

FCA enforcement action: asset manager receives a public censure, but no UK fine

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On 2 August 2024, the Financial Conduct Authority (the "FCA") issued a final notice to H2O AM LLP ("H2O"), in which it imposed a public censure for a series of regulatory failings in relation to certain investments that funds under H2O's management had made between 2015 and 2019.

Significantly, in this case, the FCA decided not to impose a financial penalty on H2O in the UK. H2O had taken a series of remedial actions following emergence of the issues, including conducting a culture review, amending senior management roles and responsibilities, implementing improvements to its governance, systems and controls (particularly around due diligence in selecting and managing investments), committing funds to compensate certain affected investors, agreeing to waive certain fees for affected investors, and agreeing no longer to conduct regulated activities in the UK within a defined time frame. Among other matters, the case shows the impact that pro-active remediation of those affected by regulatory issues may have on the overall outcome of FCA enforcement action.

Background

The factual background to the matter as found by the FCA was relatively complex. By way of a high level summary, between 2015 and 2019, H2O arranged for a series of funds under its management to make a series of investments into entities controlled or introduced by an individual who was linked to H2O's CEO. H2O argued that these had been made as part of a 'core plus' strategy for the relevant funds, pursuant to which a small proportion of their assets was invested in higher risk investments expected to pay a higher return. The FCA found, however, that H2O's approach to the private debt element of these funds was 'unusual', as it ultimately focused on investing almost exclusively in companies controlled or introduced by one individual.

In 2019, press coverage about the exposure of the relevant funds to these investments prompted significant investor redemptions. The FCA required H2O to commission a Skilled Person's review and report on a number of issues, including the effectiveness of its due diligence process and management of conflicts of interests in relation to some of the investments. In August 2020, following valuation uncertainties, the French financial services regulator (Autorité des Marchés Financiers, ("AMF")) required H2O to suspend subscriptions and redemptions for three of the funds, citing significant exposures to the

investments in question. H2O voluntarily suspended subscriptions and redemptions for four additional funds. The FCA in the UK, and the AMF in France, started to investigate.

The FCA's findings

In its final notice, the FCA found that H2O had committed a number of breaches of UK financial services regulation, including FCA Principle 2, parts of COLL (the FCA Sourcebook on Collective Investment Schemes, which sets out duties of authorised fund managers in relation to UCITS), FCA Principle 3 and FCA Principle 11.

The FCA's review of the approach, governance and controls that H2O had in place, versus regulatory expectations (starting at para 4.19 of the final notice) may be of interest to UK-regulated asset managers reviewing their own approaches. In summary, the FCA found that H2O had:

- put in place high level procedures with respect to due diligence, but failed to follow them, or meet the standards of due diligence to be expected of an authorised fund manager in the circumstances;
- failed to obtain sufficient (or in some cases any) due diligence information to enable it to evaluate adequately the merits, risks and valuations of the relevant investments, or to support decisions to enter into the relevant investments, or to enable it effectively to assess (and manage) ongoing merits, valuations and risks in them;
- failed to carry out ongoing due diligence on the relevant investments, prior to press coverage in 2019.

Ultimately, in the FCA's view, these failures meant that the relevant funds managed by H2O had entered into investments which were higher-risk, predominantly unlisted and less liquid than other investments, without having appropriately considered their merits and risks, and often without having a reasonable basis for establishing their values.

With respect to governance, systems and controls, the FCA found that H2O had:

- failed to implement the kinds of policies and other systems and controls that would have led to an appropriate level of due diligence being conducted at each stage;
- failed to ensure that its policies relating to gifts, hospitality, record keeping and conflicts of interest were complied with (the FCA found in particular that some H2O staff had received hospitality beyond de minimis value without records being kept in all cases);
- failed to institute and / or maintain appropriate governance arrangements to review and scrutinise investment decisions; in particular in the FCA's view, H2O's Risk and Compliance functions did not have adequate oversight of or engage in effective challenge or monitoring of the investment decision-making process; and
- provided some documents and information to the FCA (as it exercised its supervisory and enforcement functions) that were false and / or misleading.

Two key points of interest in the FCA's approach

Practitioners and firms may find two points in the FCA's approach to be of particular interest.

First, there was some cross-border difference in approach by different regulators. In particular, the UK FCA and French AMF approached the issue of sanction differently. The AMF in France imposed a fine on

H2O in 2023, whereas the FCA did not (but recognised in its reasoning the fine that the AMF had already imposed in relation to materially the same conduct).

Secondly, the FCA's reasoning with respect to the penalty is interesting, as it indicates the role that a firm's pro-active remediation of those affected by regulatory breaches can play in arguments over sanction during the enforcement process. The FCA has in the past (for example in [a speech in June 2023](#)) drawn attention to the effect that firms' pro-active provision of remediation and redress may have on its approach. In this case, while the FCA found that H2O's breaches were 'extremely serious', it also found that its objectives could be appropriately achieved by means of a public censure instead of a fine.

Among the key factors in the FCA's decision were the potential effect of a further fine on sums available to compensate affected investors and (see section 6 of the final notice) the fact that H2O had:

- voluntarily secured €250m to be applied for the purpose of compensating certain affected investors;
- formally waived its right to fees and investments totalling €320m for the benefit of certain affected investors;
- committed to applying any value realised from relevant assets to pay certain affected investors; and
- agreed voluntarily to apply to cancel its UK regulatory permissions and cease to conduct regulated activities in the UK within a defined timeline.

The FCA also took into account H2O's financial resources, and the existence of a significant penalty imposed in France by the AMF in respect of alleged misconduct relating to the same investments (albeit that was subject to appeal).

Next steps

AG regularly advises a wide range of financial services firms on regulatory interactions and enforcement investigations. If you would like to discuss this further, please contact the authors.