

Royal Court gives clear guidance on roles and responsibilities of Designated Managers

Bordeaux Services (Guernsey) Limited (“Bordeaux”) & Ors v The Guernsey Financial Services Commission (“the Commission”), unreported 18/2016

On 11 May 2016 the Royal Court of Guernsey issued its judgment following an appeal by a licensee and individual directors (the **appellants**) in respect of the length of prohibitions and the level of some of the fines imposed on them by the Commission in relation to issues arising from the administration of a Guernsey company connected to the Arch Cru investment fund (the **RC Decision**).

The decisions appealed were originally made by a UK Queens Counsel who had been appointed to carry out the role of Senior Decision Maker (or **SDM**) for the Commission in accordance with the Commission’s decision-making process. The Court made useful findings on how SDMs should come to their findings, and what matters should be set out in their decisions.

The Court also helpfully provided important guidance on the roles and responsibilities of Boards of licensees when carrying out their functions as a Designated Manager and Fund Director.

The Bordeaux directors did not appeal the individual fines imposed, or the public statement issued by the Commission. The Court found that the Commission was justified in imposing a fine on Bordeaux, but remitted the issue of the amount to the SDM for reconsideration and/or clarification as to reasoning. The prohibition orders against each of the directors under the *Protection of Investors (Bailiwick of Guernsey) Law, 1987* (the **POI Law**) and the *Regulation of Fiduciaries, Administration Businesses and Company Directors etc, (Bailiwick of Guernsey) Law, 2002* (the **Fiduciaries Law**) were also upheld, although the length of the prohibition in respect of one of the directors was remitted for reconsideration and/or clarification as to reasoning.

The appeal

Despite accepting that there were failings, the appellants considered that the individual prohibitions were unreasonable, and that the fine against the Bordeaux was excessive. The appellants also alleged that the Commission had failed to demonstrate that their conduct had caused any loss to investors.

The Commission’s case was that it was not necessary to prove a causative loss, because its focus was on the directors’ fitness and propriety with regards to the Regulatory Laws, and whether they had acted with prudence, sound judgment, integrity and skill when performing their functions as a Designated Manager.

Findings

The Deputy Bailiff was not persuaded by the appellants’ Advocate that the SDM had misunderstood the nature of the relationship that Bordeaux (as administrator of the Fund) held with Arch Financial Products LLP (**Arch FP**) (the Investment Manager for the Fund).

Conflicts of interest

One of the core issues identified by the Commission was the way in which the appellants managed conflicts of interest that arose, especially where two of the directors of Bordeaux also sat on the board of the Fund. The SDM recognised “that investors and potential investors were aware that investments might be made in circumstances in which there was a conflict of interest”; however he went on to say: “there is no evidence that the Bordeaux Directors ever managed a conflict of interest and within the Fund structure, Bordeaux was the only independent entity in a position to fulfil the role”.¹ The Deputy Bailiff



Guernsey Financial
Services Commission

This decision of the Royal Court confirms the Commission’s view that merely adhering to the contractual relationship and scheme particulars is not necessarily enough for a Designated Manager to be properly carrying out their functions.

Proper policies and procedures must be in place to ensure accurate record-keeping and appropriate oversight. Conflicts of interest must be avoided and due diligence, professional skill, sound judgment and prudence must all be exercised by a licensee and its directors.

Failure to meet these standards will result in non-fulfilment of the applicable minimum criteria for licensing (MCL) so that the “fit and proper person” test is not satisfied. Where there are numerous instances of non-fulfilment of the MCL this may justify a prohibition order being imposed.

observed that any failure to manage conflicts of interest that were acknowledged as being likely to exist is going to result in a finding of non-fulfilment of the minimum criteria for

¹ Para 42, RC Decision.

licensing (the **MCL**). He went further to note that multiple failings are likely to be regarded as making the non-fulfilment worse, and could not disagree with the SDM's conclusion that there had been "*serious failings*" in relation to the failure to manage conflicts of interest.

Failures to notify NAVs

Similarly, the Deputy Bailiff found that the late notifications of NAVs to the Channel Islands Stock Exchange were relevant to the Commission's assessment of whether the MCL was fulfilled. The RC Decision adopts the SDM's statement that "*the delays appear to be in part attributable in failures on the part of Bordeaux to organise its business with the appropriate degree of diligence and professionalism in breach of POI Schedule 4 para 1(1)(b) and para 2(1)(a) and (b) and the Fiduciaries Law Schedule 1 para 1(1)(a) and (b)*."² It was recognised that these failings would not of themselves merit the making of prohibition orders, however they could be taken into account when considering all of the failings against the MCL.

Oversight by the Administrator

The SDM had concluded that "*Bordeaux was totally reliant on the Investment Manager to provide such [NAV] valuations*". The appellants claimed that there was no evidence that the valuation method used by Arch FP was incorrect, and challenged the SDM's finding that "*Bordeaux should have taken steps to understand the methodology employed and put in place a procedure to check on the valuations produced by Arch FP*".³

Further findings of the SDM in respect of oversight failings are referred to in the RC Decision; for example the shipping notes, where the stance taken by the Bordeaux Directors "*was completely unquestioning*" and the undue reliance on Arch FP in respect of pricing information and a failure to question the rationale for significant variances in the value of the shares.

The Deputy Bailiff accepted that Bordeaux was permitted by its

relationship with Arch FP to delegate, and that the Bordeaux directors were not expected to have any investment expertise. However, the Court considered that on the facts the SDM was entitled to conclude that the absence of appropriate oversight had been demonstrated, and that "[t]hese failures involves a failure to act with competence and soundness of judgment, with diligence and prudence and with appropriate professional skill: POI Schedule 4 para 1(1)(a), (b) and para 2(1)(a) and (b) and Fiduciaries Law Schedule 1 para 1(1)(a) and (b) and para 3(2)(a) and (b)".⁴ The Deputy Bailiff concluded that it was the number of failings that gave rise to the overall impression that the Bordeaux directors were not to be regarded as fit and proper persons. The Deputy Bailiff rejected an argument that the SDM had disregarded the contractual position, and held that the SDM was correctly referring to the non-fulfilment by the Bordeaux Directors of their statutory obligations.

Compliance with the scheme particulars

The Court dismissed an argument that the appellants could not be criticised for failing to monitor whether investments complied with the scheme particulars unless there was evidence that investments were actually made outside the scheme documents. In the Deputy Bailiff's opinion the SDM's finding that "*the failure to monitor whether investments complied with the Scheme Particulars manifested lack of a competence and soundness of judgment, diligence, prudence and appropriate skill*" refers directly to the requirements of the MCL.⁵

The Court was also satisfied that the SDM was entitled to take into account instances of funds being released without sufficient scrutiny when assessing compliance with the MCL. The Deputy Bailiff found that the SDM could not be criticised for concluding that it was "*apparent that Bordeaux did not have adequate procedures in place relating to the making of payments. These functions were not adequately understood by staff resulting in a gap surrounding the review of payments*

contributing to a failure to ensure compliance with the Fund's documentation and to protect the interests of investors."⁶

In dealing with the Fund's investment in ships and whether they were a sustainable opportunity (as required by the scheme particulars) the Court stressed that the issue was not whether or not the shipping investments were a sustainable opportunity, but whether or not the administrator had given sufficient thought to the question. The Court was satisfied that the SDM was able to find that "*[t]he requirements of the Scheme Particulars and investors' best interests were not considered by Bordeaux. The impact of these failings were serious and greater scrutiny and due diligence on payments may have saved the investors from some of the losses they incurred.*"⁷

Record-keeping and documentation

The SDM had found that "*Bordeaux's level of control over the role of the Investment Manager was significantly reduced by not maintaining or having sight of original documentation.*" He also found that transaction documents were missing for up to a year and a half and "[w]hilst, at all material times Bordeaux was aware of the transactions being entered into on behalf of the ICs, albeit after the event, the structure of these transactions and the fees being taken by Arch FP, any enquiry by Bordeaux was limited and insufficient. Bordeaux should have ensured that procedures were in place to prevent the fees being charged or paid as opposed to having to recover the fees after they had been paid".

The Deputy Bailiff considered that these failings were not "serious", but rather "ordinary". On this basis the SDM was entitled to conclude that missing documentation was symptomatic of an absence of proper internal organisation. In the Deputy Bailiff's view the "*level of oversight, and so control, was reduced below what it would have been had more stringent steps been taken by Bordeaux. This all forms part of a pattern of the level of scrutiny of what was taking*

² Para 44, RC Decision.

³ Para 45, RC Decision.

⁴ Paras 46-47, RC Decision.

⁵ Para 48, RC Decision.

⁶ Para 49, RC Decision.

⁷ Paras 50-51, RC Decision.

place by the Bordeaux Directors being inadequate”.⁸

The RC Decision acknowledges that it is common practice to use templates and draft board minutes; and the Commission should take account of this reality. However, in this case there was evidence that some meetings were apparently minuted by a person not actually in attendance. In those circumstances the Deputy Bailiff considered that the SDM was justified in concluding that “*the records of the company would not have been accurate and represented a misleading record of affairs*” with the result that “[t]he conduct of the Board of Bordeaux demonstrates a failure to understand the requirement to keep full, proper and not misleading records in respect of the controlled investment business undertaken.”⁹

Compliance procedures and training

The SDM had been critical about the absence of periodic reviews of Bordeaux’s written procedures, and its client take-on procedures. These findings were not challenged on appeal, but the Deputy Bailiff observed that these findings were also relevant to a consideration of the non-fulfilment of the MCL. The RC Decision reproduces the SDM’s feeling that “[a]lthough Arch FP was authorised and regulated by the FSA, Bordeaux should have taken appropriate steps to monitor Arch FP, particularly as they were a new client to Bordeaux and Arch FP had not previously managed a Guernsey closed-ended fund before. Bordeaux should have ensured that appropriate client take-on procedures were in place to identify potential risks with new business. Failure to do so was (amongst other matters) a failure to fulfil the Fiduciary Law Schedule 1 para 3(2)(f). It also showed a failure to act with the appropriate level of skill and competence, and diligence.”¹⁰

The Court was also of the view that two failings relating to training (no relevant or effective sanctions training, and a failure to ensure staff were trained adequately or experienced enough) were also relevant to the consideration of the MCL.

Effect of the failings

The Court rejected an argument from the appellants that it was necessary for there to be evidence of a causal link to loss by investors.

Ultimately the Deputy Bailiff concluded that each of the various failings identified in the SDM’s decision were all properly matters to be taken into account by him in considering compliance with the MCL.¹¹ The question the Deputy Bailiff then had to answer was whether the failings justified the sanctions imposed, and whether the case had been made out under each of the applicable Regulatory Laws.

The appellants argued that no prohibition orders should have been made in the absence of a finding of dishonesty or serious lack of competence impacting on a person’s integrity. This view was rejected by the Court, which held that prohibition orders “*can be imposed where the combination of the failings identified leads to a risk to the public*”¹².

In this case the RC Decision records that the numerous references to non-fulfilment of the applicable MCL opened the door for the imposition of prohibition orders under the POI Law and the Fiduciaries Law.

Prohibitions against the directors under the *Banking Supervision (Bailiwick of Guernsey) Law, 1994*, the *Insurance Business (Bailiwick of Guernsey) Law, 2002* and the *Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law, 2002* were set aside on the basis that the foundation for these decisions had not been set out adequately in the SDM’s statement of reasons. The Court did, however, expressly acknowledge that the Commission could form the view that the failings found affected the directors’ fitness and propriety under these laws, and choose to commence additional enforcement actions.

⁸ Para 53, RC Decision.

⁹ Para 55, RC Decision.

¹⁰ Para 56, RC Decision.

¹¹ Para 58, RC Decision.

¹² Para 64, RC Decision.