CLIENT BRIEFING

REGULATORY HEAT FORCES TOUGH DECISIONS FOR FAMILY OFFICES IN 2012 (PART 3)

By Rosalyn Breedy

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Rosalyn Breedy, of Breedy Henderson Solicitors, continues her survey of the regulatory landscape for family offices and explains why they urgently need to make a decision about whether or not they wish to manage third party money.

In the first of this three-part series, Rosalyn Breedy examined the Dodd-Frank reforms and the AIFMD. In part 2, she outlined the implications of the regulations on family offices and in Part 3, she considers whether private investors will be better protected under the new regime.

Market stability

The good news for investors is that the global post-2008 regulatory focus on increased capital adequacy and liquidity, risk management, market abuse, financial crime and consumer protection should mean that the previous macro instability of the global financial system should be better managed in the foreseeable future.

This does not mean that there will never be severe shocks, failures of financial institution or mis-sold products. But, hopefully, by seeking to remove the extra-ordinary levels of leverage from the system and engaging with effective risk management the overall system risk is lowered.

A number of issues still need to be worked on by the regulators, including resolution of the Eurozone crisis; the negotiation of orderly resolution and wind down procedures across jurisdictions for failing financial institutions; recognition and effective protection of client accounts.

Better enforcement

Fortunately for investors, is that it is becoming increasingly evident that the interests of all investors not just retail investors are moving up the agenda of regulators and the courts.

Post financial crisis, the UK Financial Services Authority put in place a ‘credible deterrence’ strategy which is a deliberate strengthening of its enforcement function to achieve better outcomes for consumers across markets. The strategy involves the use of higher penalties, bringing criminal prosecutions, focusing on the responsibilities of individuals especially holders of significant influence functions. In the area of consumer protection, the FSA is holding firms to account for misconduct and requiring them to make good on the losses they cause consumers.

Since 2007 the FSA has issued fines in excess of £150 million and prohibited 200 individuals from the financial services industry. In the six months prior to their September 2011 paper, enforcement action secured redress which is expected to be in excess of £150 million and ten criminal convictions for insider dealing have been obtained, with sentences of up to three years and four months.

The Nera Economic Consulting Trends Survey on regulatory enforcement in UK financial markets, published in July 2011, notes “with the exception of insider dealing, enforcement seems to have shifted from violations of market integrity (a classification we use for behaviour

that distorts or otherwise negatively affects financial markets, as described below) and towards actions aimed at consumer protection."

By way of example, the new hard-hitting approach taken by the UK regulator was demonstrated following the fall of Mercurius Capital Management Ltd, a UK FSA authorised entity that managed Mercurius International Fund Ltd, a Cayman Islands hedge fund.

During the relevant period from July 2006 to January 2008, Mercurius had about 20 investors who had collectively invested approximately EUR 35 million. The fund was placed in voluntary liquidation on 11 January 2008.

CEO Michiel Visser and Compliance officer Oluwole Fagbulu were prosecuted by the FSA for:

- committing market abuse in the form of market manipulation to bolster the Fund's net asset value;
- repeatedly disregarding the investment restrictions set out in the fund's offering memorandum;
- undertaking fictitious transactions designed to give an inflated and false impression of the value of the fund's assets; and
- repeatedly issuing misleading communications to investors.

Visser's investment decisions were found to have been outside the restrictions under which he was supposed to operate and placed the fund in a precarious position.

This was concealed from investors for over a year and enabled the fund to raise £8mn of new capital in the three months prior to its collapse.

In August 2011, Visser was fined £2 million, the largest ever fine imposed on an individual by the FSA. Fagbulu, was fined £350,000, although this was later reduced to £100,000 on the grounds of financial hardship.

The fines were imposed for breach of Principle 1 of the FSA's statements of principle for approved persons (APER), which requires an approved person to act with integrity, and for market abuse. Both men were also banned from performing any regulated activity in the future.

The tribunal accepted that Fagbulu may not have fully understood the nature of his actions. This was not a defense, nor an excuse. As the designated compliance officer, he failed to perform his duty to ensure that Mercurius complied with the relevant regulatory requirements.

Another relevant case, this time heard by the courts, was that of *Weavering Macro Fixed Income Fund Limited (In Liquidation) vs. Stefan Peterson and Hans Ekstrom*, where the Grand Court of the Cayman Islands handed down a judgment which re-stated the legal duties of directors. The directors of the fund who were found by the court not to have properly carried out their duties were found responsible for wilful neglect and default, and have been ordered to pay an eye-watering sum of US$ 111 million, plus costs.

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Don’t suffer in silence

This hard-hitting approach from the regulators, at least in the UK, seems set to go further by widening the class of consumers protected, conducting thematic reviews and not waiting until a problem has actually blown up.

By the end of this year, the UK will have put in place a new model of regulation ready for 2013:

- The Financial Policy Committee (within the Bank of England), will be responsible for protecting the stability of the financial system as a whole and macro-prudential regulation.
- The Prudential Regulation Authority will be a subsidiary of the Bank of England, supervising deposit-takers, insurers and a small number of significant investment firms.
- The Financial Conduct Authority (FCA) will be responsible for: regulating conduct in retail and wholesale markets, including both exchange operated markets and over- the-counter dealing; supervising the trading infrastructure that supports those markets (apart from clearing and settlement which will be supervised by the Bank of England); and the prudential regulation of firms not regulated by the Prudential Regulation Authority.

The approach paper published by the FCA in September 2011 stated that one of the three operational objectives of the FCA would be to secure an appropriate degree of protection for the consumer. The paper also indicated that there a step change in the intensity of supervision and outcomes delivered.

The definition of ‘consumer’ in the draft legislation is much broader and looks set to include investment funds and investors in hedge funds - potentially affording private wealth investors a greater degree of protection.

Furthermore, paragraph 3.9 of the approach paper also states that “Building on the work of the FSA, the FCA will seek to intervene earlier in retail markets to protect consumers before they suffer direct effects as a result of failures in those markets.”

More recently, Martin Wheatley, the chief executive designate of the new UK Financial Conduct Authority promised, in addition to maintaining a steady stream of enforcement cases to maintain the FSA credible deterrence strategy, that “The watchword for the new institution will be more intensive supervision. We will be looking at things from a consumer perspective, rather than from an industry perspective.”…..“We will work more closely with firms to make sure the products they design go through a real testing process and serve a real purpose. When we start to hear of problems with a product, we will go in much earlier than in the past."

It was reported by Compliance Complete UK and Europe that Ed Harley, FSA Head of Asset Management, at a recent hedge fund conference offered some insight on the future of hedge fund supervision ‘.Warning of intrusive conduct-focussed thematic reviews and prudential focus, Harley told hedge fund managers “to expect us to come and see you.” He said that the FCA would be moving away from relationship management to a more thematic approach which would see them analyse issues in the industry so that they understood business models more accurately. Harley said his department had seen the boundary between the hedge fund industry

and the mainstream asset management industry blurring. Hedge fund specialists were managing UCITS funds, mainstream asset managers with hedge fund characteristics.

The moral of this story for private investors is that, in addition to engaging in their own risk management and usual due diligence, they should not be afraid of engaging with the Financial Conduct Authority earlier if they feel they have not been treated properly.

Beware of structural investor protection issues

Within hedge funds, investors rely upon the independent director for protection. This is because where there is a separation between ownership and control of a company, decision making can be difficult to monitor. How do shareholders know that the managers making the day-to-day decisions are operating to maximise shareholder value? This lack of information is known as the principal-agent problem. The decisions and performances of the agents are difficult to monitor and the incentives of the agent may differ from that of the principal.

In addition, many private investors actually hold their shares in hedge funds via nominee accounts operated by trust companies. This means that, under many hedge fund articles, the investors who do not have legal title to fund shares are not able to enforce directly their rights as shareholders without the prompt co-operation of their trust company. It may even be difficult to find out who the other shareholders are so as to combine and requisition meetings. This may seem like a small issue but it is actually critical to the effective protection of investors.

This is why the role of the independent director in hedge funds is especially important as a matter of corporate governance.

However, last year a report in the FT showed that there were a number of individuals holding a large number of hedge fund directorships. A bank document reportedly showed that one individual was on more than 560 boards, while analysis of US filings showed several holding over 250 and several others over 100 directorships.

The Cayman funds industry is debating the role of the director and the governance issue currently. It is difficult to prescribe a maximum number of roles for a director, but one cannot help thinking that this issue is one that needs to be addressed immediately and appropriately for investors to continue to support the industry.

Regulators have made great strides in focusing on enforcement, requiring robust business models and on addressing the issues of transparency and disclosure which have all helped to protect the private investor. Some investors have also worked hard to address information asymmetries and negotiate fees and key contract terms which seek to align the interests of the investor and the fund manager. However, the issue of effective corporate governance for hedge funds still needs to be addressed for the industry to flourish further.

Paul Woolley, professor of the London School of Economics and a former fund manager, raised the issue in the FT recently when he said that even if all the "smart money has the information, the interests of market participants often conflict".

Conclusion

On one hand the accelerated pace and approach of regulation has affected private investors decision making can be difficult to monitor. How do shareholders know that the managers adequacy reserves and compliance costs. But, this has to be balanced by the fact that great steps have been made to enhance the stability of the macro financial system and a greater recognition of the rights of the private investor. This all serves to build confidence in the industry which, according to Rosalyn Breedy, can only be a good thing.

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