

FCA Imposes £17.6 Million Fine on Investment Adviser for Mismanagement of Conflicts of Interest

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On February 24, 2015, the UK Financial Conduct Authority (FCA) imposed a £17.6 million fine on a UK institutional investment adviser (UK Adviser) for failing to fairly manage conflicts of interest among the UK Adviser's side-by-side managed funds. This enforcement action highlights the FCA's increasing focus on the handling of conflicts of interest by investment advisers.

Summary

According to the FCA's [final notice](#), the UK Adviser employed a side-by-side management strategy from 2005 to 2013 whereby funds that paid differing levels of performance fees were managed by the same trading desk. This compensation structure created an incentive for the trading desk to favor funds with higher performance fees through a practice of "cherry picking." While the UK Adviser had a general policy of requiring trades to be allocated in a timely manner, weaknesses in the UK Adviser's systems and controls allowed traders to delay the allocation of executed trades for several hours without detection and to assess the performance of the trades before making such allocations. As a result, traders were able to enhance the performance of funds with higher performance fees by allocating favorable trades to these funds and less favorable trades to funds with lower performance fees.

In 2013, the UK Adviser discovered evidence of the improper trade allocations and self-reported its findings to the FCA. It also provided £132 million in compensation to funds that may have been adversely impacted.

Based on the foregoing, the FCA concluded that the UK Adviser had breached Principle 3 and Principle 8 of the FCA's Principles of Businesses, which require an investment adviser to (i) take reasonable care to organize and control its affairs effectively with adequate risk management systems and (ii) manage conflicts of interest fairly between itself and its customers, and between customers and other clients. Among other things, the FCA found that the UK Adviser failed to adopt and implement policies and procedures that address the specific risks associated with side-by-side management. It also found that although the UK Adviser was able to detect certain weaknesses in its systems and controls through internal audits, it did not take sufficient steps to ensure that the weaknesses were remedied. As a penalty for these breaches, the FCA imposed a £17.6 million fine on the UK Adviser.

Implications

This enforcement action signals the importance of a robust control environment with effective policies for managing conflicts of interest and detecting and correcting violations, particularly for investment advisers that manage funds on a side-by-side basis. Investment advisers that are based in the UK or have operations in the UK should review their policies and procedures to establish that they meet the standards set forth in the FCA's final notice as well as its Principles for Business and other related rules. Investment advisers should also be aware that the US Securities and Exchange Commission has sanctioned investment advisers in the past for mismanagement of side-by-side funds and requires that investment advisers disclose side-by-side management arrangements and the associated conflicts in the investment advisers' regulatory filings and client brochures (including in Part 2A of the investment advisers' Form ADV).

If you have any questions regarding the foregoing, please feel free to contact your regular Proskauer lawyer or any of the Proskauer lawyers listed in this alert.

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