

Investment Management Alert

February 27, 2015

UK Financial Conduct Authority Issues Significant Financial Penalty in Respect of Management of Conflicts of Interest by Asset Manager

Summary

This alert sets out details of a recently published final notice issued by the UK Financial Conduct Authority (FCA) regarding the management of conflicts of interest within UK-licensed investment managers. This alert is likely to be of particular interest to both UK-headquartered investment managers and non-UK-headquartered investment managers with material investment management operations in the United Kingdom.

Outline of Final Notice

On 24 February 2015, the FCA published a final notice, bringing to a conclusion enforcement actions undertaken recently against a significant UK-based institutional asset manager (the “Manager”). The text of the final notice can be accessed [here](#).

The enforcement actions undertaken by the FCA relate to issues identified as a result of the Manager arranging the management of client portfolios on what is referred to as a “side-by-side” basis. These are arrangements where portfolio management teams are given responsibility for managing multiple client portfolios simultaneously. The various client portfolios being managed on a side-by-side basis were subject to differing management and performance fee arrangements, such that certain of the portfolios had the capacity to generate greater management and performance fee revenue for the Manager.

These circumstances created the potential for conflicts of interest to arise, where portfolio management teams within the Manager could be incentivised to allocate transactions undertaken between the client portfolios in a manner that favoured those portfolios generating higher levels of management and performance fees for the Manager. The investigations and enforcement actions undertaken by the FCA determined that the Manager had failed to manage these conflicts of interest adequately. In particular, the FCA determined that the Manager adopted a deficient control environment for management of the conflicts of interest and that portfolio managers had, as a consequence, been able to engage in a practice referred to as “cherry picking”. This is the practice of allocating successful transactions to client portfolios generating greater management and performance fee revenues at the expense of the interests of other client portfolios.

The FCA’s final notice concludes that these failures on the part of the Manager amount to breaches of the FCA’s Principle 3 (“A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.”) and Principle 8 (“A firm must manage conflicts of interest fairly, both between itself and its customers and between the customer and another client.”). In

addition, the final notice concludes that the Manager has also breached a number of rules relating to the management of conflicts of interest set out in the FCA's *Conduct of Business Sourcebook* (COBS).

In respect of these breaches, the FCA has imposed a financial penalty on the Manager of £17,607,000.

Issues of Note

The FCA's final notice restates the significant regulatory focus being brought to bear on the question of conflicts of interest in the asset management sector. The broad issue of conflicts of interest has been repeatedly identified as a regulatory priority for the FCA. The significant level of the financial penalty imposed on the Manager demonstrates the FCA's commitment to enforcing rigorous standards of conduct in respect of the prevention and management of conflicts of interest.

The final notice sets out in unequivocal terms the FCA's expectations in respect of the policies and procedures to be adopted by asset managers who run portfolios on a side-by-side basis. These expectations are particularly relevant to hedge fund managers who are increasingly running a number of parallel portfolios, implementing substantially similar investment strategies. It is also relevant to those managers who have expanded their product lines to include regulated European UCITS products or regulated US mutual fund products, where the regulated product will often generate fee income at a much lower level than unregulated funds also being managed by the portfolio management team.

It is important for managers intending to operate portfolios on a side-by-side basis to ensure that they have in place adequate systems and controls to prevent the adoption of practices that could crystallise potential conflicts of interest. This is significant in respect of the allocation policies to be adopted by managers and the ongoing compliance monitoring processes seeking to ensure the effectiveness of these policies and procedures.

There are a number of actions that we would recommend relevant managers undertaking in light of the content of the final notice:

- Managers should review their policies and procedures in respect of the management of conflicts of interest to ensure that they are consistent with the expectations of the FCA set out in the final notice.
- To the extent that the manager does not currently undertake any program of review of the allocation of transactions amongst client portfolios, we would recommend that the manager institute such a program as part of its ongoing compliance monitoring process.
- Managers should consider internal management information and reporting generated in respect of questions of conflicts of interest and allocations. Adjustments should be made where necessary to ensure that the firm's senior management is aware of and apprised on an ongoing basis of the effectiveness of the policies and procedures.
- Managers should consider implementing a programme of internal training regarding the identification and prevention of conflicts of interest, with a view to ensuring that the firm's culture is appropriately attenuated to these issues.

It is also notable that the US Securities Exchange Commission (SEC) requires registered investment advisers to disclose the management of conflicts relating to differing fee types in public regulatory filings. Those firms that are regulated by the FCA and registered with the SEC should consider the extent to which policies and procedures adopted for the purposes of addressing the concerns of either regulatory authority individually are adequate for ensuring compliance with the other authority.

Contact Information

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