr Farrell contended that the question as to the price the Guernsey Cells were going to pay, including as it did a large premium as opposed to the price the existing shareholders paid only a few months before, was irrelevant. In the light of that our

finding is that the basis of the valuation of the shares and therefore whether the price to be paid could be justified was not discussed. There was also no evidence that the question of cover for the interest and capital under the facility for the Revolving Discounted Note Issuance Facility was discussed.

294. The Authority maintains that the disclosure exercise in respect of the initial transaction was of limited value in any event because by the time it was given the transaction had already been completed. We agree that it is clearly preferable that advance consent is given, but in appropriate circumstances fully informed consent given shortly after a transaction can be effective, on the assumption that the transaction is capable of being reversed if the consent is not forthcoming. However, the difficulty in this case is that in our view the consent given was not fully informed in the absence of a full and frank disclosure as to first the equity valuation and rationale for the Guernsey Cells acquiring shares at a large premium so soon after the existing shareholders had subscribed at par, and secondly the terms of the revolving debt facility and the ability of Cru to service and repay it The Guernsey Directors were given no information on which they could therefore make a proper assessment as to whether the transaction was in the interest of the Guernsey Cells and assess whether the fairness of the price was affected by the fact that much of the value was attributable to the Distribution Agreement with Arch as we discussed in paragraph 283 above.

295. As far as the subsequent increases in the revolving debt facility were concerned, Mr Stanley submits that AFP's decision that these increases did not require disclosure was reasonable. He submits that the fact that the Guernsey Directors were happy with the principle of the borrowings was sufficient and the commercial terms would be left to AFP's judgment. Mr Farrell and Mr Addison in their evidence relied on three factors to justify the stance they took. First, that the IMAs did not compel them to disclose the transactions in any event. We have rejected this contention in the regulatory context as a matter of principle in our earlier discussion on the applicable regulatory standards. Secondly, although the increases were significant, in relative terms they were not large at all given the expansion in Cru's business and finally that the sums concerned were "small and proportionate".

296. In our view the assertion that there is no need for disclosure and approval of a substantial increase in an exposure to a close business associate when the sums advanced are proportionate to the progress that Cru was making in the development of its business is misconceived. The validity of that judgment should have been properly considered and challenged by a non-conflicted party in full possession of the relevant facts as to the state of Cru's business at the time and in particular the implications of the increased lending facility for interest, capital and security cover. There was no evidence to support Mr Farrell's and Mr Addison's assertion that the amounts of increase were in fact proportionate to the development of Cru's business. In our view if it was appropriate to seek the Guernsey Directors' consent to the initial transaction it was likewise appropriate to seek their consent to the subsequent substantial increases in potential exposure.

297. There are also concerns regarding the allocation of the increased exposure amongst the various Guernsey Cells. Both the initial equity investment and debt exposure was allocated equally amongst three Guernsey Cells (SO1, SO2 and PF1). In respect of the May 2007 increase in the debt facility, the three existing Guernsey Cell investors had an equal allocation of 13.47% of the amended facility with two additional Guernsey Cells (PF3 and PF4) having an exposure of 34.76% and 24.83% respectively. In relation to the further increase in September 2007, the existing Guernsey Cells kept their existing allocations and another Guernsey Cell was allocated a potential exposure of up to £1.5 million. It also appears that warrants were issued at some stage to PF3 and PF4.

298. There appears to be no record of what consideration was given as to the allocation of the exposure amongst the various Guernsey Cells. The interests of the Guernsey Cells concerned could not be regarded as fully aligned in their interests because at this stage their investors were different (even if there was some significant overlap).

299. We now turn to the question as to the adequacy of the record made by AFP of the conflict and the steps taken to manage it.

300. AFP relies on three groups of document in that regard. They were all prepared by Mr Farrell with Mr Addison's assistance. First, it relies on the "Note for the Investment Committee and Senior Management" completed in March 2007. This Note records the following steps taken with regard to conflicts:

(1) The structure of the transaction was in the best interests of the clients concerned and the investment was of an appropriate size;

(2) Senior Management and Compliance were consulted. The transaction was approved by unanimous shareholder resolution of Cru and its legal advisers;

(3) Pricing and valuation of the securities was in line with applicable market standards in the light of Cru's business plan; and

(4) Fair treatment for the investors concerned where clients interests are not fully aligned with those of the firm or other clients.

301. Secondly, it relied on the three ICPs detailed in paragraph 4 of Part 2 of Appendix 1.

302. Finally, it relied on the note of 2 September 2008 headed "Review of Activist Positions and Related Conflicts of Interest". This note records little specific information regarding the Cru Transaction other than to record that the conflict was managed by being disclosed to the Guernsey Directors and to the "external Arch Cru Investment Committee". It described the conflict as being the provision of finance and equity to a related party distributor but that the conflict rating was "low". Under a heading entitled "Experience to date ("proof of the pudding")" it recorded that early repayment of part of the principal was received in July 2008 and an additional early part payment was due at the end of 2008.

303. Mr Addison accepted in cross-examination that the record was not as thorough as it should have been. In our view these documents, either separately or taken together, cannot be regarded as an adequate record of the conflicts of interest arising out of the Cru Transaction and the steps taken to mitigate them. By reference to the matters suggested by Mr Stanley to be included in a properly drafted conflicts record (as set out in paragraph 134(11) above) the notes failed to deal with the decision making process for the transaction, any specific detailed analysis of the conflict and the significance of the risks associated and the key mitigating factors, or whether independent advice had been received. The ICPs refer only to the conflicts arising out of the debt aspect of the transaction and not the equity and do not refer to the disclosure made to the Guernsey Directors. "The Review of Activist Positions" wrongly in our view, rates the conflict as "low" and does not explain why the investment is in the best interests of the Guernsey Cells. None of the documents deal with any potential conflict between the interests of the various funds involved, except to assert that there has been "fair treatment" of the clients concerned.

304. We can therefore set out our conclusions on whether the steps taken to manage and record the conflicts arising in respect of the Cru Transactions were adequate. They are very similar to the conclusions we reached in respect of the AGL Transaction as follows:

(1) The decision making process was seriously flawed. Mr Farrell chaired the Investment Committee and was its most influential member in the decision to make the investment, bringing the investment proposal to the committee representing AFP. He also presented the merits of the investment to the Guernsey Directors on behalf of AFP and there was no-one to represent the views of the portfolio managers on the merits of the transaction for the Guernsey Cells;

(2) There was no independent scrutiny of the transaction from the perspective of the UK Funds;

(3) There was no detailed and formal proposal document presented to the Investment Committee prior to the transaction being approved setting out the conflict, why it amounted to a conflict and its seriousness, and how it was to be managed;

(4) There was no independent valuation of Cru. In the circumstances where the transaction involved an investment in AFP's own infrastructure that was essential in the absence of a robust negotiation on behalf of the investor;

(5) The limited roles assumed by Mr Meader and Mr Radford in their capacity as Guernsey Directors and the fact that they were given very little time to assess the transaction and develop and ask probing questions about the price to be paid for the shares and the terms of the debt facility meant that their consent could not be considered as fully informed;

(6) There was no consent from the Guernsey Directors to the increase in the funding provided by the Guernsey Cells;

(7) These serious deficiencies were not outweighed by AFP's arguments that the terms of the transaction were favourable and that there was fair treatment for the Guernsey Cells. There was a serious risk in the circumstances that the Guernsey Cells did not enter into the transaction on the best possible terms, whether or not that turned out actually to be the case; and

(8) The recording of the conflicts and manner in which the conflicts were managed was seriously inadequate.

305. We therefore conclude that the manner in which AFP managed this conflict was in breach of Principle 8 and the associated COB and SYSC Rules. We now turn to consider whether AFP acted without integrity in respect of its conduct in that regard.

306. As we analysed in paragraphs 197 and 198 above and in relation to the AGL Transaction, if we were to find that Mr Farrell and Mr Addison failed to act with integrity in relation to the steps they took in managing the conflicts arising in respect of the Cru Transaction, then it follows that AFP also failed to act with integrity in that regard.

307. We have identified in paragraph 212 above that the correct approach to take in determining this issue is to consider whether Mr Farrell and Mr Addison were aware that there was an unacceptable risk that the conflicts arising in respect of the Cru Transaction would not be managed fairly if they failed to take further steps to mitigate the risk, that risk being obvious to someone in their position and having their level of experience.

308. We have found that the conflicts arising in this case between the interests of the Guernsey Cells and the UK Funds on the one hand and AFP and its close business associate, namely Cru, on the other hand were very serious conflicts, involving in respect of the subscription for new shares and the debt facility, a significant investment in AFP's infrastructure.

309. As a result of our conclusions on the inadequacy of the steps taken to manage the conflicts arising in our view there was an unacceptable risk that the Guernsey Cells and the UK Funds would be disadvantaged by the Cru Transaction and accordingly that the risk had not been managed fairly.

310. We repeat our finding that Mr Farrell and Mr Addison are both highly experienced investment professionals. They were both fully aware that the Cru Transaction gave rise to conflicts that required appropriate management. Consequently, in our view it would have been obvious to both of them as it was in relation to the AGL Transaction that neither Mr Meader nor Mr Radford were, through their brief review of the transaction, undertaking a meaningful negotiation of the transaction on behalf of the Guernsey Cells and indeed there was no evidence that their experience and expertise equipped them to do so. Indeed, because of the inadequacy of the disclosure made to them there was no basis on which they could have done so.

311. It would also have been obvious to Mr Farrell and Mr Addison that in the absence of any explanation as to the pricing of the equity investment that the consent given on 15 February 2007 was not fully informed.

312. In relation to the subsequent increases in the debt finance provided it would have been obvious to Mr Farrell and Mr Addison that, in the absence of any explanation to the Guernsey Directors as to whether the size of the increase in the investment in relation to the progress in Cru's business development at the time the increase was made, there was an unacceptable risk that the conflict was not being managed fairly.

313. In our view, as with the AGL Transaction, the only right course of action to take to manage the conflict fairly in the light of the serious nature of the conflict, the lack of adequate disclosure and the lack of an independent valuation (which was not tempered by an arm's length negotiation of the terms of the transaction) was to decline to enter into the transaction. In failing to take this course of action Mr Farrell and Mr Addison failed to act with integrity and consequently so did AFP.

The Lonscale Transaction

314. In brief, a number of Guernsey Cells provided finance in an amount of £20.2 million that enabled Lonscale Limited, a company set up by an associate of Mr Farrell called Mr Lee Barkman, to acquire the Clubeasy group of companies. A further £0.8 million was loaned to Lonscale by an associate of Mr Barkman for the same purpose. Of the £21 million so provided, £15 million was used to pay the purchase price for the acquisition with the balance of £6 million being used to pay £3 million in fees to each of AFP and Mr Barkman. AFP's fees were in respect of its services as corporate finance adviser on the transaction. Mr Farrell had become a director of Lonscale by the time the purchase of Clubeasy took place in October 2007.

315. We set out in Part 3 of Appendix 2 details of the chronology of this transaction and the steps taken to record it. This Appendix does not deal with the material facts in dispute, which we address below.

316. It was common ground that this transaction created a conflict. There was a direct conflict between AFP and its client, the Guernsey Cells. As it was common ground that AFP's fee was only payable if the Lonscale Transaction completed, there was a clear incentive for AFP to do its best as corporate finance adviser to ensure that happened, whereas it was only in the interests of the Guernsey Cells to invest if the transaction was in their interests and then only on the best terms available. There was also a conflict between AFP's two clients, its corporate finance client Mr Barkman and its investment management client, the Guernsey Cells. There were therefore clear risks that the Guernsey Cells would enter into a transaction that was not in their interest, or on terms which were much less favourable than would have been achieved in an arm's length transaction. In that context, it was not just a question of assessing whether the price paid was justifiable, but also whether the fees charged by AFP were as reasonable as they might be when negotiated between parties at arm's length.

317. In relation to the fees, in cash-flow terms they were met out of the monies lent by the Guernsey Cells. In stark terms, of the £21 million lent by the Guernsey Cells 28.6% of it was used to meet the fees. Mr King's view was that even with that level of fee the Clubeasy Group appeared to be worth much more than was paid for it, but that view was based purely on the net asset value of the group and there was no formal valuation on which the Guernsey Cells could rely which dealt with other factors such as rental income from the properties concerned and likely returns. It is also to be borne in mind that at this stage all other funding options had been withdrawn so that the Guernsey Cells were the lender of last resort.

318. In these circumstances the conflict was as serious as could be imagined. Under the regulatory standards prevailing at the time it required rigorous challenge and robust management so as to ensure that the Guernsey Cells, and as a consequence the UK Funds, were not disadvantaged.

319. Mr Stanley appeared to accept that the conflict was serious; he observed that the fee payable to AFP was substantial such that there would be a worry that it would skew judgment. He also observed that it was not envisaged until late in the day that the Guernsey Cells would make the level of investment that they ultimately did and that although it was a success fee it was not necessarily dependent on the Guernsey Cells investing; he submitted (as Mr Farrell asserted in his evidence) that if the Guernsey Cells did not invest another way would be found to complete the transaction.

320. We reject that submission. The tenor of Mr Farrell's email of 24 October 2007, following him learning the bank funding had fallen through and which was sent only five days before the transaction completed, is that there was no realistic funding alternative so every effort was made to accommodate the investment within the Guernsey Cells. There is certainly no evidence to support Mr Farrell's assertion that another way could have been found to complete the acquisition of Clubeasy Group.

321. Mr Stanley submitted that the strength of the conflict was weakened because it was a "one off" rather than a continuing conflict in that once the transaction had taken place AFP would no longer be in a position of conflict in relation to the ongoing operation of Lonscale. Clearly, the conflict would have been even more serious had it been ongoing but the fact that it was transactional did not in our view mitigate the seriousness of the initial conflict. All it means is that there may have been no ongoing requirement to manage the conflict.

322. Whilst, unlike the AGL Transaction, there was an arm's length negotiation in that it appears that the price for the purchase of the Clubeasy Group was negotiated between Lonscale and the vendor, Mr Hayes, so that the case for an independent valuation is weaker, we do not put any weight on AFP's contention that despite the size of the fees the transaction was a good deal for the Guernsey Cells because its true value was much higher than £21 million. At the end of the day in a private negotiated transaction of this type the best evidence of value is the price actually paid, which in this case was £15 million.

323. There appear to be no ICPs prepared for this transaction and no Investment Committee minutes exist for it which suggests that the decision to invest was taken informally, as we have found to be the case generally after April 2007. Consistent with the position we have found in relation to the AGL and Cru Transactions and our findings in paragraph 99 above, Mr Farrell is likely to have taken the lead on the approval process, bringing forward the opportunity wearing his AFP corporate finance "hat" to the portfolio managers and then participating in the decision making process, which led to the investment being made, as the most influential member of the Investment Committee and a dominant figure when it came to investment decisions.

324. It is against that background that we turn to measure the quality of the conflict management process that AFP undertook.

325. It is common ground that the Guernsey Directors were not asked to approve the loans made by the Guernsey Cells. On AFP's case, Mr Meader was informed by Mr Addison of the transaction in general terms and stated that he had no objection in principle to the Guernsey Cells investing in a transaction that AFP is structuring and for which it is receiving a substantial fee. It is accepted that at no time was Mr Meader told the amount of the fee. The Authority invites us to find that no such conversation took place.

326. The evidence is somewhat confusing on this point. In his witness statement, Mr Addison says he telephoned Mr Meader in August 2007, after Mr Farrell had told him the Guernsey Cells may invest in the transaction, and asked him if the Guernsey Directors would object to the Guernsey Cells' involvement in an investment in which it had already been agreed that AFP would be paid a fee. Mr Addison stated at that stage the amount of the fee was not known so he was seeking approval in principle and Mr Meader said he had no objection. Mr Addison's oral evidence was slightly different in that he stated that he may have told Mr Meader that the fee was in seven figures and that Mr Meader was relaxed about the transaction. This account is consistent to a degree with what Mr Meader says in his statement, namely that there may have been a courtesy call from AFP advising of the transaction but he does not recall that specifically and he does not recall disclosure of the fees payable to AFP.

327. Mr Farrell's oral evidence was that he asked Mr Addison to speak to the Guernsey Directors about the transaction and that Mr Addison told him sometime in early to mid August 2007 that Mr Meader was very relaxed and was surprisingly so, thus making it clear that his understanding was that there had been a conversation between Mr Addison and Mr Meader and not with Mr Radford, either instead of or as well as Mr Meader.

328. However in his cross-examination in the High Court in the Lonscale proceedings, after Mr Farrell had said that there had been a conversation between Mr Meader and Mr Addison as described above, Mr Farrell was challenged to explain why in a request for further information regarding his defence in those proceedings he had stated that the conversation had been with Mr Radford, the suggestion being that that statement was untrue, which Mr Farrell denied.

329. Similarly in these proceedings Mr Farrell and Mr Addison were referred to a note of a purported telephone conversation between Mr Radford and Mr Farrell and Mr Addison on 15 August 2011 in which Mr Radford is recorded as having confirmed that Mr Farrell and Mr Addison had discussed Lonscale with him and the fact that AFP would be taking a fee from the transaction but he would check his notes when he got back into the office to see if he had anything officially recorded. It does not appear that Mr Radford did revert on this point and in his statement in these proceedings he says he was not aware that AFP was to receive a fee for its role in the transaction. He does, however, state that the Lonscale investment was discussed in detail by Mr Addison after the event at various Board Meetings and he believed he would have explained the transaction at the next Board Meeting on 22 November 2007, although Mr Radford says he cannot recall the precise terms of the disclosures made.

330. The Authority invites us to find that as a consequence of this inconsistency, the fact that no contemporaneous note was made of the conversation with Mr Meader and no mention of it was made in the note prepared in January 2010 referred to in paragraph 7 of part 3 to Appendix 1, no conversation with either of the Guernsey Directors did in fact take place.

331. In our view, although neither Mr Addison's or Mr Farrell's evidence is satisfactory on the point and offered no rational explanation for the inconsistency, the most likely explanation, and we so find, is that the conversation between Mr Addison and Mr Meader did take place. Mr Meader's explanation is consistent in general with Mr Addison's account, and Mr Radford, in his conversation with Mr Farrell and Mr Addison is referring to what he got to know *after* the transaction (possibly in November 2007). This is not inconsistent with his statement, which, when referring to the fact that he was not aware AFP "was to receive a fee", was referring to the position *before* the transaction was concluded.

332. Our conclusions on whether the steps taken to manage and record the conflicts arising in respect of the Lonscale Transaction were adequate are as follows:

(1) As with the AGL and Cru Transactions the decision making process was seriously flawed. There was no formal approval process from the point of view of the Guernsey Cells and no ICPs were prepared. The initiative for the transaction came from Mr Farrell, who was also in the lead on the corporate finance side for AFP. There is no evidence as to what factors the portfolio managers took into account in deciding the investment was appropriate in the light of the fact that no other funding was available at the time.

(2) The Guernsey Directors were not asked to approve the transaction; at best there was an indication that an investment of this type with AFP receiving a fee was acceptable in principle. In reality therefore no unconflicted person took part in the decision making process on the part of the Guernsey Cells.

(3) There was no independent scrutiny of the transaction from the perspective of the UK Funds.

(4) The fact that the price paid by the Guernsey Cells including the fees was considered to be favourable does not outweigh these serious deficiencies. In any event, as we indicated above, the actual purchase price paid for the business represented that arrived at after an arms length negotiation with the vendor which may be said to represent the true value of the assets concerned. In addition very substantial fees were paid.

(5) There was no contemporaneous note recording the conflict and how it was managed and the January 2010 Note referred to in paragraph 7 of part 3 of Appendix 2 does not deal in any detail with how the conflict was managed.

333. It is therefore clear that in reality no meaningful attempt was made to manage and record this very serious conflict at all. We observe that no attempt was made to comply with Mr Symington's advice, referred to in paragraph 4 of Part 3 of Appendix 2, of the need to document the reasons for a transaction via Arch Treasury and provide a paper trail for dealing with the conflict in a fair manner. There was no evidential basis for the statement that Mr Farrell made in cross examination that in substance the conflict was managed very well.

334. We therefore conclude that the manner in which AFP managed this conflict was in breach of Principle 8 and the associated COB and SYSC Rules. We now turn to consider whether AFP acted without integrity in respect of the conduct in this regard. As with the AGL and the Cru Transactions, Mr Farrell and Mr Addison were responsible for the management of the conflicts issues arising in respect of the transaction, Mr Farrell as the primary driver behind the transaction and Mr Addison in his role as compliance officer. Consequently, if we were to find that Mr Farrell and Mr Addison acted without integrity in relation to the steps they took in managing the conflicts then it follows that AFP also failed to act with integrity in that regard.

335. We apply the same approach in determining this issue as we did in relation to the AGL and the Cru Transactions, that is we consider whether Mr Farrell and Mr Addison were aware that there was an unacceptable risk that the conflicts arising in respect of the transaction would not be managed fairly if they failed to take further steps to mitigate the risk, that risk being obvious to someone in their position and having their level of experience.

336. We have found that the conflict arising in this case was as serious as could be imagined, involving the payment of a substantial fee to AFP where that fee would only be payable if the transaction completed and where AFP procured that the Guernsey Cells make the necessary investment to enable the transaction to proceed at a time when no other alternative sources were available. In these circumstances, and there being no serious attempt to manage the conflict, there was in our view an unacceptable risk that the Guernsey Cells and the UK Funds would be disadvantaged by the Lonscale Transaction and accordingly that the risk had not been managed fairly.

337. As we have found, Mr Farrell and Mr Addison are both highly experienced investment professionals. They were both fully aware that the Lonscale Transaction gave rise to a conflict that required appropriate management. It would have been obvious to them that a brief discussion with Mr Meader concerning the transaction in principle and disclosure to him of the fact that AFP would receive a fee was grossly inadequate in the circumstances as a means of managing this conflict. In our view it was essential that the amount of the fee, the fact that it was being funded by the Guernsey Cells and being shared between AFP and Mr Barkman should all have been disclosed to and approved by the Guernsey Directors.

338. In these circumstances in our view the only right course of action to take in the absence of any other meaningful steps to manage the conflict would be to decline to enter into the transaction. In failing to take this course of action Mr Farrell and Mr Addison failed to act with integrity and so did AFP.

The Nice Transaction

339. In brief, a number of Guernsey Cells and AGL co-invested in Nice Group Limited, a property company. The initial transactions took place in September 2007 when two Guernsey Cells (RE1 and RE2) purchased for cash 15% of Nice's equity from its directors for £3.75 million as well as a 15% interest in an associated limited liability partnership for £0.75 million and unspecified AGL shareholders transferred 2% of AGL's issued share capital to Nice in return for the issue to AGL of a 5% interest in each of Nice Group Limited and the associated limited liability partnership. In addition, AIN paid £1 for an issue of equity warrants in respect of Nice Group Limited shares, exercisable at any time but on the understanding that this would be within one year. The agreement dated 21 September 2007 setting out these transactions, described as a property advisory agreement, also made provision for AGL and Nice to share property advisory fees arising from properties managed by Nice and owned directly or indirectly by those Guernsey Cells investing directly in Nice.

340. Subsequently, on 18 February 2008 Mr Farrell became a director and chairman of Nice. Another Guernsey Cell (PF3) provided a one year 12.5% debt facility of £1.5 million on 27 February 2008. On 24 April 2008, AIN sold the equity warrants to the two Guernsey Cells for £50,000 and in November and December 2008, when Nice was in some financial difficulty, a Guernsey Cell that had not previously been exposed to Nice made loans to it of £250,000 and £850,000 respectively. By the end of December 2008 the two Guernsey Cells (RE1 and RE2) and AGL together held 85% of the Nice Group.

341. We set out in Part 4 of Appendix 2 further details of this transaction and the steps taken to record it.

342. It was common ground that this transaction created a number of conflicts.

343. First, there was a direct conflict of the co-investment type, that is where there is a risk that the firm or its associate obtains terms that are more favourable than those

obtained for its client. This is potentially an issue in relation to the investment by AGL through the share swap on the one hand and the investment in cash by the Guernsey Cells on the other, taking into account also the provisions of the Property Advisory Agreement relating to the sharing of investment management fees.

5 344. Secondly, there was a direct conflict of the counterparty type in relation to the sale of the warrants, where there was a clear risk of disadvantage to the Guernsey Cells in that AGL has an interest in maximising the price at which the warrants were sold whereas the Guernsey Cells have an interest in acquiring them at the lowest possible price. There was therefore a clear risk, as Mr Stanley accepted, that the 10 Guernsey Cells might enter into a transaction which was not in their interests, or on terms which were less favourable to them than would have been achieved in an arm's length transaction.

345. Thirdly, the loans from PF3 and RE3 to Nice created a conflict between clients in that the effect of the loans was to help protect the equity investments of the 15 Guernsey Cells that had invested in Nice equity without diluting them as was explicitly stated in the December 2008 ICP. The loans also stood to benefit AGL as an equity investor. Mr Farrell had a personal conflict as chairman of Nice. These conflicts again created a clear risk that PF3 and RE3 might enter into a transaction which was not in their interests, or on terms which were less favourable to them than 20 would have been achieved in an arm's length transaction.

346. Mr Stanley submitted that the conflicts in relation to these transactions were not particularly strong. They were not to be regarded as "close to home" in the way the AGL and Cru Transactions were because there was no previous relationship with Nice. With regard to the initial transaction, if there was commercial parity of interest 25 then there was alignment of interest. With regard to the warrant transaction, the sums involved were small in absolute terms, and very small as far as AGL and the Guernsey Cells were concerned. As regards the loans, although the interests of the various Guernsey Cells were not exactly aligned (because the various funds invested in different proportions) there were no external investors in any of them and 30 significant overlap of investors in each Guernsey Cell. He submits the first and second loans were for relatively small sums. AGL's own direct equity interest was aligned with the interests of the Guernsey Cells that made the equity investment and because they had a far greater interest than AGL the inter- client conflicts predominated.

347. In our view these submissions seriously downplay the strength of the conflicts. 35 As far as the initial equity transactions are concerned, a closer examination of the structure of these leads to a conclusion that there was in reality no parity of interest. There was a crucial difference in the way in which AGL and the Guernsey Cells co-invested in that the latter subscribed for their shares in cash, the subscription price being based on a valuation that was agreed between AGL and Nice, whereas AGL 40 provided no cash for its investment; it received its shares in Nice in return for its own shareholders transferring some of their own AGL shares. AGL therefore acquired its equity interest in Nice for no cash consideration while the Guernsey Cells paid cash for their shares with investors' funds that went straight to three Nice directors rather than subscribing for new equity in Nice. We agree with Miss Carss-Frisk's

submission that there was an obvious risk that the fact that AFP was making available to Nice £3.75 million of the Guernsey Cells' resources would influence the Nice Directors to accept the particular number of AGL's shares being offered in return for the equity interest that AGL sought for itself in Nice. This cannot be regarded as a typical private equity co-investment situation which Mr Farrell, unconvincingly in our view, sought to maintain that it was.

348. Furthermore, as we have indicated and Miss Carss-Frisk observed, the number of shares AGL received and the price the Guernsey Cells paid was established on the basis of valuations calculated by reference to AGL's own profit forecasts and the selection of one of a number of possible earnings multipliers. As we found in relation to the AGL Transaction (see paragraph 227 above) there are a variety of approaches that can be taken under BVCA guidelines to the valuation of private equity investments.

349. In this situation, as we found in the case of the AGL Transaction, in the absence of an independently verified valuation there is an unacceptable risk that the conflict was not being managed fairly if other steps were not taken to protect the Guernsey Cells' interests.

350. The other aspect of the initial transaction which is at odds with there being parity of treatment is the arrangements under the Property Advisory Agreement. As was common ground this document is poorly and inconsistently drafted. It appears to give Nice a role in sourcing properties for the two Guernsey Cells that were parties to the agreement (both being real estate funds) and then a further role in managing those properties. In relation to the latter role, as AFP was the investment manager of the Guernsey Cells, such a role ought properly to have been created by AFP delegating part of its investment management role to Nice, but AFP is not a party to the agreement; AGL and AIN are the only Arch companies that are parties. On that basis, clause 1.8 of the agreement, which provides for the sharing of investment management fees only makes sense if it was intended that AFP would share with Nice that part of its investment management fee that was attributable to the management of the properties introduced by Nice. Accordingly it would make no commercial sense that the investment management fees were shared with the Guernsey Cells, which Clause 13.2 of the agreement seems to provide for, unless it was intended that AFP would rebate its share of the fees to the Guernsey Cells, and there was no suggestion of that. We therefore find that the agreement was intended to share fees between AFP and Nice.

351. Both Mr Addison and Mr Farrell gave unconvincing evidence on what was intended; Mr Addison stated that he advised that fees could not be shared with Arch because of the terms of the Guernsey Cells' prospectuses, but presumably that advice was given after the agreement was completed otherwise the clause would not have appeared in the agreement in the first place. Therefore even if, as Mr Addison asserted, no fees were actually shared the agreement was concluded on the basis that they could be and so in our view at the time the agreement was entered into the conflict should have been managed taking into account that provision. Mr Farrell maintained that the fee sharing was only intended to apply to new funds that were

launched and not to the existing Guernsey Cells but no limitation to that effect appears in the agreement. In the light of that and the absence of any other evidence to support Mr Farrell's assertion we reject it.

352. In relation to the warrant transaction, AIN as nominee of AGL received these for nominal consideration of £1. They were sold to the Guernsey Cells for £50,000. There was therefore no parity of treatment because the Guernsey Cells were not given any warrants alongside those issued to AIN. Had that happened then they could have exercised them without having to pay a premium to acquire them. Mr Farrell, in answer to questions from the Tribunal on this issue, said that the warrants had been given to AIN alone because the Guernsey Cells had already acquired their intended exposure of 15% of Nice and AGL was unable at the time to acquire more than 5% so entered into a forward commitment to acquire a further 5% stake in a year's time through the exercise of the warrants.

353. This scenario clearly indicates how serious this conflict was. What happens is that in the context of the understanding between AGL and Nice that the warrants be exercised within a year, AGL decides it does not wish to increase its exposure to Nice equity at a time when financial difficulties in Nice are beginning to become apparent. This is after one of the Guernsey Cells has recently provided Nice with a working capital facility and the equity ratchet has operated because profit targets have not been met. Accordingly AGL offloads its forward commitment to subscribe for further equity, as Mr Farrell describes it, on to the Guernsey Cells for immediate exercise and receives a large profit on the sale in return. In those circumstances there is an unacceptable risk if the conflict is not fairly managed that AGL will be seen to have put its own interests in not subscribing for further capital in Nice before the interests of the Guernsey Cells. Although Mr Farrell contended that AGL did not have the cash flow to exercise the warrants in our view it is more likely that it did not wish to increase its exposure.

354. As far as the later lending by the relevant Guernsey Cells is concerned, a serious conflict arises between the debt and the equity investors in that it is freely admitted in the investment rationale for the transactions that one of the purposes of the lending is to protect the existing equity investment. Not only does the lending seek to protect the investment of different Guernsey Cells but it also has the effect of protecting AGL's own investment with no financial contribution at any time having been made by AGL itself to what ultimately turned out to be a failed rescue operation. The scope for there being an unacceptable risk that if the conflict was not fairly managed AGL will be seen to have put its own interests before those of the Guernsey Cells is clearly apparent. We therefore cannot accept that the inter-client conflict predominated.

355. Neither for the reasons we have given in relation to the previous transactions we have reviewed do we accept Mr Stanley's submissions that the seriousness of the conflicts is diminished by the fact that they involved small sums of money. In particular, in relation to the warrant transaction the exercise of the warrants involved a substantial outlay.

356. Therefore in our view these were serious conflicts which under the regulatory standards prevailing at the time required robust management and rigorous challenge so as to ensure that the Guernsey Cells, and as a consequence, the UK Funds were not disadvantaged.

357. It is against that background that we need to measure the quality of the conflict management that AFP undertook.

358. In terms of the decision making process relating to the investments by the Guernsey Cells it is clear that Mr Farrell was the primary driver behind the initial transaction, leading the negotiations with Nice, primarily wearing an AGL "hat" and then bringing the transaction to the Investment Committee for approval on behalf of the Guernsey Cells. There is no formal Investment Committee minute but as we found in relation to the other transactions we have reviewed Mr Farrell participated in the decision to invest as a "reasonably dominant" member of that Committee.

359. In relation to the warrant transaction, Mr Farrell confirmed that he proposed the price to be paid by the Guernsey Cells. We accept that there was some degree of negotiation with the portfolio managers in that the original price proposed by Mr Farrell was reduced from £100,000 to £50,000.

360. In relation to the subsequent loan transactions, it is recorded that Mr Farrell abstained from voting on the decision to lend in February 2008 due to his directorship in Nice and did not attend the Investment Committee meeting in December 2008.

361. There is, however, no evidence of any steps being taken to follow Mr Symington's advice (as referred to in paragraph 13 of part 4 of Appendix 2) that the decision to invest was taken independently without any real or perceived pressure from Arch management.

362. Neither did Mr Addison or Mr Farrell take steps to disclose the initial transactions in advance to the Guernsey Directors. Mr Addison took the view that it was unnecessary to do so because, based on AFP's experience with previous transactions, they knew what their reaction would be, that is that the Guernsey Directors would be happy with the transaction. Mr Farrell gave evidence to the same effect. This answer makes it apparent that by this stage they knew that the Guernsey directors would not raise any issues as to the risks attaching to the investment or whether there was any undisclosed benefit accruing to AGL.

363. Neither was there any disclosure of the warrants transaction. Mr Addison's explanation for this was that there was separation of decision making in that it was negotiated between Mr Farrell representing AGL and Mr Smith representing the portfolio managers. There was, however, very limited disclosure of the last two loan facilities granted in that there was a formal board meeting at which the Guernsey Directors and Mr Addison approved the facilities. Mr Farrell's explanation for this was that there was at this stage a conflict between the debt and equity investors but there is no evidence that any meaningful discussion took place as to the merits of the transaction with the Guernsey Directors. There is therefore no evidence to show that

the consent was fully informed and in particular whether the Guernsey Directors were aware of the serious financial difficulties Nice was in at the time.

364. In the absence of prior disclosure and an independent valuation the only other step advanced as to how the conflict was managed was by Mr Farrell who relied on the investment merits of the transaction and the feedback that the Guernsey Directors had provided on the earlier transactions.

365. We now turn to the adequacy of the record made by AFP of the conflicts and the steps taken to manage them. The only documentary records, as described in Part 4 of Appendix 2, are:

(1) the ICPs prepared for the transaction;

(2) the Review of Activist Positions and Related Conflicts of Interest dated 2 September 2008; and

(3) the Conflicts of Interest File Note created on 23 February 2009.

366. There is therefore no contemporaneous note concerning conflicts regarding the initial transactions or the various loan transactions. In relation to the latter, as described in paragraph 13 of Part 4 of Appendix 2, AFP had recently received advice that conflicts should be formally documented. Mr Farrell's response as to why this advice had not been followed was simply that the transactions took place at a very busy time so other matters were prioritised.

367. Those documents that were created as a record of the steps taken to manage the conflicts were wholly inadequate in that the only step identified was the fact that the transactions were favourable to the Guernsey Cells. The Review of Activist Positions etc. document makes no mention of the warrants transaction or the potential fees under the Property Advisory Agreement. They manifestly fail to deal in any detail with the matters suggested to be included in a properly drafted conflicts record (as set out in paragraph 134(11) above). None of the documents deal with any conflict between the interests of the various funds and Guernsey Cells involved.

368. We can therefore set out our conclusions on whether the steps taken to manage and record the conflicts arising in respect of the Nice Transaction were adequate. They are very similar to the conclusions we reached in respect of the other transactions as follows:

(1) The decision making process was seriously flawed, with Mr Farrell's involvement both for AGL and as the most influential member of the Investment Committee making any suggestion that there was an appropriate arm's length negotiation with the portfolio managers untenable. The fact that there was some negotiation on the price of the warrants has to be seen against the background of AGL wishing to offload its commitment to make further equity investment in Nice which cried out for some independent involvement in the process. There is no evidence of Mr Symington's advice about the need for there to be no real or perceived pressure from AGL on the portfolio managers being heeded. The preparation of detailed ICPs for the various transactions involved was inconsistent.

(2) This situation was compounded by the fact that the Guernsey Directors were not asked to consent to the various transactions and no other meaningful steps were taken to manage the conflicts in the absence of such consent, such as obtaining independent valuations.

(3) There was no separate scrutiny of the transactions from the perspective of the UK Funds and no attempt to consider the respective differing interests of those Guernsey Cells who held equity and those who held or were to hold debt.

(4) These serious deficiencies were not outweighed by arguments as to the favourable nature of the deals from the point of view of the Guernsey Cells. Indeed the later loan transactions were extremely risky, as demonstrated by the high interest rates and the limited nature of the security available. There is no evidence that the Investment Committee properly considered whether the terms of the further debt and equity funding provided the Guernsey Cells with an adequate return to reflect properly the investment risks being taken.

(5) The recording of the conflicts and the manner in which the conflicts were managed was seriously inadequate.

369. We therefore conclude that the manner in which AFP managed this conflict was in breach of Principle 8 and the associated COB and SYSC Rules. We now turn to consider whether AFP acted without integrity in respect of its conduct in that regard. As with the previous transactions we have reviewed, Mr Farrell and Mr Addison were responsible for the management of the conflicts issues arising in respect of the transaction, Mr Farrell as the primary driver behind the transaction and Mr Addison in his role as compliance officer. Consequently, if we were to find that Mr Farrell and Mr Addison acted without integrity in relation to the steps that they took in managing the conflicts then it follows that AFP also failed to act without integrity in that regard.

370. We apply the same approach to determining this issue as we did in respect of the other transactions we have reviewed: see paragraph 335 above.

371. We have found in paragraphs 353 and 354 above that the circumstances regarding the granting of the warrants to AIN, their subsequent transfer to the Guernsey Cells and the rationale for the further loans made provide clear evidence of an unacceptable risk that AGL has put its own interests first in reducing its commitment to subscribe for Nice equity at the expense of the Guernsey Cells and leaving the Guernsey Cells alone to take the risks involved in the further loans, without AGL itself taking on any further additional exposure. The failure by Mr Farrell and Mr Addison to take any meaningful steps to manage these serious conflicts as they emerged leads inevitably to the conclusion that in fact AGL's interests were put ahead of those of the Guernsey Cells.

372. Neither was any attempt made to follow Mr Symington's advice as to how conflicts of this type should be managed and recorded. Mr Farrell's only explanation as to why the advice was not followed was that it was a busy time and other matters were prioritised.

373. These are not the acts and omissions of senior and highly experienced professionals seeking to manage the situations that they faced with integrity. They

were both fully aware that the circumstances of the initial and subsequent transactions gave rise to conflicts that required appropriate management. Indeed they took advice as to how to manage such conflicts and failed to have regard to it when considering the arrangements regarding the subsequent loans. It would have been obvious to them that such limited steps that they took to manage the serious conflicts that arose were grossly inadequate.

374. In these circumstances in our view the only right course of action to take in the absence of any meaningful steps to manage the conflicts would have been for AFP to have declined to enter into the Nice Transaction at the outset and, having failed to do that, to have not made the further investments on behalf of the Guernsey Cells. In failing to take this course of action Mr Farrell and Mr Addison failed to act with integrity and so did AFP.

Issues 5 and 6: Whether AFP failed in breach of Principle 3 and associated SYSC Rules to take reasonable care to have effective compliance monitoring procedures in place and to ensure that the results of compliance monitoring were adequately recorded and reported to senior management and whether Mr Addison failed in breach of Statement of Principle 7 to take reasonable steps to ensure that AFP complied with the relevant standards required by Principle 3 in that regard.

375. The Authority's case on this issue is based on its contention that given the growing complexity of AFP's business as it developed over time and the risks it faced then it should have implemented a formal compliance monitoring programme in addition to the informal and *ad hoc* compliance monitoring measures that the Authority accepts AFP did in fact adopt.

376. The Authority contends that Mr Addison was responsible for this alleged failing in that he, as the member of senior management responsible for compliance, failed to take reasonable steps to ensure that there was an adequate, formal and independent compliance monitoring programme in place, together with the regular reporting of compliance issues to senior management for their consideration.

377. Both Principle 3 (the regulatory provision that AFP is alleged to have breached) and Statement of Principle 7 (the regulatory provision that Mr Addison is alleged to have breached) require performance to a standard of reasonable care. We do not understand it to be in dispute that Mr Addison as compliance officer was responsible for ensuring that AFP complied with the standard required of it by Principle 3 in respect of its compliance monitoring procedures so if we find that AFP failed to meet the requisite standard it follows that likewise Mr Addison will have failed to meet the requisite standard under Statement of Principle 7. We therefore proceed to deal with Issues 5 and 6 together.

378. We should say at the outset that Principle 3 does not specifically require that a firm should put in place a formal compliance monitoring programme with regular reporting of compliance issues to senior management. The requirement may be subsumed within the general requirement of Principle 3 to take reasonable care to

organise and control its affairs responsibly and effectively, with adequate risk management systems.

379. SYSC 3.2.6A which was in force throughout the Relevant Period makes it clear that the systems must be comprehensive and proportionate to the nature, scale and complexity of the firm's activities, which in our view makes it clear that the extent to which a formal monitoring programme was required will depend upon the scale and complexity of the firm's business.

380. SYSC 6.1.2R which came into force on 1 November 2007 also makes it clear that the measures a firm puts in place must take into account the nature, scale and complexity of its business, but SYSC 6.1.3R specifically provides that the firm must have an independent compliance function which among other things must monitor and assess on a regular basis the adequacy of the firm's compliance policies and procedures. As we have found in paragraph 74 above, by September 2007 there had been a rapid growth in the funds managed by AFP which was by then a multifunctional firm with a number of different business lines that, as we have also found, gave rise to a number of inherent conflicts of interest. This growth had also been reflected in the rise in AFP's headcount. As a result of these developments and the more specific requirements of SYSC 6.1.3R in our view it is clear that in order to meet the requirements of Principle 3 there is no question that AFP should have had by 1 November 2007 a formal compliance monitoring programme with regular reporting of compliance issues to senior management. We explore below whether in fact such a programme should have been implemented at an earlier stage.

381. We therefore turn to consider the arrangements that AFP envisaged would be put in place to carry out compliance monitoring and reporting and what steps were actually carried out.

382. The various compliance manuals that AFP had in place throughout the Relevant Period all envisaged that there would be compliance reporting and a compliance monitoring plan. The first compliance manual, issued in March 2005 specifically provided that the Compliance Officer would report to the governing body as required and would provide quarterly reports on the operation of the compliance systems and controls. The manual also referred to the fact that compliance monitoring would be conducted by the Compliance Officer "in accordance with the AFP Compliance Monitoring Plan." It appears that the latter did exist in the form of various compliance monitoring tests set out in a document that predated the first compliance manual but Mr Addison confirmed that in practice these tests were not carried out.

383. AFP's March 2006 compliance manual essentially repeats the provisions of the 2005 manual with regard to compliance monitoring and reporting. In February 2008 a revised compliance manual was produced in conjunction with Methuen Consulting which, as Mr Addison stated, was designed to reflect the new obligations under SYSC that came into force on 1 November 2007. It contained a section on compliance monitoring which stated that the Compliance Officer met his responsibilities to monitor compliance on an on-going basis by preparing and following a compliance monitoring programme which contains detailed tests of the firm's compliance in each

of the areas of regulation to which the firm is subject. This section also stated that the Compliance Officer would report the results of compliance monitoring to the board. There was also a section referring to the fact that the Compliance Officer would maintain a formal record of compliance breaches, including a record of how the firm's internal control and risk procedures have been enhanced following a breach.

384. Also in February 2008 AFP purchased a compliance monitoring programme from Methuen Consulting. It would appear that this document was not particularly customised for AFP as it was sent in draft form within hours of Mr Addison confirming he wished Methuen to provide it and it contains thirty pages of detailed tests to be carried out at specified intervals.

385. Mr Addison confirmed in his evidence that none of the compliance monitoring tests referred to in the various documents mentioned above were in fact implemented in the manner envisaged. As regards reporting to the Board Mr Addison emphasised that reports were made on compliance issues but he accepted that was only where there was something necessary to tell them and that the routine quarterly reports envisaged were not provided. With regard to the breaches record envisaged by the February 2008 compliance manual, there was no evidence before the Tribunal that such record was ever prepared; in the absence of such evidence we are unable to accept Mr Addison's assertion in his oral evidence that such a record existed. Mr Addison stated that the programme purchased from Methuen was very complex and "over the top" and was not particularly helpful in getting down to the real needs of compliance monitoring. Although Mr Addison stated that he did introduce the monitoring procedures specified, in the light of his statement that he started to "weed out" the document and find the areas that were relevant to AFP before he handed over the compliance role to Mr Hartley and Mr Addison's admission that the procedures were not fully implemented, we find that they were not implemented to any material extent.

386. In the absence of any formal monitoring plan Mr Addison's monitoring activities can be summarised as follows:

(1) Being aware of what individuals at AFP were doing and picking up on issues and potential breaches as they arose, adopting a one to one approach which Mr Addison contended was sufficient taking into account the nature, scale and complexity of the business as it grew;

(2) Periodically reviewing and updating policies and manuals;

(3) Ensuring compliance manuals had been circulated and read, keeping a spreadsheet for this purpose and providing practical guidance on the areas of the manual on which staff should focus;

(4) Arranging appropriate training for staff, often on a one to one basis and providing refreshers on key compliance issues when necessary;

(5) Undertaking spot checks on deal tickets, monitoring financial promotions and meeting the marketing manager regularly to ensure marketing materials were compliant;

(6) Reporting to the board or relevant committees on compliance issues where necessary; and

(7) Reporting compliance breaches to the Authority where necessary.

387. We accept that the approach adopted by Mr Addison could be regarded as reasonable in the early period whilst AFP was small and before it implemented the novel fund structures which gave rise to new and significant risks to its business, particularly because of the inherent conflicts in AFP's new business model once the Guernsey Cell structures had been put in place and significant investments were made in them by the UK Funds. Mr Addison had available to him the necessary tools to create formal compliance monitoring procedures at an early stage in successive compliance manuals. Although not specifically tailored to AFP's needs they could have been adapted. Mr Addison, belatedly in February 2008 in his SYSC report identified compliance monitoring as an area that needed consideration later that year or in 2009 through the employment of experienced individuals. However, it was not until November 2008 with the employment of Mr Hartley that the area was given sufficient attention. This was well after the implementation of the new SYSC Rules in November 2007 but in our view the move to more formal compliance monitoring procedures should have happened much earlier, when the Investment Funds were launched.

388. We accept Miss Carss-Frisk's submission that a formal compliance monitoring programme provides discipline to the frequency, depth, breadth and reporting of compliance monitoring and is especially important in firms with complex or novel business models or which are growing over time, all of which applied to AFP. Regular reporting to a firm's governing body is also a good discipline as it will prompt the compliance officer to consider whether the firm's systems and controls need review regardless of whether there is anything specific to report.

389. We therefore conclude that the failure during the Relevant Period to implement an adequate, formal and independent compliance monitoring programme constituted a failure by AFP, in breach of Principle 3, to take reasonable care to organise and control its affairs responsibly and effectively resulting in AFP not having adequate risk management systems in place in relation to its various roles as a corporate finance adviser and also as investment manager to the Guernsey Cells and the UK Funds. Mr Addison failed to take reasonable steps to ensure that such a programme was in place. He also failed to ensure there was regular reporting of compliance issues to senior management and consequently such failures amounted to a breach of Statement of Principle 7 on his part.

Issues 7 and 8: Whether AFP failed in breach of Principle 3 to take reasonable care to ensure that it had adequate systems for segregating and controlling its access to, and use of, non-public information concerning the Guernsey Cells and whether Mr Farrell and Mr Addison in breach of Statement of Principle 7 failed to take reasonable steps to ensure that AFP complied with the relevant standards of Principle 3 in that regard.

390. The Authority's case on these issues is based on its contention that AFP breached Principle 3 by failing to ensure that it had adequate systems for segregating and controlling its access to and use of non-public information about the Guernsey Cells, and failing to recognise and manage fairly the conflicts between the interests of the Guernsey Cells, their shareholders and the UK Funds resulting from the risk of use by AFP of such non-public information.

391. The Authority contends that Mr Farrell and Mr Addison were responsible for this alleged failing as they, as the responsible members of senior management in this regard, failed to take reasonable steps to ensure that AFP had adequate systems for managing the matters referred to in paragraph 390 above.

392. As we have observed in relation to the compliance monitoring issue, both Principle 3 and Statement of Principle 7 (the relevant regulatory provisions in relation to these issues) require performance to a standard of reasonable care. We do not understand it to be in dispute that Mr Farrell as Chief Executive of AFP and Mr Addison as its Compliance Officer were responsible for ensuring that AFP complied with the standards required of it by Principle 3 in relation to these issues so if we find that AFP failed to meet the requisite standard it follows that likewise Mr Farrell and Mr Addison will have failed to meet the requisite standard under Statement of Principle 7.We therefore proceed to deal with Issues 7 and 8 together.

393. There is no dispute on the underlying facts in relation to these issues. Prior to December 2008, the same individuals were in charge of making investment decisions not only at the Guernsey Cell level but also at the UK Fund level; persons who made investment decisions on behalf of the UK Funds had information that went further than the published net asset value ("NAV") of the Guernsey Cells, including access to AFP's NAV model for the Guernsey Cells and information that supported that model. There was no separate discussion of investment proposals or decisions at the Guernsey Cell and UK Fund levels. AFP also provided to Winterflood, the market maker in the Guernsey Cells' shares, indicative prices at which it would be willing to buy and sell shares in the Guernsey Cells.

394. It is common ground that because of AFP's dual role as investment manager of the Guernsey Cells and of the UK Funds there was a risk that those individuals at AFP making decisions on behalf of the UK Funds had access to more information about the Guernsey Cells and their underlying investments than that available publicly. As the Authority submitted, the use of non-public information by market participants can undermine both the price formation process and the presence of a level playing field between market participants. Although investment directly in shares of the Guernsey Cells by investors other than the UK Funds was limited (particularly in the early period after the establishment of the first Guernsey Cells) because the shares were from the outset listed on the CISX, there was a risk that there was an inequality of information held by the external investors and AFP in its capacity as investment manager of the UK Funds. On any particular dealing day the information available to the external investor would be historic, in particular he would rely on the latest published NAV which would be an aggregate value of the investments held, whereas AFP would have had more up to date information through its role as investment

manager of the Guernsey Cells, in particular through access to the NAV model that contained information about particular investments, such as their current mark to market value. Thus when making investment decisions on behalf of the UK Funds there was a risk that decisions would be made by AFP's fund managers on the basis of non-published price sensitive information.

395. In his evidence, Mr Addison justified the absence of separate decision making processes from the outset for the Guernsey Cells and the UK Funds because of the "fundamental alignment (and community of interest) between the UK Funds and the [Guernsey] Cells, which were set up specifically for the UK Funds to implement their strategic investment allocations".

396. Mr Stanley submitted that this approach was reasonable at the outset for the following reasons:

(1) As Mr Addison's evidence shows, there was no intention to generate profits by the UK Funds engaging in the tactical trading of shares in the Guernsey Cells;

(2) It was not to be expected and it was not expected that there would be a large active market in the shares of the Guernsey Cells, particularly as the shares were designed to be long term investments;

(3) The actual number of transactions with external investors during the whole of the Relevant Period was small and many of the Guernsey Cells had no external investors; and

(4) Consequently, there was little practical risk that AFP would use non-public information to the detriment of the external investors. In those circumstances, the risk could be managed adequately by placing reliance on the portfolio managers not to misuse non-public information, it not being practical to establish Chinese Walls in an organisation as small as AFP was at the time.

397. Nevertheless as time passed AFP changed its view and decided that it was necessary to take steps to separate the investment management of the Guernsey Cells from that of the UK Funds.

398. There was some dispute as to where the impetus for this change came from. Mr Derks' evidence was that he together with Mr Hartley, after the latter joined AFP and Mr Derks was appointed Chief Investment Officer in November 2008, were the catalyst for the change, which was not finally fully implemented until January 2009. Mr Derks also maintained that he had been pressing Mr Farrell for the change throughout 2008, although he cannot remember the content of any specific conversations and when they occurred. In addition, although Mr Derks asserted that the failure to make progress on this issue was one of the factors that led him to resign from the board of the Arch Group companies in November 2008 and his agreement to return as Chief Investment Officer shortly afterwards was conditional on this issue being addressed, neither his letter of resignation or any other material we have seen reflects that.

399. It is clear, however, that Mr Farrell himself had recognised the need for separation by 27 August 2008. On that day he sent an email to Mr Addison and others, including Mr Derks, in which he recognised that AFP should act as a fiduciary in all cases and that "formal separation of roles (fund hats) is essential for this." In the absence of any evidence to support Mr Derks' assertions we give Mr Farrell credit for taking the initiative on the issue.

400. Mr Stanley correctly identified that the issue for us to determine is whether the formal separation, with the creation of a Chinese Wall between the Guernsey and the UK investment management functions which ultimately transpired, should have happened earlier than it did. Mr Stanley recognised the difficulty of identifying the precise moment at which it could be said that separation was necessary and was unable to elucidate at what point the factors that he identified as justifying a lack of separation as set out in paragraph 396 above ceased to be compelling.

401. In our view the reason for this difficulty is that there is no reason whether by reason of logic or practicality for the separation not to have been made at the outset of the investment structure adopted by AFP, that is in February 2007 when the first Guernsey Cells were listed on the CISX. In our view the need to manage the proper use of non-public and potentially price sensitive information is fundamental to the orderly operation of financial markets and cannot be diluted on the grounds that in practice the risk of the information being misused was small. In any event, AFP would have had no means of knowing whether the information had been used or not, as it is not easily monitored in the absence of a Chinese Wall.

402. Neither is the argument that the interests of the external investors and the UK Funds are fully aligned compelling. We have explained in paragraph 125(3) above the inherent conflict of interest in the structure between an external investor who may expect the Guernsey Cells, as closed ended vehicles, to take a long term view on its investments and the interests of the UK Funds who may desire, for instance, cash to be generated to assist with redemption requests. Also there cannot be an alignment of interest if there is an inequality of information about an underlying investment in a Guernsey Cell between different investors in that Guernsey Cell. An external investor will have available only published information on which to base his decision to deal in Guernsey Cell shares while AFP, if privy to unpublished information regarding the underlying investment, will have an advantage over the external investor. Mr Farrell did not appear in his cross- examination to appreciate the importance of these factors when defending the alignment of interest principle which is a matter of considerable concern.

403. As the Authority submitted there was no reason in theory or practice why in February 2007 AFP could not have taken the following steps:

(1) Established separate and distinct investment committees;

(2) Placed controls over the provision of indicative prices to Winterflood so that persons responsible for providing those prices did not have access to material non-public information; and

(3) Restricted access to AFP's servers and records management systems to ensure that those involved in decision making for the UK Funds did not have access to material non-public information.

Inevitably, such arrangements may have involved some duplication of staff beyond what was necessary for an integrated structure thereby having costs implications but we see no reason why a firm should be allowed to compromise on the necessary standards simply on the grounds of cost.

404. We therefore conclude that the failure from February 2007 to ensure that there were adequate systems for segregating and controlling access to non-public information about the Guernsey Cells and to recognise and manage fairly the conflicts of interest between the interests of the Guernsey Cells, their shareholders and the UK Funds resulting from the risk of use by AFP of such non-public information constituted a failure by AFP, in breach of Principle 3, to take reasonable care to organise its affairs responsibly and effectively. Both Mr Addison and Mr Farrell failed to take reasonable steps to ensure that such systems were in place and such failure amounted to a breach by each of them of Statement of Principle 7.

Issues 9 and 10: Whether AFP failed in breach of Principle 2 to ensure that the Sub-Funds of the UK funds aimed to provide a prudent spread of risk through its management of the liquidity of the property of the UK Funds in the light of the composition of their investment portfolios and whether Mr Farrell in breach of Statement of Principle 6 failed to exercise due skill, care and diligence in performing his functions relating to liquidity management of the UK Funds.

Introduction

405. We should make it clear from the outset that the Authority's case on prudent spread of risk is limited in its scope. It does not seek to argue that the fact that the UK Funds were predominantly invested in shares of the Guernsey Cells meant that there had been a failure to ensure that a prudent spread of risk had been provided in relation to asset allocation across different types of investments. The only respect in which criticisms are made of decisions to invest in the shares of Guernsey Cells is in relation to the continued investment in such shares during a period of market turmoil and illiquidity and at a time when the cash levels in the Sub-Funds were below stated target buffer levels. The Authority's case is that, in the context of the novel structure, AFP failed to ensure that the Sub-Funds' scheme property aimed to provide a prudent spread of risk given (a) the substantial investment of that property in shares of Guernsey Cells which, the Authority contends, had limited liquidity; and (b) its failure to maintain sufficient cash balances or other very liquid assets in the Sub-Funds. In other words, the issue for us to decide is whether in managing the investment portfolios of the Sub-Funds AFP failed to aim to ensure that sufficient cash or near cash liquidity was maintained in the relevant scheme property in the light of the composition of the investment portfolios.

406. Mr Farrell had a prominent role in setting the investment strategy of the Sub-Funds and their asset allocation, as to be expected from his position as CEO and the

most influential member of the Investment Committee. In the light of this, we do not take it to be disputed that if we find AFP to be in breach of Principle 2 with regard to the prudent spread of risk obligation, then it follows that Mr Farrell will be in breach of Statement of Principle 6 by failing to act with due, skill care and diligence in performing his functions in relation to liquidity management of the UK Funds. We therefore deal with Issues 9 and 10 together.

Legal and regulatory issues

407. It is necessary to examine in some detail the nature of the obligation that AFP owed the UK Funds in relation to the liquidity issue.

408. The first point to note is that COLL 5.6.3R, as set out in paragraph 29 above, is not directly applicable to AFP. In relation to the UK Funds it applies to Capita as the ACD of those funds. As we have seen, Capita delegated the management of the scheme property of the UK Funds to AFP pursuant to an IMA and in that IMA AFP promised contractually in effect to carry out its duties in such a manner that Capita, who would be responsible for the acts and omissions of its delegate, would not be in breach of its regulatory obligations as ACD, including its obligations under COLL 5.6.3R. Therefore as a matter of contract AFP was required to comply with the standard laid down in that rule.

409. As far as AFP's regulatory obligation is concerned, which is the relevant issue for this Tribunal, it was common ground that Principle 2 sets the relevant standard. It is a general provision, applying to all the activities carried out by a fund manager such as AFP for a client which constitute regulated activities. That will certainly include its activities in carrying out the investment management of the scheme property of each of the Sub-Funds and it therefore requires AFP to act with due skill, care and diligence in carrying out that function.

410. Miss Carss-Frisk submits that since AFP was contractually bound by the prudent spread of risk obligation a failure to fulfil that obligation would amount to a failure to comply with Principle 2. Mr Stanley submits that approach is incorrect and the obligation imposed upon AFP and Mr Farrell is to act with due skill, care and diligence, that is in a manner which is not negligent.

411. We agree with Mr Stanley's analysis on this point, although as Mr Stanley pointed out himself, it is in practice a distinction without a difference. In our view a delegate of an ACD would, in order to meet his obligation of acting with due skill, care and diligence, comply with the requirements of COLL 5.6.3R but the obligation in COLL 5.6.3R is not an absolute one. It requires the fund manager to ensure that the scheme property *aims to provide* a prudent spread of risk. This formulation is consistent with the standard of due skill, care and diligence. We agree with Miss Carss-Frisk that this standard must be tested objectively, in other words whether the steps taken by the fund manager to meet this aim achieved the requisite standard when looked at from the perspective of a reasonable fund manager managing the fund in question, taking into account, as the rule requires, the published investment objectives and policy of the fund. Mr Shrimpton applied this formulation in his expert's report

and in our view he was correct to do so. If the steps taken by AFP met that test then in our view it would have acted with due skill, care and diligence and met its obligations under Principle 2.

412. It is also important to note that in judging whether a professional person has acted with due, skill care and diligence, the law recognises that where there is a range of views that reasonable professionals could hold, then so long as the professional has acted within that range of views he is not to be taken to have acted negligently.

413. Mr Stanley took us to *Nye Saunders & Partners v Bristow* (1987) 37 BLR 92 which considered the duty and standard of care expected of an architect. Stephen Brown LJ expressed it in the following terms:

> "The duty and standard of care to be expected from Mr Nye was accepted as being that which applied to any profession or calling which required special skill, knowledge or experience. The test is that formulated in a medical negligence case-*Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582. Where there is a conflict as to whether he has discharged that duty, the courts approach the matter upon the basis of considering whether there was evidence that at the time a responsible body of architects would have taken the view that the way in which the subject of enquiry had carried out his duties was an appropriate way of carrying out the duty, and would not hold him guilty of negligence merely because there was a body of competent professional opinion which held that he was at fault. The onus of proving negligence, of course, rests firmly upon the person who alleges it…"

We accept that a professional fund manager falls within the category of a profession or calling that requires special skill, knowledge or experience. We are also aware that such professionals will have different views as to the correct approach to be taken to achieving a prudent spread of risk. As we shall see, that is well illustrated by the differing views of the two experts in this case. We therefore agree with Mr Stanley that in a grey area or where there is a responsible body of opinion which might have done one thing or another, it is difficult to say that a professional has been negligent when he has taken one particular course rather than another as long as he has acted within the range of reasonable views that could have been followed.

414. There was some debate between the experts as to whether COLL 5.6.3R requires the consideration of liquidity risk as well as market risk. We agree with the Authority, and in the end it did not appear to be disputed by the experts, that a reasonable fund manager would take into account the liquidity risk of his chosen investments as an aspect of investment risk.

415. The reason why AFP had to have had regard to liquidity risk is obvious. The UK Funds offered daily redemptions with settlement in cash within four days so a degree of liquidity would be necessary to meet anticipated redemptions. In volatile markets, increased amounts of cash may be held until the markets settle. These requirements were expressed in the various prospectuses for the UK Funds during the Relevant Period.

416. The prospectuses for the Investment Funds dated 5 July 2006 and 28 June 2007 stated:

> "From time to time and in particular during periods of uncertain or volatile markets the Investment Manager may choose to hold a substantial proportion of the property of the [Sub-Funds] in money market instruments and/or cash deposits."

417. The prospectus for the Investment Funds dated 6 December 2007 and all the later prospectuses for the Investment Funds dealt with the issue in more detail as follows:

> "Normally, a [Sub-Fund] will be fully invested save for an amount to enable redemption of shares, efficient management of the [Sub-Fund] in relation to their strategic objective and other purposes which may be reasonably regarded as ancillary to the investment object of the sub-funds.
>
> This amount will vary depending upon prevailing circumstances and although it would not normally exceed 10% of the total value of the [Sub-Fund], there may be times when the Investment Manager considers stock markets to be overpriced or that a period of instability exists which presents unusual risks. In such cases or during such periods, a higher level of liquidity may be maintained, and if considered prudent, the amount of cash or near cash instruments held would be increased. Unless market conditions were deemed unusually risky, the increased amount and period would not be expected to exceed 30% and six months respectively."

418. The prospectuses for the Diversified Funds dated 25 September 2007 and 2 April 2008 contained wording along similar lines but put more emphasis on the need to increase cash levels where exceptional numbers of redemptions are anticipated as follows:

> "The ACD at its discretion and as considered appropriate retain liquid funds in each [Sub-Fund] at any time. The cash I [sic] may be held in order to enable the pursuit of the [Sub-Fund's] investment objectives, redemption of units, efficient management of the [Sub-Fund] in accordance with its investment objectives or any other purposes which may reasonably be regarded as ancillary to the investment objectives of the [Sub-Fund]. The ACD expects the liquid funds of a [Sub-Fund] to vary between 0 and 25 per cent of the value of the property of the [Sub-Fund] at any one time. Liquidity may be at the upper end of, or even exceed, this range under certain circumstances such as where large market movements and/or an exceptional number of redemptions are anticipated or the [Sub-Fund] is in receipt of large cash sums upon the creation of shares or realisation of investments."

419. It is important to note that these provisions all recognise that cash and near cash holdings are to be regarded as ancillary to the investments of the fund and that normally it is expected that the fund is to be fully invested. This reflects the provisions of COLL 5.5.3R, as set out in paragraph 29 above, which provides that cash and near cash *must not* be retained in the scheme property except for ancillary purposes. The investment manager therefore has to carry out what can be in challenging market conditions a difficult balancing exercise between the presumption, which we take from COLL 5.5.3R, that funds should be fully invested at all times and

the need to maintain sufficient liquidity. As Mr Stanley correctly put it, the investment manager is not entitled simply to “play safe” even in difficult market conditions by maintaining large amounts of cash or near cash assets which went beyond what was reasonably necessary to enable redemption of units or the other purposes permitted by COLL 5.5.3R. Maintaining more cash than was necessary would be as much a breach of the rule as maintaining too little. Investors are paying for the expertise of the investment manager in seeking to generate returns even in difficult market conditions (perhaps especially so) and whilst those investors who decide not to continue with the risk of their investment need to be reasonably satisfied that funds will be available to redeem their units, those investors who wish to continue their investment can reasonably expect the investment strategy to be maintained through full investment.

420. As we have identified above, in difficult situations reasonable professionals may disagree about what should be done in a particular case and there may be no one right answer but a range of professionally reasonable approaches. Mr Shrimpton put the dilemma that a reasonable investment manager faces well in his oral evidence. Although his view was that for funds such as the UK Funds the need to have sufficient liquidity was important the investment manager was “between a rock and a hard place”. We therefore assess the steps that AFP took to manage liquidity taking full account of these factors.

Findings of fact

421. There was little dispute about the material facts relating to the manner in which liquidity was managed and the cash buffers maintained at any particular time.

422. It was clear from Mr Farrell’s evidence that AFP aimed to maintain a typical cash position of approximately 10% to 15% in each UK Fund. It is also clear that this target was not raised as a result of increasing market volatility and potentially higher levels of redemption after the summer of 2007, when the “storm clouds” of the financial crisis, as Mr Shrimpton put it and as summarised in paragraph 78 above, began to build. In Mr Addison’s letter of 24 February 2009 to Capita it was explained that it had been AFP’s experience that this position had been sufficient over the past two years, but in the current market conditions (that is the period post Lehmans which Mr Shrimpton characterised as a period of market breakdown) they had been attempting to raise liquidity levels to near the top end of the 10-15% band, due to the reduced liquidity of listed investments “during these challenging and unprecedented markets.” The letter also observed that there had been a period of heavy redemptions and extreme market movements at the same time and AFP had managed that situation satisfactorily. The letter explained that AFP sought to achieve this by selling investments into the market, and that they were conscious of avoiding adverse price impact in doing so and hence were proceeding with caution.

423. In fact it appears from representations that AFP made to the Authority on its Warning Notice that in August 2008 it raised its guideline cash levels to 20%. Mr Derks asserted that he pressed continually during 2008 for the target to be raised to be in the 20-25% range but none of the minutes of discussions at the Commitments

Committee, which considered and reviewed the liquidity position regularly particularly after August 2008, make reference to Mr Derks' concerns. He was present at many of these meetings and had sight of the minutes so he had adequate opportunity to raise the issue if he felt the minutes did not fairly record his views. We therefore find that throughout the Relevant Period there was a consensus within AFP as to its approach to the liquidity issue.

424. In our view it is appropriate to look at AFP's performance in managing liquidity by dividing the Relevant Period into three smaller periods. First, there is the period between the launch of the Investment Funds and July 2007 before the "storm clouds" Mr Shrimpton referred to began to build when trading conditions were stable. Secondly, there is the period of heightened volatility between July 2007 and August 2008. Finally, there is the period of market breakdown after September 2008.

425. In relation to the stable period, the evidence provided by Mr Cook shows that at all times when the position was tested (on a monthly basis) net cash or near cash holdings exceeded the 10% target (and was often above 15%) except on 31 July 2007 in one Sub-Fund, the Specialist Portfolio, when it fell to 7.3% before recovering the following month to 15.1%.

426. In relation to the period of heightened volatility, by 1 October 2007 the launch of three new Sub-Funds had brought in substantial new cash balances, resulting in total liquidity across the UK Funds reaching 30%, although the Specialist Portfolio was below 10% at 8%. From 30 November 2007 to 31 March 2008 the UK Funds as a whole had month- end cash balances above 10%, sometimes significantly so, but the newly launched funds all fell below 10% for most of the period, again sometimes significantly so. Between March and September 2008 only the Specialist Portfolio was consistently above 10% although the Investment Portfolio and the UK Funds overall were often only a small amount below the 10% figure.

427. In relation to the period of market breakdown, the pattern was overall similar to that between April and September 2008, although there was a marked deterioration in the ratio of the Investment Portfolio, to 2.8% by 13 March 2009, reducing the overall position in the UK Funds to below 10%, at 6.6%. It should be noted that in December 2008 the Finance Fund was successfully launched, which was marketed on the basis that its focus would be on private finance which at that stage AFP felt offered a better investment proposition than investment in equities or publicly traded securities or bank deposits. It appears to be the case that the launch of this fund assisted overall liquidity significantly, because as well as retaining significant cash balances of its own, as we mentioned in paragraph 80 above, it invested the proceeds it raised in the Guernsey Cells. It therefore was able to purchase the shares of Guernsey Cells which other Sub-Funds wished to sell to fund the redemption requests that they were experiencing. By 17 March 2009, the Finance Fund had purchased shares in other Guernsey Cells for £30.1 million, almost all of them from the Investment Portfolio.

428. Mr Cook's evidence also shows that the UK Funds' investment in assets other than shares in the Guernsey Cells was low; it declined from a peak of 38.4% of total assets in January 2007 to 0.5% or less after 30 June 2008 and was no higher than

5.4% in any quarterly period after January 2007. Mr Cook's evidence also shows that the UK Funds continued to make investments in the Guernsey Cells when the cash or near cash holdings of the Sub-Fund in question were below the 10% figure during the period between January and September 2008.

429. Mr Cook's evidence also shows that trading on the CISX in shares of the Guernsey Cells by external counterparties was very limited. He identified 258 trades in the 557 trading days between 12 February 2007 and 24 April 2009. These trades totalled £18.799 million in value with an average trade value of £72,863. During this period the average daily value of all Guernsey Cell shares held by the UK Funds was £238.9 million. External investment in Guernsey Cells through the primary market was also limited; during the period between 25 January 2007 to 30 September 2008 25.5% of shares offered for subscription were purchased by external investors, over half of which were issued in one Guernsey Cell, ARL Private Finance IC Limited. It is therefore right to conclude that the ability to trade on the CISX in practice provided little liquidity for the shares in the Guernsey Cells.

430. The Guernsey Cells were able, subject to the constraints of Guernsey company law and the Rules of the CISX, to effect buy backs of their own shares which would of course have realised cash for the UK Funds. The evidence shows that buy backs from the Investment Funds were limited during the Relevant Period, amounting to just under £15 million in total so that there is little evidence that buy backs offered a significant source of liquidity.

431. We do not take it to be in dispute that the underlying assets of the Guernsey Cells were largely illiquid, consisting predominantly of a mix of private equity, private finance, real estate and forestry, asset backed loans, and other alternative investments. These are the type of assets that are generally held for the long term and are not readily realisable for cash on regulated markets. Generating cash, for example to fund share buy backs, would not therefore have been a straightforward exercise.

432. It is therefore clear to us that both the Guernsey Cells shares themselves and their underlying assets were generally illiquid.

Expert evidence

433. Both Mr Shrimpton and Mr Tyrtania have had extensive experience of the practicalities of fund management, and in particular of the management of collective schemes.

434. Mr Shrimpton had 14 years of experience at Goldman Sachs of managing investment funds before joining the Authority where he spent eight years with responsibility for supervision and policy issues relating to collective investment schemes, including OEICS. Latterly, he has been a member of Kinetic Partners LLP where he co-heads their UK regulatory practice, providing regulatory and compliance services to investment firms. Mr Stanley criticised Mr Shrimpton's lack of recent practical experience of managing investments and his failure to support his opinion by reference to the actual current practice of investment managers. We reject those

criticisms; in our view the combination of Mr Shrimpton's practical investment management experience and recent wide experience of regulation in practice make him qualified to express an expert opinion on the approach taken by investment managers of OEICS in respect of liquidity. In that regard we note his experience in relation to the management of Emerging Market funds and supervision of alternative asset managers, sectors where the management of liquidity is important in the light of the tendency for greater illiquidity in the portfolios of such funds.

435. Mr Tyrtania has extensive experience of management of private client portfolios and collective investment schemes, including OEICS, as well as regulatory experience in compliance management roles, latterly as a consultant providing compliance, regulatory, risk management and product development services to asset management companies. We note his experience in managing a UK Smaller Companies Unit Trust, where he had experience of dealing with liquidity issues in relation to a fund which invested in less extensively traded equities.

436. As Mr Stanley observed, both experts strayed into areas which were outside the scope of their remit, in particular where they expressed their own views as to the interpretation of COLL 5.6. 3R. It is the role of the Tribunal to determine what meets the requirements of that rule. We have determined the correct legal test to apply in that context, that is where there is a range of reasonable views as to a course of action that may be taken, the question is whether the professional concerned acted within that range.

437. Mr Shrimpton's and Mr Tyrtania's opinions are valuable in assisting the Tribunal to assess whether the approach taken by AFP fell within that range and in particular was consistent with the actions that a reasonable fund manager in that position could take.

438. In that regard there is only one issue dealt with by the experts that we need to examine in any detail (although it is the core issue) namely whether AFP during the period after the launch of the UK Funds maintained an adequate cash buffer within the Funds to deal with redemptions. Mr Tyrtania put forward a number of indicators of liquidity which he suggested demonstrated a degree of liquidity in the Guernsey Cell Shares, that is bid and offer spread, discount to NAV, price drivers, market capitalisation, ownership of investment, normal market size for transactions in the shares and number of active market makers. In the end after cross -examination he did not advance these with any degree of enthusiasm and we saw nothing in his evidence on these factors to detract from our conclusion that the shares in the Guernsey Cells were largely illiquid, as shown by the trading data produced by Mr Cook. As we previously observed, Mr Tyrtania's report was confined to the position of the Investment Funds and therefore his report is more limited in its usefulness.

439. Both experts agreed that the assessment of an appropriate level of cash is a matter of judgment. Mr Shrimpton's view was that the 10 to 15% range adopted by AFP was a reasonable threshold for the Sub-Funds during normal market conditions. In the period of heightened volatility that he identified, he would have expected a reasonable fund manager to re-evaluate the position and in his opinion a cash level of

15 to 20% would have been appropriate from mid-2007 to September 2008. During the period of market breakdown, Mr Shrimpton accepted there was little more the reasonable fund manager could do but he would have sought to maintain this cash target and not invest further into illiquid assets.

5 440. Mr Tyrtania's position was that cash holdings in excess of 10% would be unusual for any fully invested fund that did not set out in its policy to allocate funds to cash on a dynamic asset allocation basis. He referred to his experience of managing a UK Smaller Companies Fund during a period of steady redemptions and poor market conditions after the burst of the dot.com bubble in 2001 where he aimed to maintain 10 cash levels at 3 to 5%. Whilst he would expect the manager to re-evaluate the position in the light of building "storm clouds" it was reasonable for the manager to look at the position of his own fund, its experience with redemptions and inflows and whether they had seen that their asset class remained attractive. It was only if AFP's position appeared to be compromised that the cash buffer should be increased. In his view if 15 AFP increased the levels of cash as suggested by Mr Shrimpton from mid 2007 it would have been holding too much cash for too long a period. With the benefit of hindsight it was possible to see how much was actually needed, the result being that there was some cash left at the end of the period.

441. In summary, the difference between the experts is that Mr Shrimpton's 20 judgment was that a reasonable investment manager in AFP's position would have aimed to increase the cash buffer to between 15 and 20% during the period of heightened volatility and would not have made further investments in illiquid assets during the period of market breakdown, whereas Mr Tyrtania's judgment was that it was reasonable for AFP to maintain its target of 10 to 15% and carry on investing in 25 the Guernsey Cells.

442. It appears to us that the Tribunal needs to consider whether Mr Shrimpton's and Mr Tyrtania's views reflect a range of views that a reasonable fund manager in AFP's position could have held at the time. Therefore, if we conclude that Mr Tyrtania's views are ones that no reasonable fund manager could have held at the time there is 30 strong evidence that AFP failed to meet the requisite standard. In that regard, neither expert was able to provide evidence of how investment managers behaved in relation to similar funds, especially during the Relevant Period. That could be because there are no similar funds, although evidence as to the liquidity targets of the listed UK private equity funds (which admittedly would be closed ended) might have been 35 useful. We therefore have to accept that the evidence of how fund managers have dealt with liquidity in similarly challenging situations is very limited.

Discussion

443. It is clear from our findings of fact that the only issue we have to consider in determining whether AFP met the requisite standard is whether it ensured that it 40 aimed to maintain an adequate cash buffer as that would be the only significant tool available to it to manage liquidity during the Relevant Period. It is also clear that there is no dispute that the target of 10 to 15% set by AFP was adequate for the first of the three periods we identified in paragraph 424 above. It is also clear that the only

criticism made of AFP in relation to the third of those periods was that it continued to invest in the Guernsey Cells at a time when its cash and near cash holdings were below its target. The area of dispute is therefore whether in the second period the target should have been increased to between 15 and 20%.

444. Miss Carss-Frisk essentially submitted that we should accept Mr Shrimpton's rather than Mr Tyrtania's judgment on these issues. She supported this submission by reference to the wording in the various prospectuses. She submits that they provide a strong indication of what would be expected of a prudent investment manager in this context. In particular, they variously made clear that the Sub-Funds may be expected to hold a "substantial proportion" of scheme property in liquid assets "from time to time and in particular during periods of uncertain and volatile markets" and that although the amount of cash would not normally exceed 10%, a higher level of liquidity may be obtained during "a period of instability…which presents unusual risks." Unless market conditions were deemed "unusually risky" "the increased amount and period would not be expected to exceed 30% and six months respectively." Miss Carss-Frisk therefore submits that it is therefore contemplated that even at times when market conditions are not "unusually risky", liquidity at 30% may be appropriate, and the overall impression being created by the prospectus wording was that a prudent investment manager will increase the cash buffer from its normal level in periods of heightened market volatility.

445. Looking at the cash position of the Sub-Funds over the period of heightened volatility, we agree with Mr Stanley's assessment that the pattern was one of fairly consistent cash holdings, and where the figures began to decline, particularly in the Investment Portfolio after April 2008, it may be argued that this was a consequence of the cash buffer doing its job in the face of increased redemptions. There was, however, no evidence of a serious depletion to the buffer, the position of the Investment Portfolio remaining in the 8 to 9.5% range in the latter part of this period. It was not unreasonable for AFP to take the view, as it appeared to do, that in a period of heightened volatility the Investment Portfolio, which represented 96% of the assets of the Investment Funds, and 78% of the total assets of the UK Funds at April 2008 remained attractive and there continued to be a healthy inflow of funds, with the result that the increased level of redemptions could be adequately managed by its existing levels of cash. As Mr Tyrtania pointed out, the levels of cash were at this stage three times what might be expected for a fund investing in smaller companies at a time of increased redemptions, so that in striking the balance between the presumption of remaining fully invested and keeping sufficient cash to fund redemptions it could be argued that AFP's judgment in not increasing the target at this stage was reasonable.

446. In our view the wording of the prospectuses do not affect the position. Their primary focus is on informing the investor as to the circumstances in which the presumption of full investment may not apply and indicates that in this context the cash holdings could rise as high as 30% in times of market instability. The reference in the Diversified Funds prospectus to liquidity being as high as 25% in the event of an exceptional number of redemptions does not in our view in any respect commit the investment manager to increasing the target to that figure. We agree with Mr Stanley

that the prospectuses gave AFP very considerable freedom of movement but they did not commit AFP to any particular level of cash.

447. With regard to the continued purchase of Guernsey Cell shares during the period of market breakdown, the evidence shows that the only fund in which there were substantial purchases of Guernsey Cell shares after August 2008 was in the Finance Fund and we have explained the rationale for that in paragraph 428 above. It is not part of the Authority's case that it was inappropriate for the Finance Fund to invest in this way.

448. Taking all these considerations together, and taking both Mr Shrimpton's and Mr Tyrtania's views, as representing a body of experience as to how reasonable fund managers might have behaved when put in AFP's position our conclusion is that the steps taken by AFP in managing liquidity were not outside the range of reasonable decisions that were open to it. In coming to this conclusion we are not saying that Mr Tyrtania was right and Mr Shrimpton was wrong. On the evidence before us it can be said that both were right in that either approach was correct on the basis of being a reasonable approach to be followed and at the end of the day there was not a gaping chasm between the respective targets that each thought to be reasonable. The burden is on the Authority to prove negligence and we conclude that it has not been satisfied.

Conclusion

449. We therefore conclude that AFP did not fail to meet the requisite standard required under Principle 2 with regard to its management of the liquidity of the property of the UK Funds. It follows that Mr Farrell did not fail to meet the requisite standard under Statement of Principle 6 in performing his functions in relation to this issue.

Issue 11: Whether any failings of AFP found to have occurred merit the imposition of a public censure

450. We have found that the Authority has proved its case in respect of all of the issues we have had to determine in relation to AFP save for the issue concerning prudent spread of risk. The Authority is not seeking the imposition of a financial penalty on AFP because of its financial position. AFP is no longer trading and has no significant assets. In those circumstances the Authority invites us to determine that the appropriate action for the Authority to take is to publish a statement pursuant to Section 205 FSMA that AFP has contravened the relevant requirements imposed upon it under FSMA. It also invites us to make directions to the effect that but for AFP's financial position the contraventions concerned would have merited the imposition of a financial penalty of £9 million pursuant to Section 206 FSMA.

451. There can be no question that we have found that AFP has committed serious breaches of Principles 1, 3 and 8. Those breaches were repeated and prolonged. At its peak AFP managed a large amount of funds raised by a significant number of retail investors. In those circumstances there can be no question that a public censure is justified.

452. The question then arises as to whether it is appropriate for the statement published pursuant to Section 205 to go further and indicate the financial penalty that would have been imposed but for AFP's financial circumstances. In our view this course would be appropriate and would assist with the objective of deterrence because by so doing the Authority would indicate to the market the seriousness of the breaches and the size of penalty that might be expected if similar breaches were to occur in the future. Additionally, where the question of the imposition of penalties on individuals who it is found were culpable in relation to the corporate failings arises it is important to ensure that there is a proper degree of proportionality between the corporate and individual penalties.

453. There can be no question that in the present case a substantial penalty would have been justified for the following reasons, as submitted by the Authority:

(1) *Deterrence:* A substantial penalty would assist in promoting high standards of regulatory conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches and demonstrating generally the benefits of compliant behaviour.

(2) *The nature, seriousness and impact of the breach:* We characterise the failures with regard to the management of conflicts of interest generally and in respect of the Four Transactions as being particularly serious. The failings demonstrated fundamental flaws in AFP's business model which allowed it to take on a position of trust as a fiduciary and a manager of large amounts of money raised from retail investors without any proper thought being given as to how to establish effective arrangements for conflict management in the light of AFP's different business strands. These failings are dealt with in detail in paragraphs 172 to 191 above. When advice was belatedly taken on how to manage and record conflicts it was not followed, the only reason being given was that there were other priorities. This failure led directly to the failings we have identified with regard to the Four Transactions where the behaviour concerned demonstrated serious failings to act with integrity and involved the putting of AFP's and its associates' interests ahead of those of its customers. The breaches in question extended over a period of nearly three years. At its peak, AFP managed funds of approximately £645 million and there were over 6000 investors in the UK Funds. The breaches therefore had a serious market impact. AFP earned approximately £42 million in the financial years covering the Relevant Period.

(3) *The extent to which the breach was deliberate and reckless:* We have found the breaches of Principle 1 to have involved a lack of integrity, although not deliberate and dishonest behaviour.

(4) *The size, financial resources and other circumstances of the person on whom the penalty is to be imposed:* Although AFP was a relatively small firm, the size of the assets it managed meant that its failings potentially

had a significant impact and it earned substantial fees from it activities over the Relevant Period.

454. In terms of mitigating factors, we have found that the Authority has not made out its case on the liquidity issue. However, the Authority's case on that issue was a narrow one and involved finely balanced questions of judgment. Dealt with in isolation, if the case had been made out we would not have expected that it would have merited a penalty that would have made a significant difference to the overall penalty. AFP did take steps to deal with its failings on some of the issues. In particular, it recognised the need to deal with the separation of management and following the recruitment of Mr Hartley it took steps to improve its conflicts management and compliance monitoring policies and procedures. These actions were, however, all taken towards the end of the Relevant Period. AFP also agreed with the Authority in April 2009 voluntarily to vary its permission so as not to perform any regulated activities without the Authority's approval.

455. We do not, however, find that these factors diminish the need to have imposed a substantial financial penalty. In our view the conflicts of interest failings were sufficiently serious alone in the context of AFP's business and its potential market impact and the level of fees AFP earned to have justified a penalty of £9 million. Indeed in our view they would have justified a higher penalty, but as the Tribunal has indicated in a number of recent decisions it is reluctant to increase penalties save in clear cases, such as where the evidence before the Tribunal reveals the conduct to be more serious than was known to the Authority when it set the penalty, since doing so may deter those with meritorious references from pursuing them for fear that the penalty may be increased.

456. We therefore conclude that but for its financial position, AFP's failings would have justified the imposition of a penalty of £9 million.

Issue 12: Whether the Authority is time barred from imposing a financial penalty upon Mr Farrell and Mr Addison pursuant to section 66 FSMA

457. The statutory provisions regarding the limitation period for proceedings in respect of the imposition of financial penalties on an approved person and the extension of that period effected in June 2010 are summarised in paragraph 16 above.

458. Mr Farrell and Mr Addison argue that in so far as they were guilty of misconduct the Authority knew of that misconduct in or around April 2009. At that time section 66(4) FSMA imposed a two-year time limit on the Authority to issue a Warning Notice if it proposed to impose a financial penalty and since the Warning Notice was issued on 22 February 2012 the Authority was accordingly out of time to impose a financial penalty on them. The Authority contends that section 66(4) was amended on 8 June 2010 (at which time the Authority was not time-barred from taking action against Mr Farrell and Mr Addison under section 66) such that the relevant time limit was then three years rather than two and on the basis that the Warning Notice was issued before April 2012 it is lawful to impose a financial penalty in this case.

459. As Mr Stanley put it, this issue is purely one of statutory construction. Parliament could have saved us from the trouble of construing the statute if it had made it clear what the effect of the extension of the period was on investigations that were in progress when the statute was amended. Mr Stanley took us to a statute where it did just that: Section 62(1) of the Policing and Crime Act 2009 altered a particular limitation period from twelve to twenty years. When it did so, it explicitly provided that the new limitation period should apply to causes of action which accrued before, as well as to causes of action which accrue after, the commencement of the section, but not to causes of action that had been barred before it entered into force. That is in effect the result for which the Authority contends in this case.

460. In the absence of such a provision in Section 12 of the Financial Services Act 2010, which made the amendments to Section 66, we have to consider whether any degree of retrospection was intended by the amendments. There are two principles of construction that are potentially relevant in this context.

461. First, there is the principle against doubtful penalisation, namely that a person should not be penalised except under clear law. Where it applies, it operates as a principle which may require ambiguities to be construed in favour of the person who would otherwise be penalised. This Tribunal has considered this principle in the context of regulatory provisions: see *Lehman Brothers Pension Scheme* [2012] where the Tribunal held that the fact that the legislation concerned the protection of the public meant less weight should be given to that principle. The Court of Appeal, in approving this reasoning stated that the principle "is a good servant which should not be unthinkingly allowed to dominate the process of interpretation whenever it applies", as per Arden LJ at paragraph 62 of the judgment at [2013] EWCA Civ 751. Although we are considering provisions of FSMA that are more obviously penal than those designed specifically to protect the public, notably the prohibition provisions in Section 56 of FSMA, we place limited weight on the principle in this case.

462. Secondly, there is the principle against retrospectivity, but as this Tribunal held at paragraph 153 of *Lehman Brothers Pension Scheme* approving Bennion on Statutory Interpretation, the mere fact that a change is operative with regard to past events does not mean that it is objectively retrospective.

463. In our view these two principles are overshadowed by another principle, that is the distinction between procedure and substance and there is relevant case law to guide us on this principle. The cases show that a statute will not be found to be retrospective so as to take away a substantive as opposed to a procedural right unless such a construction is unavoidable and the question as to whether a right is substantive is to be determined by examining whether the right in question is an accrued right.

464. In *Yew Bon Tew v Kenderan Bas Mara* [1983] 1 AC 553 a bus being driven by the respondent's employee injured the appellants on 5 April 1972. The time limit for a claim expired after twelve months under the law then in force, and so expired on 5 April 1973. In June 1974 a new statute came into force, substituting a period of 3 years, and a claim was then brought on 20 March 1975, which would be in time if the

new period applied. The Privy Council held that the claim was time barred. The reasoning for this decision was expressed by Lord Brightman at page 563B as follows:

> "Their Lordships consider that the proper approach to the construction of the Act of 1974 is not to decide what label to apply to it, procedural or otherwise, but to see whether the statute, if applied retrospectively to a particular type of case would impair existing rights and obligations."

He then went on to say at page 563D :

> "In their Lordships' view, an accrued right to plead a time bar, which is acquired after the lapse of the statutory period, is in every sense a right, even though it arises under an act which is procedural. It is a right which is not to be taken away by conferring on the statute a retrospective operation, unless such a construction is unavoidable."

465. In our view there is nothing in Section 12 of the Financial Services Act 2012 that requires an unavoidable construction that it is retrospective. It is completely silent on the point. The question is therefore whether it removes an accrued right or not. If it does, then we should find that the imposition of a financial penalty on Mr Farrell and Mr Addison is time barred.

466. Mr Stanley submits that Section 66(4) as originally enacted gave Mr Farrell and Mr Addison an accrued right when the Authority commenced their investigation against them to have that investigation dealt with during the two year period then provided.

467. We reject that submission. In *Yew Bon Tew* the Privy Council approved the reasoning in two cases which dealt with the effect of a statutory extension to a limitation period that had not yet expired, which are summarised as follows.

468. In *R v Chandra* [1905] 2 KB 335 the accused was charged with an offence committed on 15 July 1904 when a three months' time limit applied to the prosecution of such offences, which expired on 15 October 1904. On 1 October 1904 the time limit was extended by statute to six months, which meant it now expired on 15 January 1905. The prosecution was commenced on 27 December 1904 and was held to be in time.

469. Lord Alverstone CJ said at pages 338 to 339:

> "The rule is clearly established that, apart from any special circumstances appearing on the face of the statute in question, statutes which make alterations in procedure are retrospective….This statute does not alter the character of the offence, or take away any defence which was formerly open to the prisoner. It is a mere matter of procedure, and according to all the authorities it is therefore retrospective."

470. Channell J agreed and said:

> "If the time under the old Act had expired before the new Act came into operation the question would have been entirely different, and in my view it would not have enabled a prosecution to be maintained even within six months from the offence."

471. In *Maxwell v Murphy* (1957) 96 CLR 261, a judgment of the High Court of Australia came to the same view. The following passage of Williams J at page 277 was approved at page 562 of *Yew Bon Tew*:

> "Statutes of limitation are often classed as procedural statutes. But it would be unwise to attribute a prima facie retrospective effect to all statutes of limitation. Two classes of case can be considered. An existing statute of limitation may be altered by enlarging or abridging the time within which proceedings may be instituted. If the time is enlarged whilst a person is still within time under existing law to institute a cause of action the statute might well be classed as procedural. Similarly if the time is abridged whilst such person is still left with time within which to institute a cause of action the statute might well be classed as procedural. But if the time is enlarged when a person is out of time to institute a cause of action so as to enable the action to be brought within the new time or is abridged so as to deprive him of time within which to institute it whilst he still has time to do so, very different considerations could arise. A cause of action which can be enforced is a very different thing to a cause of action the remedy for which is barred by lapse of time. Statutes which enable a person to enforce a cause of action which was then barred or provide a bar to an existing cause of action by abridging the time for its institution could hardly be described as merely procedural. They would affect substantive rights."

472. The reasoning from these cases is clear and persuasive in the current case. It leads to the inevitable conclusion that the two year limitation period originally enacted in section 66(4) was not an accrued right at the time the period was extended to three years on 8 June 2010. Accordingly, as the Warning Notices were issued to Mr Farrell and Mr Addison within the new three year limitation period the Tribunal has jurisdiction to impose financial penalties on them in respect of our findings against them on this reference.

Issue 13: whether any failings of Mr Farrell and Mr Addison merit the imposition of a financial penalty, and if so the appropriate amount of those penalties.

Mr Farrell

473. As we found to be the case with AFP Mr Farrell's breaches, in his case of Statement of Principles 1 and 7, were serious, repeated and prolonged. In those circumstances there can be no question that a substantial financial penalty is justified. In that regard the following factors identified by the Authority are relevant:

(1) *Deterrence:* The same considerations apply as we identified in relation to AFP in paragraph 453 above.

(2) *The nature, seriousness and impact of the breach:* The same considerations apply as we identified in relation to AFP in paragraph 453 above.

(3) *The extent to which the breach was deliberate or reckless:* Again the same considerations apply as we identified in relation to AFP whose failure to act with integrity in relation to the Four Transactions was attributable to the acts and omissions of Mr Farrell.

(4) *The size, financial resources and other circumstances of the person on whom the penalty is to be imposed:* Mr Farrell earned £211,000 during the Relevant Period from his role at AFP. He also made a gain of £2,044,514 on the sale of some of his AGL shares during the Relevant Period, including £492,364 from the sale of such shares as part of the AGL Transaction. Therefore, although Mr Farrell is currently not earning any significant income, these benefits should be brought into account when considering the level of financial penalty. Mr Farrell does not contend that payment of the penalty referred to in his Decision Notice would cause him serious financial hardship.

474. The same mitigating factors we identified in relation to AFP apply in relation to Mr Farrell. As with AFP, he has not previously been subject to any disciplinary action.

475. We do not find that these factors diminish the need to impose a substantial financial penalty and the conflicts of interests failings, involving as they did repeated failures to act without integrity on Mr Farrell's part, would alone in our view justify a higher penalty than that sought, but for the reasons set out in paragraph 455 above we will not increase it.

476. In the circumstances we believe a financial penalty of £650,000 to be proportionate and strikes the right balance between corporate and individual responsibility for the breaches that occurred.

Mr Addison

477. In our view exactly the same considerations apply to Mr Addison as apply to Mr Farrell. Mr Addison earned £267,000 from his role at AFP during the Relevant Period. Bearing in mind the respective responsibilities of Mr Farrell and Mr Addison, in our view a much lower penalty for Mr Addison is justified and in our view a financial penalty of £200,000 would be proportionate. Mr Addison does not contend that the imposition of a financial penalty of that amount would cause him serious financial hardship.

Issues 14 and 15: Whether any failings of Mr Farrell and Mr Addison merit the withdrawal of their approvals under section 63 FSMA and prohibition orders under section 56 FSMA

478. We have found serious failings to act with integrity on the part of Mr Farrell and Mr Addison. The Authority's guidance and previous cases in this Tribunal leads to the inevitable conclusion that in those circumstances Mr Farrell and Mr Addison can no longer be regarded as fit and proper persons to be involved in any regulated activities and in the interests of consumer protection and the proper functioning of markets their

current approvals should be withdrawn and they be prohibited from performing any function in relation to any regulated activity carried on by any authorised person, exempt person or exempt professional firm.

Conclusions

5 479. The references are allowed in relation to the prudent spread of risk issue but are dismissed in relation to all other issues to which the references relate. Our decision is unanimous.

Directions

480. We determine that the appropriate action for the Authority to take in relation to
10 these references is:

(1) To publish a statement under Section 205 FSMA to the effect that AFP has contravened Principles 1, 3 and 8 (and in the latter two cases the related SYSC and COB Rules) and but for its financial position a financial penalty of £9 million would have been imposed in respect of such
15 contraventions;

(2) To impose on Mr Farrell a financial penalty of £650,000 for failure to comply with Statements of Principle 1 and 7 pursuant to section 66(3)(a) FSMA;

(3)To impose on Mr Addison a financial penalty of £200,000 for failure to
20 comply with Statements of Principle 1 and 7 pursuant to section 66(3)(a) FSMA;

(4)To withdraw Mr Farrell's and Mr Addison's approvals to carry out controlled functions pursuant to section 63 FSMA; and

(5)To make orders, pursuant to section 56 FSMA, prohibiting Mr Farrell
25 and Mr Addison from performing any function in relation to any regulated activities carried on by any authorised or exempt persons, or exempt professional firm, on the grounds that they are not fit and proper persons.

481. We remit these references to the Authority with the direction that effect be given to our determination.

30

TIMOTHY HERRINGTON
UPPER TRIBUNAL JUDGE

35 **RELEASE DATE: 19 January 2015**

APPENDIX 1

Part 1

5 **Relevant COB Rules in relation to conflicts of interest (in force prior to 1 November 2007)**

7.1.2 Principle 8 (conflicts of interest) requires a firm to manage conflicts of interest fairly. This section aims to ensure that
10 when a firm has, or may have, a conflict of interest between itself and its customer, or between one customer and another customer, the firm pays due regard to the interests of each customer and manages the conflict of interest fairly.

7.1.3 If a firm has or may have:

15 (1) a material interest in a transaction to be entered into with or for a customer, or

(2) a relationship that gives or may give rise to a conflict of interest in relation to a transaction in (1); or

(3) an interest in a transaction that is, or may be, in conflict
20 with the interest of any of the firm's customers; or

(4) customers with conflicting interests in relation to a transaction;

the firm must not knowingly advise, or deal in the exercise of discretion, in relation to that transaction unless it takes
25 reasonable steps to ensure fair treatment for the customer (see COB 2.4.7 G (Attribution of knowledge)).

7.1.4 (1) For the purposes of COB 7.1.3 R, a firm should manage a conflict of interest by taking reasonable steps in one or more of the following ways:

30 (a) disclosing an interest to a customer; or

(b) relying on a policy of independence; or

(c) establishing internal arrangements (Chinese walls); or

(d) declining to act for a customer.

(2) Contravention of (1) may be relied on as tending to
35 establish contravention of COB 7.1.3 R.

(3) Compliance of (1) may be relied on as tending to establish compliance with COB 7.1.3 R.

7.1.5 The following are examples of material interest or conflicts of interest that a firm should disclose under COB 7.1.4 E (1):

40 (1) dealing in investments as principal (unless the firm is acting as a market maker);

(2) dealing in investments as agent for more than one party;

(3) a recommendation to buy or sell a designated investment in which one of the firm's customers has given instructions to buy or sell;

(4) a recommendation to buy or sell a designated investment in which the firm has respectively a long or short position;

(5) acting as a broker fund adviser.

7.1.6 (1) In disclosing an interest to a customer, a firm should:

(a) disclose to the customer, either orally or in writing, any material interest or conflict of interest it has, or may have, whether generally or in relation to a specific transaction, before it advises the customer about the transaction or before it deals on behalf of the customer in the exercise of discretion in relation to the transaction; and

(b) be able to demonstrate that it has taken reasonable steps to ensure that the customer does not object to that material interest or conflict of interest.

Policy of independence

7.1.7 COB 7.1.4 E (1)(b) recognises that a firm may demonstrate that it has taken reasonable steps to ensure fair treatment for its customers by relying on a policy of independence. If a firm relies on a policy of independence, that policy should:

(1) require the relevant employee to disregard any material interest or conflict of interest when advising a customer or dealing for a customer in the exercise of discretion;

(2) be recorded in writing by the firm and made known to the relevant employee;

(3) be disclosed to a private customer stating that the firm may have a material interest or conflict of interest relating to the transaction or service concerned.

Establishing internal arrangements

7.1.8 A firm may manage a conflict of interest by establishing and maintaining the arrangements set out in COB 2.4 (Chinese walls).

Declining to act for a customer

7.1.9 If a firm determines that it is unable to manage a conflict of interest using one of the methods described above, it should decline to act on behalf of the customer.

Relevant provisions of SYSC in force throughout the Relevant Period

3.2.6 A firm must take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system …

3.2.6A A firm must ensure that these systems and controls

…

(2) are comprehensive and proportionate to the nature, scale and complexity of its activities.

3.2.6C A firm must carry out regular assessments of the adequacy of these systems and controls to ensure that it continues to comply with SYSC 3.2.6A R.

3.2.2R (1) A firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system.

6.1.1 A common platform firm must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and appointed representatives (or where applicable, tied agents) with its obligations under the regulatory system …

Relevant provisions of SYSC coming into force on 1 November 2007

6.1.2R A common platform firm must, taking into account the nature, scale and complexity of its business, and the nature and range of investment services and activities undertaken in the course of that business, establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under the regulatory system, as well as associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable the FSA to exercise its powers effectively under the regulatory system and to enable any other competent authority to exercise its powers effectively under MiFID.

6.1.3R A common platform firm must maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:

(1) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures and procedures put in place in accordance with SYSC 6.1.2 R, and the actions taken to address any deficiencies in the firm's compliance with its obligations;

(2) to advise and assist the relevant persons responsible for carrying out regulated activities to comply with the firm's obligations under the regulatory system.

6.1.4R in order to enable the compliance function to discharge its responsibilities properly and independently, a common platform firm must ensure that the following conditions are satisfied:

(1) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;

(2) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting as to compliance required by SYSC 4.3.2 R;

(3) the relevant persons involved in the compliance functions must not be involved in the performance of services or activities they monitor;

(4) the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

9.1.1R A firm must arrange for orderly records to be kept of its business and internal organisation including all services and transactions undertaken by it, which must be sufficient to enable the FSA or any other relevant competent authority under MiFID to monitor the firm's compliance with the requirements under the regulatory system, and in particular to ascertain that the firm has complied with all obligations with respect to clients.

9.1.3R In relation to its MiFID business, a common platform firm must retain records in a medium that allows the storage of information in a way accessible for future reference by the FSA or any other relevant competent authority under MiFID, and so that the following conditions are met:

(1) the FSA or any other relevant competent authority under MiFID must be able to access them readily and to reconstitute each key stage of the processing of each transaction;

(2) it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections and amendments, to be easily ascertained;

(3) it must not be possible for the records otherwise to be manipulated or altered.

10.1.1 This section applies to a common platform firm which provides services to its clients in the course of carrying on regulatory activities or ancillary activities.

10.1.3 A common platform firm must take all reasonable steps to identify conflicts of interest between:

(1) the firm, including its managers, employees and appointed representatives (or where applicable, tied agents), or any person directly or indirectly linked to them by control, and a client of the firm; or

(2) one client of the firm and another client;

that arise or may arise in the course of the firm providing any service referred to in SYSC 10.1.1 R.

10.1.4 For the purposes of identifying the types of conflict of interest that arise, or may arise, in the course of providing a service and whose existence may entail a material risk of damage to

the interests of a client, a common platform firm must take into account, as a minimum, whether the firm or a relevant person, or a person directly or indirectly linked by control to the firm:

(1) is likely to make a financial gain, or avoid a financial loss, at the expense of the client;

(2) has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;

(3) has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;

(4) carries on the same business as the client; or

(5) receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.

The conflict of interest may result from the firm or person providing a service referred to in SYSC 10.1.1 R or engaging in any other activity.

10.1.5 The circumstances which should be treated as giving rise to a conflict of interest cover cases where there is a conflict between the interests of the firm or certain persons connected to the firm or the firm's group and the duty the firm owes to a client; or between the differing interests of two or more of its clients, to whom the firm owes in each case a duty. It is not enough that the firm may gain a benefit if there is not also a possible disadvantage to a client, or that one client to whom the firm owes a duty may make a gain or avoid a loss without there being a concomitant possible loss to another such client.

10.1.6 A common platform firm must keep and regularly update a record of the kinds of service or activity carried out by or on behalf of the firm in which a conflict of interest entailing a material risk of damage to the interest of one or more clients has arisen or, in the case of an ongoing service or activity, may arise.

10.1.7 A common platform firm must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest as defined in SYSC 10.1.3 R from constituting or giving rise to a material risk of damage to the interests of its clients.

10.1.8 (1) If arrangements made by a common platform firm under SYSC 10.1.7 R to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of a client will be prevented, the firm must clearly disclose the general nature and/or sources of

conflicts of interest to the client before undertaking business for the client.

(2) The disclosure must:

(a) be made in a durable medium; and

(b) include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises.

10.1.9 Common platform firms should aim to identify and manage the conflicts of interest arising in relation to their various business lines and their group's activities under the comprehensive conflicts of interest policy. In particular, the disclosure of conflicts of interest by a firm should not exempt it from the obligation to maintain and operate the effective organisational and administrative arrangements under SYSC 10.1.7 R. While disclosure of specific conflicts of interest is required by SYSC 10.1.8 R, an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is not permitted.

10.1.10 (1) A common platform firm must establish, implement and maintain an effective conflicts of interest policy that is set out in writing and is appropriate to the size and organisation of the firm and the nature, scale and complexity of its business.

(2) Where the common platform firm is a member of a group, the policy must also taken into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members.

10.1.11 (1) The conflicts of interest policy must include the following content:

(a) it must identify in accordance with SYSC 10.1.3 R and SYSC 10.1.4 R, by reference to the specific services and activities carried out by or on behalf of the common platform firm, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients; and

(b) it must specify procedures to be followed and measures to be adopted in order to manage such conflicts.

(2) The procedures and measures provided for in paragraph (1)(b) must:

(a) be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest of the kind specified in paragraph (1)(a) carry on those activities at a level of independence appropriate to the size and activities of the common

platform firm and of the group to which it belongs, and to the materiality of the risk of damage to the interests of clients; and

(b) include such of the following as are necessary and appropriate for the common platform firm to ensure the requisite degree of independence:

(i) effective procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients;

(ii) the separate supervision of relevant persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the firm;

(iii) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;

(iv) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out services or activities; and

(v) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate services or activities where such involvement may impair the proper management of conflicts of interest.

(3) If the adoption or the practice of one or more of those measures and procedures does not ensure the requisite level of independence, a common platform firm must adopt such alternative or additional measures and procedures as are necessary and appropriate for the purposes of paragraph (1)(b).

10.1.12 In drawing up a conflicts of interest policy which identifies circumstances which constitute or may give rise to a conflict of interest, a common platform firm should pay special attention to the activities of investment research and advice, proprietary trading, portfolio management and corporate finance business, including underwriting or selling in an offering of securities and advising on mergers and acquisitions. In particular, such special attention is appropriate where the firm or a person directly or indirectly

linked by control to the firm performs a combination of two or more of those activities.

10.2.2 (1) When a common platform firm establishes and maintains a Chinese wall (that is, an arrangement that requires information held by a person in the course of carrying on one part of the business to be withheld from, or not to be used for, persons with or for whom it acts in the course of carrying on other part of its business) it may:

(a) withhold or not use the information held; and

(b) for that purpose, permit persons employed in the first part of its business to withhold the information held from those employed in that other part of the business;

but only to the extent that the business of one of those parts involves the carrying on of regulated activities or ancillary activities.

(2) Information may also be withheld or not used by a common platform firm when this is required by an established arrangement maintained between different parts of the business (of any kind) in the same group. This provision does not affect any requirement to transmit or use information that may arise apart from the rules in COB or COBS.

(3) For the purpose of this rule, "maintains" includes taking reasonable steps to ensure that the arrangements remain effective and are adequately monitored, and must be interpreted accordingly.

10.2.4 When any of the rules of COB, COBS or CASS apply to a common platform firm that acts with knowledge, the firm will not be taken to act with knowledge for the purposes of that rule if none of the relevant individuals involved on behalf of the firm acts with that knowledge as a result of arrangements established under SYSC 10.2.2 R.

10.2.5 When a common platform firm manages a conflict of interest using the arrangements in SYSC 10.2.2 R which take the form of a Chinese wall, individuals on the other side of the wall will not be regarded as being in possession of knowledge denied to them as a result of the Chinese wall.

Part 2

Section 56 FSMA

(1) Subsection (2) applies if it appears to the Authority that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person.

(2) The Authority may make an order ("a prohibition order") prohibiting the individual from performing a specified function, any function falling within a specified description or any function.

(3) A prohibition order may relate to –

(a) a specified regulated activity, any regulated activity falling within a specified description or all regulated activities.

(b) authorised persons generally or any person within a specified class of authorised person.

(4) An individual who performs or agrees to perform a function in breach of a prohibition order is guilty of an offence and liable on summary conviction to a fine not exceeding level 5 on the standard scale.

(5) In proceedings for an offence under subsection (4) it is a defence for the accused to show that he took all reasonable precautions and exercised all due diligence to avoid committing the offence.

(6) An authorised person must take reasonable care to ensure that no function of his, in relation to the carrying on of a regulated activity, is performed by a person who is prohibited from performing that function by a prohibition order.

(7) The Authority may, on the application of the individual named in a prohibition order, vary or revoke it.

(8) This section applies to the performance of functions in relation to a regulated activity carried on by –

(a) a person who is an exempt person in relation to that activity, and

(b) a person to whom, as a result of Part XX, the general prohibition does not apply in relation to that activity,

as it applies to the performance of functions in relation to a regulated activity carried on by an authorised person.

(9) "Specified" means specified in the prohibition order.

APPENDIX 2

Part 1 – Details of the AGL Transaction

1. AGL had been considered as a potential investment for the portfolio managed by AFP by 5 July 2006; the minutes of an Arch Cru Investment Committee meeting held on that date refers to it as a possible investment.

2. On 23 January 2007 the Investment Committee met and reported that the first seven Guernsey Cells had been incorporated and held assets in total of US$100 million. The minutes record that amongst the recommendations made for initial investment was an investment in 8-10% AGL Convertible Loan Notes and in AGL equity. The allocations amongst the Guernsey Cells were larger than those subsequently subscribed, the amount invested when the transaction was completed being £660,000 in Convertible Loan Notes and £510,000 in newly subscribed AGL shares.

3. Those present at the meeting were Mr Farrell, Mr Derks, Mr King, Mr Smith and Mr Jeffs. It is not clear from the minutes who presented the recommendation but there is no evidence to counter the inference from the minutes that the decision was made by the Committee as a whole, including Mr Farrell who as we have found, was the most influential member of the Committee and as we have also found, chaired it.

4. There is no evidence of any written ICP being presented to the Investment Committee setting out the rationale for the investment, or identifying any conflicts involved and how they are to be managed.

5. Although this is not referred to in the Investment Committee minutes, Mr Farrell's evidence (which we accept on this point) was that the Investment Committee considered that as part of the conflicts management process, AFP should discuss the prospect of an investment into AGL with the Guernsey Cell Directors and seek their approval before it was made. Mr Addison and Mr Farrell, as the primary contacts with those directors, were to carry out that exercise.

6. Telephone calls took place regarding the AGL Transaction between Mr Addison and Mr Farrell on the one hand and Mr Meader and Mr Radford on the other hand on or about 8 February 2007 and on 14 February 2007.

7. On 9 February 2007 Mr Farrell emailed the AFP portfolio managers noting that an "Arch Funding pack of docs" was to be sent to Bordeaux once prepared; that the transaction should be "properly considered/written up and minuted" and that the valuation policy was to be described.

8. On 15 February 2007 Mr Farrell and Mr Addison met Mr Meader and Mr Radford in Guernsey to discuss the AGL transaction. Mr Radford did not stay for the whole meeting, Amongst the documents brought to the meeting and given to Mr Meader and Mr Radford was a business plan

summary for AGL and AFP prepared in connection with the proposed issuance of the AGL Loan Notes and Equity. This document disclosed that the amount sought to be raised was £1.5 million, structured as a £0.5 million equity "purchase" (although new shares were subscribed) and a £1 million revolving short term discount debt facility. The purpose of this funding was said to be in order to grow AFP's operations by investments in infrastructure, staff and venture costs. An Appendix to the document disclosed that the equity pricing equated to a multiple of 12.5 times 2007/8 prospective gross profit or 7-8 times 2007/8 prospective revenue, with a comment that this "was looking conservative in light of recent disclosures between AGL Management, Cru Management and a large potential institutional investor interested in a combined stake." This indicated a valuation of between £15.37 and £15.52 million.

9. The document did not mention who prepared that valuation, but it is common ground that it was Mr Farrell.

10. In fact a further valuation was prepared later and formed the basis of the price paid for the AGL shares subscribed by the Guernsey Cells on 28 February 2007. A valuation file note in respect of the AGL shares prepared in April 2007, which set out the valuation methodology employed, showed that the price paid was 10 times expected 2007 EBITDA of £1.745 million, giving a valuation of £17.45 million and therefore a share price of £96.81. The note indicated that it was intended to follow best practice valuation methodology for private equity investments such as guidelines laid down by the British Venture Capital Association (BVCA) and the International Private Equity and Venture Capital (IPEV) guidelines.

11. A higher figure was paid for the AGL shares than that envisaged by the Business Plan given to Mr Meader and Mr Radford because the valuation applying the same methodology but a lower multiplier was updated (it would appear after the meeting in Guernsey) to take account of actual earnings figures since the Business Plan was prepared.

12. Neither Mr Radford nor Mr Meader was told of the updated figure.

13. Mr Meader was content with the proposed investment in AGL. It is not clear whether Mr Radford formally approved it as he left the meeting on 15 February 2007 before it finished. In their defence in the Guernsey Proceedings, Mr Meader and Mr Radford accepted that the rationale for the investment and the conflict of interest was disclosed. They state in their defence that in terms of conflict management, it was noted that the terms of the deal were favourable, the size of the investment appropriate to the fund size, the business plan justified the investment and the price was conservative compared to comparables. The defence also records Mr Meader and Mr Radford being satisfied as to the economic rationale and appropriateness of the proposed transactions, in particular in light of their relatively modest size.

14. On 27 February 2007 AFP in its capacity as the investment manager of the Guernsey Cells entered into a Revolving Discounted Note Issuance Facility Agreement whereby three of the Guernsey Cells agreed to subscribe for up to £660,000 of zero coupon notes. Mr Farrell and Mr Addison signed this agreement on behalf of the Guernsey Cells.

15. On 28 February 2007, a written resolution of all of the shareholders of AGL resolved to allot a total of 5,268 new shares in AGL to the same Guernsey Cells (1,756 shares to each cell) at a price of £96.81 per share, thus raising £510,000.

16. The same resolution also approved transfers of 5,166 existing shares from Mr Farrell to the same three Guernsey Cells (1,722 shares to each cell) at the same price, the transactions being approved to take place on or after 15 March 2007. This gave rise to a total consideration of £500,121 payable to Mr Farrell.

17. In March 2007 Mr Farrell completed a note for the Investment Committee and Senior Management recording the conflict arising out of the transaction and the steps taken to manage it. The note records that AGL was not prepared to issue more shares than those subscribed "but an existing shareholder Robin Farrell was prepared to make up the difference through the sale of existing shares that he held".

18. In April 2007 Mr Farrell completed the note on valuation referred to in paragraph 10 above.

19. On 2 September 2008 AFP prepared a note headed "Review of Activist Positions and Related Conflicts of Interest". This note includes a table recording particular transactions, including the original investment in AGL. It describes the conflict rating as "high" and that it was mitigated by disclosure to the Directors of the Guernsey Cells and to the external Arch Cru Investment Committee.

Part 2 – Details of the Cru Transaction

1. Cru had been considered as a potential investment for the portfolio managed by AFP by 5 July 2006; the minutes of an Arch Cru Investment Committee meeting held on that date refers to it as a possible investment.

2. The minutes of the Investment Committee held on 23 January 2007 record that amongst the recommendation made for initial investment by the Guernsey Cells was an investment in 8-10% Convertible Loan Notes of Cru.

3. As was the case with the AGL Transaction (see paragraph 3 of Part 1 of this Appendix) the decision to make the investment was made by the Committee as a whole, including Mr Farrell.

4. Three ICPs were created in relation to the initial transaction and the subsequent investments made; one dated January 2007 relating to the initial investment of

£480,000 made in Cru equity, one dated January 2007 relating to the initial investment of £870,000 in Cru Loan notes and one dated 21 July 2008 also relating to an investment of £870,000 in Cru Loan Notes, issued pursuant to the loan facility referred to in paragraph 7 below. It is common ground that despite their dates, all three ICPs were in part created in July 2008. Two of the ICPs record the following under the heading "Conflicts of Interest".

> "Cru is a distributor of Arch funds on which it gets paid from the distribution agreement that is collateral to this proposed investment. While the proposed purpose of the loan will benefit Arch if it increases funds under management it will also be beneficial to the investors on the basis that it increases the collateral available to the investors.
>
> Cru has taken its own separate legal advice."

The ICPs also include a brief description of the rationale for the investment from the perspective of investors, referring to the fact that the monies raised are being used to grow investments into the UK Funds which will "increase the level of collateral for the investors", and also to the fact that the investment meets the target rate of return for the investors with a high interest cover. The ICP for the equity investment refers to it acting as a "kicker" to the investment in the Loan Notes.

5. As with the AGL Transaction (see paragraph 5 of Part 1 of this Appendix) the Investment Committee considered that as part of the conflicts management process the approval of the Guernsey Directors should be sought before the initial investment was made.

6. In the telephone calls referred to in paragraph 6 of Part 1 of this Appendix in relation to the AGL Transaction, the Cru Transaction was also discussed with the Guernsey Directors.

7. On 13 February 2007 the following documents were executed in relation to the Cru Transaction:

   (1) a subscription agreement, entered into between three of the Guernsey Cells and Cru pursuant to which each of these Cells agreed to subscribe for 160,000 voting ordinary shares (nominal value £0.0001 per share) at a price of £1 per share.

   (2) a Revolving Discounted Note Issuance Facility Agreement pursuant to which the three Guernsey Cells agreed to lend up to £870,000 (in equal shares), such lending to be evidenced by the issue of zero coupon notes, having a yield to maturity of 10% per annum. The obligations of Cru under this Agreement were secured by a deed of charge over Cru's right under the Distribution Agreement.

   (3) a Distribution Agreement between Cru and AFP pursuant to which Cru agreed to act on an exclusive basis as AFP's distributor to introduce the UK Funds and some of the Guernsey Cells to UK IFAs and their

prospective investors in return for a share of the initial charges, annual management and performance fees charged by AFP in respect of the relevant funds. AFP in its capacity as the investment manager of the Guernsey Cells executed the three agreements on behalf of the Guernsey Cells, the signatories being Mr Farrell and Mr Addison in their capacity as members of AFP.

8. At 16.39 on 14 February 2007 Mr Addison emailed to Mr Meader copies of the three agreements together with associated documentation. He also sent a copy of extracts from Cru's accounts for the year ended 30 April 2006 which showed the company had shareholders' funds at that date of £8,413.

9. At 08.28 on 15 February 2007 Mr Meader, in an email to certain of his colleagues, stated that "we should ensure that it is minuted that the offer has been fully considered by the Board and that it is in the best interests of the funds to invest".

10. On 15 February 2007 Mr Farrell and Mr Addison presented the transaction to Mr Meader and Mr Radford, although Mr Radford left before the end of the presentation. Mr Meader was content with the investment. In their defence in the Guernsey Proceedings, Mr Meader and Mr Radford note that the investment had already been made pursuant to AFP's discretion under its investment management agreements with the relevant Guernsey Cells without prior notice to or approval by the Boards of those Guernsey Cells when the presentation took place on 15 February 2007.

11. There were subsequent increases in the amount of lending made available to Cru by the Guernsey Cells under the Revolving Discounted Note Issuance Facility, on 31 May 2007 to £2,160,000, on 7 September 2007 to £3,660,000 and on 2 February 2009 to £3,876,000. The number of Guernsey Cells providing the funding was also increased. The consent of the Guernsey Directors was not sought for this additional funding.

12. In March 2007 Mr Farrell completed a note for the Investment Committee and Senior Management recording the conflict arising out of the transaction and the steps taken to manage it.

13. On 26 July 2008 AFP prepared the ICPs referred to in paragraph 4 above.

14. On 2 September 2008 AFP prepared the ICPs referred to in paragraph 4 above.

15. On 2 September 2008 AFP prepared a note headed "review of Activist Positions and Related Conflicts of Interest". This note includes a table recording particular transactions, including the investment in Cru. It describes the conflict rating as "low" and that it was mitigated by being disclosed to the Board of Directors of the Guernsey Cells and to the external Arch Cru Investment Committee. As the transaction rationale, it notes that Cru was experiencing significant growth in top-line revenue following the Distribution Agreement with AFP.

Part 3 –Details of the Lonscale Transaction

1. The essential elements of the transaction were as follows:

(1) Lonscale was a special purpose vehicle set up by Mr Barkman to acquire the Clubeasy group of companies from a Mr Jason Hayes.

5 (2) An unlisted cell company called Arch Treasury IC Limited ("AT1") managed by AFP was the vehicle through which various Guernsey Cells invested to enable AT1 to provide funding to Lonscale for the Clubeasy acquisition. The relevant Guernsey Cells provided £20.2 million in total to AT1 in August and October 2007, the investment being allocated to PF2 and PF4 (£3.9 million each), PF3 (£2.9 10 million), PF5 (£2.3 million), RE1 (£3.6 million) and RE2 (£3.6 million). In October 2007 an associate of Mr Barkman, Foundations Program Plc, also lent £0.8 million to AT1 for the same purpose.

(3) Of that total sum of £21 million, Lonscale paid £15 million to Mr Hayes in order to acquire the shares of the Clubeasy group on 29 October 2007. A further sum of 15 £1.8 million was paid to Lonscale to be available as further deferred consideration but was never in fact paid to Mr Hayes. The remaining £6 million was lent to Lonscale which was used to pay structuring fees of £3 million to each of Mr Barkman and AFP. Those fees were approved by the Board of Lonscale (which comprised Mr Barkman and Mr Farrell, the latter having become a director in August 2007) on 29 October 20 2007.

2. The basic structure for the transaction was established in July 2007. At that stage, AFP's role was confined to acting as corporate finance adviser and it was not contemplated that the Guernsey Cells would be investing. It was envisaged that the necessary funding would be provided through bank finance . There was an agreement 25 in principle at that stage that AFP and Mr Barkman would be paid structuring fees.

3. By late August 2007 Mr Barkman had agreed that the Guernsey Cells could become lenders, but it was still envisaged that the bulk of the funding would be provided by the bank finance. AFP's portfolio managers (led by Mr King) agreed to the Guernsey Cells investing in principle.

30 4. On 23 August 2007 AFP took oral advice from Mr Richard Symington of Methuen Consulting on how to manage conflicts of interest between AT1 (in which AFP's shareholders have an interest) and other funds that AFP manages. The advice is recorded in a note prepared by Mr Farrell and Mr Addison. The note records Mr Symington as advising that the other funds need not decline to invest simply because 35 AT1 was a beneficiary of the transaction in question but that "the reasons for undertaking a transaction via AT should be documented, so there is a clear paper trail for the dealing of the conflict in a fair manner".

5. As we find in paragraph 78 of this decision above, by the second half of 2007 the "storm clouds" of the financial crisis were building. By 24 October 2007 Mr Farrell 40 had been informed that the bank finance had fallen through. Mr Farrell notes in an email to Mr Barkman on that date that "you are now asking us to do the entire deal in

name" and that to do so "has required a lot of juggling to say the least". There is no contemporaneous documentary evidence produced by AFP supporting the decision for the Guernsey Cells to fill the entire funding gap. Mr Farrell's evidence is that it was discussed by relevant members of the Investment Committee and approved by the relevant portfolio managers, Mr Smith and Mr King.

6. On 29 October 2007 the transaction was completed and the payments referred to in paragraph 1(3) above were made.

7. No contemporaneous record of conflict considerations was made. Mr Farrell's note prepared in January 2010 headed "Conflict Management Summary Analysis" refers to the transaction as being one where AT1 would invest at a "fair value of £21 million and that any difference between that valuation and the eventual purchase price of the Clubeasy Group would accrue to the relevant Guernsey Cells (below £15 million) and to the originators of the transaction (down to £15 million only)".This note concealed the fact that of the £21 million invested £6 million was used to pay the fess paid to AFP and Mr Barkman and that Mr Farrell was a member of the Board of Lonscale which approved the fees as described in paragraph 1 (3) above.

Part 4-Details of the Nice Transaction

1. Mr Farrell led the negotiations for the arrangements with Nice, attending the initial meeting on 7 July 2007 with the Nice directors and putting forward proposals for AGL's and the Guernsey Cells' investment. Completion of the transaction took place on 21 September 2007.

2. For the purpose of the equity transactions referred to in the Property Advisory Agreement, Nice Group Limited was valued at £25 million and the associated limited liability partnership at £5 million, which meant for the purposes of the share swap between AGL and Nice AGL was valued at £50 million.

3. The exercise price for the warrants issued to AIN for £1 was the same as the cash price paid by the Guernsey Cells (RE1 and RE2) for the shares in Nice they subscribed for, namely £237.49 per share. The warrants were exercisable at any time, but it was understood that they would be exercised within one year of their issue.

4. The Property Advisory Agreement contained an equity "ratchet" which entitled both AGL and the Guernsey Cells to the same pro-rata increase in equity if Nice's profit forecasts were not met.

5. Clause 1 of the Property Advisory Agreement, which although not expressed as such was drafted more in the style of recitals rather than operative provisions, provided in Clause 1.8 that "Arch UK" (the defined term for AGL in the Agreement) and Nice would share equally the gross investment management fees attributable to properties purchased by the Guernsey Cells through introductions from Nice, such properties also being the subject of the provision of management services by Nice under the terms of the Property Advisory Agreement. This provision appears to be inconsistent with Clause 13.2 of the Agreement which provides that all net investment

management fees shall be shared equally between "Arch" (the defined term for the investing Guernsey Cells) and Nice Group Limited.

6. The Property Advisory Agreement made provision for AGL shareholders to provide the shares for the share swap. Mr Farrell's witness statement originally stated that "AGL shareholders invested by way of a share swap, swapping 2% of their shares in AGL for a 5% stake in Nice Group." He corrected this statement at the outset of his oral evidence, which was not challenged, to say AGL invested by way of the share swap, not its shareholders. This appears to be correct in that AGL acquired the investment in Nice, but it left unclear the question as to whether AGL provided newly issued shares in return for the Nice shares or whether they were provided in accordance with Clause 1.4 of the Property Advisory Agreement which stated that "Arch UK shareholders will give 2% of Arch UK's issued shares …and Nice will in consideration give Arch UK 5% of the issued shares of Nice…". Although the Board minutes of AGL for the meeting held on 21 September 2007 records that AGL (not its shareholders) would give 2% of its share capital we have seen no evidence of any new share issue by AGL at this time. We therefore assume that the shares were provided as set out in the Property Advisory Agreement. It is not clear who provided the shares, but in the context of certain Nice Directors wishing to acquire AGL shares, Mr Addison sent an email to individual shareholders of AGL on 27 September 2007 asking them if they were interested in selling any of their shareholding. There is also a Conflicts of Interest Note dated the same day in which Mr Derks, Mr Smith and Mr King record a decision that the Guernsey Cells would not sell any of their shares but that Mr Farrell would make up any shortfall required by potential purchasers. Mr Derks' evidence, which was not challenged on this point, was that Mr Farrell, his wife and Mr Kateb provided the shares necessary to meet the purchases and we therefore think it likely that they provided the shares required under the Property Advisory Agreement as well, and we so find.

7. There is no evidence of a formal Investment Committee decision to enter into the arrangements with Nice in 2007 and we have no evidence of any written ICP being presented to the Investment Committee setting out the rationale for the investment, or identifying any conflicts involved and how they are to be managed.

8. An ICP was, however, prepared on 26 February 2008 in the context of the proposal that one of the Guernsey Cells (PF3) provide a working capital facility of £1,515,000 to Nice for a term of one year at an interest rate of 12.50% per annum. The ICP records that the transaction fitted PF3's objective of investing in asset backed lending and presented an acceptable coupon and significant security support in the form of personal guarantees and a charge over Nice's AGL shares. It also discussed the cash flow risk; Nice's Strategic Financial Review of 17 January 2008 noted a deterioration in cash flow since November 2007 and a potential cashflow shortfall by March 2008. The ICP records that Mr Farrell abstained from voting because of his recent appointment as a director of Nice. He had been appointed chairman of the Nice Board on 18 February 2008. The ICP mentions nothing about conflicts.

9. On 10 April 2008 the equity ratchet was operated. Both AGL and the Guernsey Cells received pro rata increases in the equity and profit shares of the relevant Nice

entities and the strike price of the equity warrants was reduced to 57.14% of the original price.

10. On 22 April 2008 Mr Farrell, in an email to Mr Smith, suggests the sale of the warrants to the Guernsey Cells at a price of £100,000 which on exercise would give the Guernsey Cells a profit of £360,000, which Mr Farrell observed "amply deals with any conflicts".

11. On 23 April 2008 an ICP was prepared regarding the warrant purchase. It had now been agreed that the warrants would be acquired by the two Guernsey Cells, RE1 and RE2, each paying £25,000. The ICP recorded that the trade presented a conflict with AGL as the seller of the warrants but that "Price at which AGL offered the warrants is clearly favourable …netting £96.8k P&L gain on £25k outlay." No further justification was given for the valuation placed by Mr Farrell on the warrants. The warrants were exercised immediately after acquisition by the two Guernsey Cells for a total subscription price of £714,286. We have seen no explanation as to why it was considered in the interests of the Guernsey Cells that the warrants be exercised immediately.

12. On 2 September 2008 AFP prepared a note headed "Review of Activist Positions and Related Conflicts of Interest". This note includes a table recording particular transactions, including the initial investment in Nice and the subsequent loan facility. No mention is made of the warrant transaction or the fees payable under the Property Advisory Agreement. It records two conflicts, the first being AGL investing in equity alongside the Guernsey Cells and the Guernsey Cells investing in a related party, namely the investment adviser to the property holding SPVs in which some Guernsey Cells invest. It describes the conflict rating as "low". The second conflict is described as Nice and its principals investing in AGL equity which is rated "medium". The note states that the first conflict was mitigated by AGL and the Guernsey Cells dealing on the same terms and that the second conflict required "enhanced conflict treatment" and that the investments were to be held for the long term.

13. On 15 September 2008 Mr Farrell and Mr Smith held a meeting with Mr Symington of Methuen Consulting at which advice was sought on AFP's management process for conflicts of interest that may arise on investments made by funds AFP manages and where other Arch entities or associated individuals make investments in the same or similar securities. A note of that meeting records that Mr Symington advised that investment decisions must be taken independently by the portfolio managers without any real or perceived pressure to invest from Arch management. He emphasised the need for potential conflicts to be formally documented and managed to ensure that they are appropriately handled and is recorded as confirming that adherence to a clear policy of independence, documentation of potential conflicts, and ensuring that fund investors would not be disadvantaged by the presence of Arch as a co-investor, would together be sufficient to mitigate the potential conflicts of interest posed.

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14. In November 2008, in the light of the market difficulties then prevailing following the collapse of Lehman Brothers, Nice requested short term funding . On 18 November 2008 Mr Radford, Mr Meader and Mr Addison as the Board of a Guernsey Cell not previously exposed to Nice (RE3) approved the granting of two loan facilities to Nice for working capital purposes, one for £250,000 and another for £850,000. The first facility was granted on 20 November 2008 for a period of three years at an interest rate of 12.5% per annum and was secured by a charge over shares in AGL and a houseboat. Also in November 2008 the equity ratchet operated again due to a failure to meet targets taking the equity interests of the two Guernsey Cells in Nice to 33% each.

15. On 24 December 2008 RE3 granted the second facility, repayable after 60 days and carrying interest at 15% per annum. Again, the facility was secured by a charge over AGL shares and a houseboat.RE3 received no shares or equity warrants.

16. On 29 December 2008 an ICP was prepared in respect of the second loan facility. The ICP recorded that Nice was starved of capital and cash and had been making losses of over £100,000 a month for a significant time period. It highlighted that there was a risk that a restructuring plan designed to enable Nice to break even by 2009 was not based on reliable financial information and that without a key property management contract the business was not viable. The investment rationale was expressed as being to protect the current investments made by the two Guernsey Cells, which did not participate in any of the lending rounds.

17. On 13 February 2009 AGL transferred its interest in Nice to the Guernsey Cells for nil consideration in recognition, as recorded in a file note, of the conflict of interest posed by AGL continuing to hold this position.

18. On 23 February 2009 a Conflicts of Interest File Note was created which recorded the various elements of the transaction. The Note records, that in dealing with Nice, decisions have been consistently made to ensure the Guernsey Cells have never been disadvantaged (and have on occasion been advantaged) in respect of AGL's participation in the investment.

18. Nice went into administration on 9 March 2009.