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BRIEFING PAPER

Number 6008, 31 January 2014

CF Arch cru investment funds

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Summary

CF Arch cru investment funds were suspended in 2009 by the FSA because of concerns over their liquidity. Subsequent revelations discovered evidence of significant mis selling by IFAs. Using new powers given to it under the *Financial Services Act 2010*, the FSA sought to establish a general consumer redress scheme which was announced in December 2012 by the FSA and which was estimated at almost £32 million in January 2014.

1. CF Arch cru (AC)

1.1 Introduction

The first news of problems with this investment fund came in March 2009 when the managing company – Capita - 'suspended' the Arch Cru funds because, as an FSA spokesman said in a later speech "ultimate underlyings were illiquid assets".[1] Thus, the reason was not obviously fraud or unprofitability but a lack of liquidity which caught the fund out.

Since then however, the story has turned on the question of how AC was marketed and whether its description as a moderate risk fund was truthful. Later allegations of fraud have also been levelled by the Chairman of the holding company, Cru Investment Management, Jon Maguire.

Interestingly, a Sunday Times article written well before the fund was closed, asked various analysts to comment upon the few money funds which had managed to remain profitable amidst the financial crisis. AC was one of the funds and one of the comments was, "It has very good performance, but there's not enough information on what the fund invests in".[2]

Investors, when they discovered the extent of AC's holdings in Greek shipping fleets felt that they had been mis-sold an investment.

1.2 Press comment

Two press articles describe the background to the concerns over the funds and illustrate the complexity over what has happened and the lack of available public detail about it.

Arch Cru boss blames managers of failed funds

Publication date: 7 February 2010

Source: The Observer

THE CHAIRMAN of a £400m investment vehicle suspended by the Financial Services Authority last year has written to the Serious Fraud Office outlining his fear that the investment managers of funds he marketed and promoted may have behaved inappropriately and contributed to the funds' demise.

Jon Maguire, a colourful businessman who is chairman of Cru Investment Management, made the allegations to the SFO four weeks ago. They are vigorously denied by the investment manager, Arch Financial Products, which points out that its offices have not been raided by the SFO and that a series of checks by accountants PricewaterhouseCoopers have found nothing untoward in its behaviour.

1 Speech by Dan Walters 24 March 2009,
2 Sunday Times 3 August 2008

Arch said that the fall in the value of the CF Arch Cru funds was no different to that experienced in wider markets in the wake of the financial crisis. "We defend what we did," Robin Farrell, Arch's managing partner, said. "We had a financial crisis and therefore asset values have fallen across the board. We could not have foreseen the crisis."

Dealings in the Arch Cru funds were suspended in March last year by the funds' administrator, Capita, because of an apparent lack of liquidity - the ease with which the fund manager could sell assets to raise money for investors wanting to cash in their holdings.

Thousands of people have been waiting since then to get their money back. The funds raised just under £400m from small investors, who in December were told that their investments were worth between 20% and 40% less than they had previously believed, despite strong growth in global stock markets.

A revaluation of the funds' holdings by Capita showed that net asset values had fallen by £140m by September compared with March. Capita says it is continuing to investigate whether the previously published net asset values of the underlying assets were "accurately reported" in the period to March 2009.

In a letter to the SFO seen by the Observer, Maguire claims a direct property investment made by Arch ran contrary to its status as a "fund of funds" - an investment vehicle that takes stakes only in other investment vehicles. In addition, Maguire also alleges that Arch made a huge investment with Cru funds in a Greek shipping company. The size of the investment, claims Maguire, ran contrary to what should have been a diversified investment strategy.

Farrell also rejected these allegations. He said that Arch invested in a combination of fund-of-funds and direct investments, and that the exposure to the Greek shipping company was overstated. Also, he said that money was invested in a range of different ships rather than a single entity.

The SFO is not investigating Maguire's concerns but is understood to have suggested that the FSA continue to monitor the situation. An FSA spokesman said: "We have been working very closely with the firm and the regulators. We have been closely involved in this."

As arguments rage over the circumstances of Cru's demise, the thousands of people who invested money in supposedly low- to medium-risk funds may finally get some of their money back in the next three weeks.

After finding that the value of the assets was substantially lower than previously published figures, Capita has applied to the FSA to wind up the funds, and expects to make the first payment to investors before the end of February.

Cru crisis: Arch faces legal challenge over investment activities

Publication date: 5 January 2011

Source: Citywire

Former Arch Cru fund manager Arch Financial Products LLP is facing legal action over its investment management activities, according to its most recent accounts filed with Companies House.

The accounts show that Arch has received one claim to date and has 'been notified of other potential claims from various parties in relation to its prior investment management activities'.

The accounts do not disclose the name of the claimants but Arch said having taken legal advice it 'strongly disagrees with such claims'. It also revealed that it has 'professional indemnity insurance in place'.

Given that Arch has now plunged into loss it may be that the professional indemnity insurance will be the best hope of investors receiving some money back from Arch in the event of any successful claim being sustained.

Arch said it had not made any provision in its financial statements for any liability that may result as a result of the claims .

'The members are of the opinion that, at this stage, the partnership's obligation cannot be measured with sufficient reliability and will only be resolved by the occurrence of one or more uncertain future events not wholly within the partnership's control,' it said.

Arch refused to comment when contacted by New Model Adviser. We understand that the new board of the Channel Islands-listed cells that make up the funds has prepared a multi-million pound legal challenge for compensation over Arch's management of the Arch Cru fund cells.

Arch was replaced as manager of the cells by Spearpoint in 2009, a move accompanied by a change in the board of the cells.

The accounts, drawn up on a 'going concern' basis, suggest that the loss of the Arch Cru management contract led to a plunge in the turnover of Arch. In the year to end February 2009 it had turnover of nearly £21 million and operating profits of £6.5 million. This dropped to just £450,000 and a loss of £3.8 million the following year.

The accounts stated: 'During the year the LLP had its permissions amended and on 1 December 2009 the investment management mandate was transferred to an unrelated third-party. The change in business activities from this date has materially affected the position of the partnership,' it said.

In December Spearpoint launched legal action against Greek shipping firm Nautical Ventures, a major holding of the Arch Cru funds, in a bid to take possession of the company's fleet of ships and recover up to $43.3 million (£27.3 million) owed to the funds.

1.3 FSA Decision Notice

An official description of the collapse can be had in the FSA’s ‘Decision notice’ – its ‘sentence’ on firms investigated. The summary findings are

shown below. The main emphasis is on the lack of liquidity of the fund – consequent to decisions of the fund managers and the existence of extreme conflicts of interest within the fund:

> During the Relevant Period AFP breached Principles 1, 2, 3 and 8 in the conduct of its business as investment manager of two UK funds, the CF Arch cru Investment Funds (the "Investment Funds") and the CF Arch cru Diversified Funds (the "Diversified Funds") (together the "UK Funds") and as investment manager of 22 incorporated cell companies of Arch Guernsey ICC Limited (the "Guernsey cells") into which the UK Funds invested. The UK Funds are FSA authorised OEICs and NURSs. The Guernsey cell companies had three directors, two non-AFP directors and Mr Addison of AFP was the third director.
>
> 2.2. AFP adopted an investment allocation strategy whereby the majority of the UK Funds' scheme property was invested in the Guernsey cells. This strategy was adopted to provide investors in the UK Funds with exposure to private market assets.
>
> 2.3. AFP, as manager of the UK Funds, was required to ensure that the UK Funds' scheme property aimed to provide a prudent spread of risk. However, the investment strategy of allocating the majority of the UK Funds' investments to buy shares in the Guernsey cells had obvious inbuilt liquidity risks which AFP failed properly to manage. The setting up of this structure displayed a lack of due care, skill and diligence particularly in respect of the requirement for a Non-UCITS Retail Scheme ("NURS") to be managed in accordance with the appropriate requirements, notably the requirement for the scheme property of a NURS to aim to provide a prudent spread of risk.
>
> 2.4. The structure set up by AFP gave rise to inherent conflicts of interests and therefore the clear risk of poor and/or unsuitable investment decisions. In particular there was a risk of conflict between the interests of the UK Funds and the Guernsey cells, between the interests of the sub-funds of the UK Funds and between the interests of the Guernsey cells. There was also a significant risk of conflict of interest between AFP and the UK Funds on the one hand, and between AFP and the Guernsey cells on the other.
>
> 2.5. AFP earned structuring and transaction fees for arranging some transactions for the Guernsey cells; it also had its own investments in, or commercial arrangements with, some of the parties involved in the transactions. This created a risk that AFP would structure transactions for the Guernsey cells in such a way as to maximise its own benefit. The risk of such transactions being carried out was exacerbated by the fact that AFP had considerable discretion in its investment management role for both the Guernsey cells and the UK Funds.
>
> 2.6. However, in spite of the significant and apparent conflict risks, AFP did not maintain or operate effective operational, organisational and administrative arrangements to prevent conflicts of interests arising and failed to take reasonable steps to prevent such conflicts giving rise to material risks of damage. AFP had no consistent procedure for conflict management or recording of conflict management.
>
> 2.7. Furthermore, AFP caused the Guernsey cells to enter into four transactions in which AFP and related persons or entities stood to make gains at the expense of the Guernsey cells. AFP recklessly failed to manage the conflicts:

(1) AFP caused the Guernsey cells to purchase shares in AFP's parent company, Arch Group (UK) Limited ("AGL"), at a price determined by one of its directors with no independent verification of the price and inadequate contemporaneous recording of the conflict of interest. While Mr Farrell and Mr Addison of AFP disclosed to the non-AFP directors of the Guernsey cells that AFP was going to direct the Guernsey cells to purchase newly issued shares in AGL to raise new capital for AGL, the non-AFP directors of the Guernsey cells were not informed that Mr Farrell was also going to be selling his personal shares in AGL to the Guernsey cells for a personal capital gain of £492,359. Nor were the non-AFP directors of the Guernsey cells informed as to the price per share at which the Guernsey cells were to be purchasing the shares.

[...]

AFP's investment decision-making structure was also flawed. Before December 2008, when AFP put Chinese walls in place, the same committee was making decisions regarding the management of the UK Funds and the Guernsey cells and the Guernsey cells' underlying investments. Therefore, there was a risk that individuals making decisions at UK Fund level had knowledge of confidential information about the Guernsey cells which other external investors in the Guernsey cells and the market in general did not possess. This was particularly serious given that the Guernsey cells were publicly listed.

2.10. The compliance monitoring undertaken by AFP during the Relevant Period was also inadequate. There was no documented monitoring programme in place and put into practice until November 2008. Compliance monitoring results were not sufficiently recorded and AFP's records did not demonstrate that adequate reporting of such monitoring to senior management took place.[3]

[3] FSA Decision Notice 14 September 2012

2. Investor redress

A significant development took place on 21 June 2011 when the FSA announced the creation of a compensation package for investors. Worth £54 million, the package was voluntarily arranged by Capital Financial Managers (CFM) Ltd, BNY Mellon Trust & Depositary and HSBC bank. The FSA press release is shown in part below:

> Investors will, of course, have a choice whether to accept the offer of payment out of the payment scheme, which has been established by the firms. If they accept, it will be in full and final settlement of any claims or any remedies they may consider they would otherwise have against the firms.
>
> The FSA considers that this package is a fair and reasonable outcome, which is in the best interests of investors. It provides certainty for investors and will accelerate the return of value to investors.
>
> When added to the distributions already paid to investors and the value of the remaining assets of the Arch cru Funds, the payment scheme should mean that investors will receive a total sum which represents a significant proportion of their investment. This is currently estimated to be on average about 70% of the published net asset value of the Arch cru Funds as at the suspension of dealings on 13 March 2009.
>
> The FSA is considering the role of other parties in relation to the Arch cru Funds.
>
> Full details of how the payment scheme will work are being finalised. This includes the FSA discussing the payment scheme with the Financial Ombudsman Service (FOS) with a view to the FOS following the rules of the payment scheme when considering any complaints made by investors to the FOS against the firms in relation to the Arch cru Funds. CFM will be administering the payment scheme and will be contacting those investors who are invested in the Arch cru Funds as at 31 May 2011 with further information before the end of August 2011.[4]

On 31 August 2011, the FSA announced that it had changed the rules regarding compensation and the potential involvement of the Financial Ombudsman. Application for redress from the Financial Ombudsman had been initially rejected on the grounds that this was a class matter – all investors had been treated equally and therefore the issue was not one for the Ombudsman. This position changed when the FSA amended the rules, thus allowing the Ombudsman to align its decision making process with the payment scheme rules. The practical effect of this decision is outlined in a note from the FSA:

> If an investor accepts the offer it will be in full and final settlement of any claims or any remedies they may consider they would otherwise have against CFM, BNYM T&D and/or HSBC, in respect of acts and omissions by the firms which occurred prior to 31 August 2011. We would encourage investors to seek independent financial and/or legal advice before deciding whether to accept payment or not.

[4] FSA press release 21 June 2011

3. If investors do not accept the offer of payment from CFM, BNYM T&D and HSBC, they can pursue their own claims if they wish to do so. For example, they can complain to the Ombudsman service or bring a claim in the courts. If investors want to make a complaint to the Ombudsman service about their investment in the funds against any of the contributing parties, they must do so within six months of the date of the covering letter in the application pack. (This is the usual timeframe under which the Ombudsman service operates once a final response has been received.) However, the Ombudsman service will use the rules of the payment scheme when considering any such complaints, which will ensure a consistent regulatory approach to all investors.

4. Investors still have the right to make claims against other parties. For example, if investors believe that they were mis-sold the funds, they can make a complaint to the firm who advised them to buy the funds. The investors can subsequently refer their complaint to the Ombudsman service if they remain dissatisfied with the firm's response or if the firm does not respond within eight weeks.[5]

The CFM website, is the primary source for individuals to find out about distributions from the fund. Repeating the FSA's press release of 21 June CFM state (author's emphasis):

The FSA will, in due course, be publishing a statement of its findings in relation to CFM's role regarding the Arch Funds. **No financial penalty will be imposed by the FSA on CFM.**

CFM wrote to investors on 21st June 2011 to notify them of the payment scheme and to provide information on other matters in relation to the Arch Funds. A copy of that letter can be found on our website, www.capitafinancial.com, by entering the "Investor Services" section of the website and following the link "Investor Communications" (http://www.capitafinancial.co.uk/Investor-services-Investor-Communications-CF-Arch-Cru-Fund-Suspensions.aspx).[6]

In August, Capita wrote again to investors spelling out the details of the payment scheme. Investors were contacted in October 2011 and given until December 2011 to accept or not the payment scheme. The FSA on its Arch Cru web pages set out investors' options:

5. I am an investor in the CF Arch cru funds – what options do I have in getting my money back?

There are three different options available to investors. These are explained below. Investors should seek independent financial and/or legal advice before deciding whether or not to accept the offer.

Accepting the offer from the Payment Scheme

CFM will be writing to all eligible investors of CF Arch cru funds by 31 October 2011 explaining how much they will be offered under the Payment Scheme. In most cases, investors will then have until 31 December 2012 to accept this offer or not.

If an investor accepts the offer it will be in full and final settlement of any claims they may consider against CFM, BNYM T&D and

[5] FSA Background Note 22nd September 2011
[6] Capita website press release

> HSBC. This means that investors would not be able to pursue claims against these three firms via the courts or the Ombudsman.
>
> Investors who are considering the Payment Scheme offer should be aware that an independent financial adviser, Coull Money Limited has applied to the High Court to legally challenge, via a judicial review, our right to ensure the Ombudsman follows the Payment Scheme. We are challenging this application.
>
> If Coull Money is allowed to challenge our rights and then goes on to win the case, it could impact on how the Payment Scheme works, in particular whether the Ombudsman would have to follow the Payment Scheme for complaints about the three firms contributing to the scheme.
>
> The Ombudsman has to follow the Payment Scheme's rules while the legal proceedings (i.e. the judicial review) happen.
>
> If investors accept the offer, they will be bound by the terms of the offer, whatever the outcome of the claim for judicial review.
>
> Investors who accept the offer will still have the right to make claims against other firms. For example, if investors believe that they were mis-sold the funds, they can make a complaint to the firm who advised them to buy the funds.
>
> Pursuing a claim via the Financial Ombudsman Service or the courts
>
> If investors do not accept the offer of Payment Scheme they can pursue their own claims. For example, they can complain to the Ombudsman or bring a claim in the courts. If investors want to make a complaint to the Ombudsman against any of the contributing firms they must do so within six months of the date of the letter attaching their offer from the Payment Scheme.
>
> While the judicial review legal proceedings happen, investors should be aware that the Ombudsman has to follow the rules of the Payment Scheme for complaints about the three firms contributing to the scheme. However this may change depending on the outcome of the proceedings. We will keep this section of the website updated as events evolve.
>
> Pursuing a claim against other firms
>
> Investors who feel they were mis-sold the funds will still be able to make a complaint to the firm who advised them to buy the funds e.g. their IFA or fund manager. This can occur whether an investor accepts or turns down an offer from the Payment Scheme.[7]

In addition to the payments scheme under new powers given it by the *Financial Services Act 2010*, the FSA sought to establish a general consumer redress scheme. A FSA press release of 30 April 2012 outlined the background to this and the intention to issue consultation on how to proceed:

> On 30 April 2012 the FSA launched a consultation on a consumer redress scheme which has the potential to deliver more than £100 million and put those who invested in the Funds in the position they would have been in if they had received the right advice. The consultation on our proposals will close 31 July.
>
> 4. Evidence gathered by the FSA indicates widespread mis-selling of the Funds. It appears that the main cause of the mis-selling is

[7] FSA website at 20 February 2012

> that IFAs have sold the Funds (which the FSA considers are high risk) to investors who were not willing, or able, to take a high level of risk with their investment (by itself, or as part of a portfolio).
>
> 5. Section 404 (s.404) of the Financial Services and Markets Act 2000 (FSMA) was introduced in 2010 and this would be the first time that the FSA would use it in this way. The power enables the FSA to implement a redress scheme if we believe that a number of tests have been met including:
>
> - if it appears to the FSA that there may have been a widespread or regular failure by firms to comply with requirements; and
> - if it appears that consumers have suffered (or may suffer) loss or damage for which they could seek legal redress; and
> - we consider it desirable to make rules for the purpose of securing that redress is made to consumers (having regard to other ways in which consumers may obtain redress).

The FSA concluded its consultation process and announced the redress scheme in December 2012:

> The Financial Services Authority (FSA) has announced that firms who advised on investments in the CF Arch cru Investment and Diversified Funds must contact all their clients asking if they want their case reviewed to determine whether they were mis-sold the funds and may be eligible for redress.
>
> If clients who invested in Arch cru opt for a case review and receive redress, it will put them back into the position they would have been in had they received suitable advice. This is the first time that the FSA has used its statutory consumer redress power to implement a scheme of this type.
>
> The FSA has concluded that there was evidence of widespread mis-selling by firms who failed to assess the funds as high risk despite the fact that the funds were typically invested in non-mainstream assets such as private equity, private finance and commodities.
>
> The redress scheme launched today means advisers will have to write to all of their clients who invested in the Arch cru funds and ask if they would like to 'opt-in' to have their case reviewed. The original proposal regarding advisers proactively reviewing each sale was modified as a result of the consultation process.
>
> What happens now?
>
> Advisers will have one month from 1 April 2013 in which to contact their clients and the FSA will monitor their progress in implementing the scheme;
>
> The wording of the letters to clients have been mandated by the FSA to ensure they are clear and straightforward;
>
> Investors will only have to fill in a short form to confirm they want their case reviewed;
>
> Advisers will be required to let customers who opt-in know the outcome of their case by 9 December 2013;
>
> The amount of redress will be calculated by reference to what would have been a suitable investment for the individual investor;

> The final amount of redress paid will reflect the current value of the funds and deduct the amount an investor is eligible to claim from the separate £54 million payment scheme;
>
> Investors can apply separately to the payment scheme involving Capita Financial Managers Limited (CFM), BNY Mellon Trust & Depositary (UK) Limited (BNY) and HSBC Bank plc (HSBC), which runs until 31 December 2013.[8]

On 27 January 2014 the FCA made the following further announcement regarding compensation for Arch Cru investors:

> £31m in compensation to be paid out following FCA's Arch cru consumer redress scheme
>
> Compensation has begun to be paid by financial advisers to people who invested in the CF Arch cru Investment and Diversified funds (Arch cru) as a result of unsuitable advice. Over £8.26m has so far been received by consumers.
>
> Total redress due under the scheme is calculated to be £31.47m. In December 2012, it was estimated that the compensation package would deliver between £30m-£40m for affected investors. The money paid out under the scheme, which was overseen by the Financial Conduct Authority (FCA), is in addition to any redress investors may have received under a separate process administered by Capita Financial Managers.
>
> Clive Adamson, director of supervision at the FCA, said of the progress to date:
>
> *"The vast majority of firms have co-operated with us, helping ensure that this compensation scheme has progressed as smoothly as possible. We're now seeing compensation flow to those investors who were mis-sold. We will continue to monitor progress to ensure consumers affected by Arch cru receive redress as quickly as possible."*
>
> Under the consumer redress scheme 3,414 sales have been reviewed by firms and 85.4% of these have been found to be unsuitable. This is consistent with the results of a review undertaken by the FCA before the consumer redress scheme was set-up.
>
> Arch cru funds were high-risk products that typically invested in non-mainstream assets such as private equity and private finance. Advisers should only have recommended the funds to investors who fully understood - and were willing to accept - the risks.
>
> However, the regulator found the funds were unsuitably sold to some investors as low or medium risk products. The FCA, and its predecessor, stepped in to ensure affected investors received redress, in line with its objective to secure an appropriate degree of protection for consumers.
>
> In December 2012, it was predicted that up to 30% of affected investors would sign up to be considered for compensation. In July 2013, 353 firms informed the FCA that they had clients who qualified under the scheme. Letters were then sent every one of the 7,124 affected investors inviting them to opt-in, 47.8% chose to do so (totalling 3,405 investors).[9]

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8 FSA Press Release 17 December 2012

9 FCA Press Release 27 January 2014

BRIEFING PAPER
Number 6008, 8 June 2015

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