EXAMINATION

September 2007

Subject SA5 — Finance
Specialist Applications

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

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Chairman of the Board of Examiners

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1 (i)

- act with integrity
- act with skill
- market practice
- information about customers
- information for customers
- conflict of interest
- customer assets
- financial resources
- internal organisation
- relations with regulators

(ii)

- manage and co-ordinate internal compliance procedures
- ensure firm adheres to applicable laws and regulations
- manage relations with regulator

(iii)

Advantages

- independent oversight of trades
- prevent violation of regulations

Disadvantages

- slows down trade decision making
- profitable trades may need to be declined

(iv) Case 1:

- Motivation: create misleading impression in market that the supply of shares is reduced, thereby increasing price, then sell to buyer at inflated price.

- EU Market Abuse Directive seeks to prevent dissemination of information that is likely to give a false market signal; this action is intended to send a misleading signal and is therefore inconsistent.

- Dealers are seeking to manipulate the market by creating false information which will require internal censure; however no external violation has occurred (the proposal has now been intercepted); no external action needed.

- Proposal is also contrary to FSA ethical guidelines for personal conduct on part of the trader, as it involves disseminating fraudulent information.

- Trade is contrary to current market regulations and should be declined.

Case 2:

- Motivation: PM has inside information which is expected to lead to an increase in the price of Company Y, and intends to profit from this by buying shares in advance of the expected increase.

- Information must be comprehensive and specific enough to determine impact of competitor's trade on market price of Company Y.

- EU Market Abuse Directive seeks to prevent use of inside information which includes "precise, non-public information likely to have an effect on the price of a security"; using such information is therefore inconsistent; employee is acting contrary to market abuse directive whether or not information is correct (since employee has no basis for deciding which it is).

- Employee should advise compliance officer of the information; by failing to do so, employee will need internal censure.

- Firm may need to advise competitor that information has become public; may also need to advise FSA; FSA may wish to determine whether information may have been leaked to other market participants besides our firm.

- Trade is contrary to current market regulations and should be declined.

(v) Self-regulation:

- Parameters for key risk measures and external reports devised by state, possibly in conjunction with industry bodies.

- Voluntary compliance but with sanction from industry bodies likely (e.g. withdrawal from access to market for non-compliant members).

Statute:

- Regulator prescribes values and methods for risk measures, capital requirements, reporting requirements etc.

- Compliance enforced through inspection and, if in breach, by sanction or penalty.

My recommendation would depend on the economic size of the country and the size and depth of its financial system. A self regulated system would work better and be more cost effective in an emerging market country and a statute based system would be expected to work better in a country with a large, complex and sophisticated financial system.

2 (i)

- Planned course of action in the event of an emergency situation where normal communication, command and operating procedures are compromised.

- Should be sufficiently broad to accommodate a variety of disasters.

(ii)

- Establish priorities:

  – protect human life
  – prevent further injury
  – prevent further damage to assets or information
  – restore normal operations as quickly as possible

(iii) Example Business Continuity Plan:

- Identify an emergency coordinator

- Management succession: in the event of the senior investment management being incapacitated by a disaster, executive investment decisions can be made by the following individuals:

  – the most senior portfolio manager available
  – the most senior research analyst available
  – the most senior trader available
  – in the event that none of the above are available, any employee holding the corporate title of principal or above should oversee the liquidation of all customer portfolio positions as soon as practical

- Creation of alternative head office: all operations which cannot be carried out at head office should relocate to the backup facility at location XXX.

- Protection of records: all customer portfolio information should be backed up nightly and stored at the backup facility at location XXX; all corporate information should be backed up weekly.

- PR and news control: as soon as practical the company should issue a public statement advising of any loss of life and of any impact on its ability to continue providing investment management services to clients.

- Warning system: company could be connected to local emergency services or install smoke/fire detection systems.

- An evacuation plan for the current office building should be devised.

- A plan should be devised for the restoration of normal services after the disaster. As the building is likely to be significantly damaged after the disaster, repair/replacement thereof may take a very long time and a medium-term alternate location needs to be identified in advance.

3 (i) (1) The hedge fund's main aim is to boost the share price of the company.

The value of this and all the other divisions may not be fully reflected in the company's current share price.

The hedge fund is hoping that the sell off will cause the market to revalue the company's remaining assets.

Selling the division will crystallise gains that could be used for more high priority / higher yielding projects or possible tax advantages not taken into account in the current share price.

It may also be the right time to sell – e.g. there are currently several companies willing to pay a premium for this division, or the division is reaching maturity and the future growth / profitability is in doubt or this particular industry is expected to decline.

The main implementation issue is the potential lack of buyers for this division.

(2) Share buy-backs may be seen as a positive sign by investors and boost the share price (e.g. the company is seen to be optimistic about their future ROE potential). The share price may not reflect the company's true valuation, hence if the shares are trading below NAV, the company would benefit from buying their shares at a discount (and the discount subsequently disappears — e.g. if the company decides to go private). A more geared balance sheet (less equity and more debt finance) could also be more appropriate for this particular company. However, the Modigliani and Miller proposition states that the market value of any firm is independent of its capital structure.

(3) Improved market share, and benefit from synergies (after allowing for the cost of the merger / acquisition), access to tax shelters, less competition may mean the company will have better pricing power. Implementation issues: Making an offer for other companies will usually cause a drop in the acquiring company's share price (as most companies tend to pay too much to acquire other firms). There is a risk that the merger may not be approved by the regulatory bodies.

(4) The hedge fund wants to improve corporate governance in order to reduce the risk of company management ignoring the needs of shareholders.

Good corporate governance can create better alignment between the company and their shareholders. Independent/ Non-executive directors are seen has having less conflicts of interest (executive directors suffer from the principle agent problem), and should question the actions of management, make sure that management compensation is appropriate and not excessive, and suggest remedial actions when company management does not meet their targets. They can also be involved in the audit committees to make sure financial accounts give a "true and fair" view.

(ii) Market risk / systematic risk (beta) — stocks going down generally and being exposed to market volatility.

Stock specific risk — particularly problematic if the hedge fund is holding a concentrated portfolio. Company may try to defend itself against the hedge fund via poison pills.

Liquidity risk — not being able to get out of a stock quickly enough, particularly if they have built up a large position or if the hedge fund is geared and the broker calls back the loan.

Shorting — potentially an unlimited loss if markets go up. Some stocks cannot be borrowed for shorting, or stock gets called back by the broker once borrowed.

Foreign exchange risk — if stock is in a different currency than the currency on which the fund reports performance, though this is likely to be small.

Interest Rate risk — if the hedge fund has borrowed moneys to leverage its investments then it will be exposed to increases in the future costs of borrowing. It will also be exposed to refinancing risks and the risks of accelerated debt repayment resulting from a breach of covenant.

(iii) Hedging out market risk, e.g. buy a put option on the relevant market index. The hedge fund can also reduce their net exposure (have long positions balanced out with appropriate short positions). The hedge fund could also reduce their gearing (gross exposure).

Hedging out some of the specific risk, buy put options in the stocks they own (though may be too expensive in some markets), hedge out industry risk by shorting an industry instrument, or short another similar stock in the same industry to remove industry exposure.

Diversify portfolio as far as possible, and invest mainly in liquid stocks.

Diversify sources of borrowing. The hedge fund would want to be able to borrow stock and have lines of credit from more than one broker to reduce the impact of short stocks that are called back / or when asked to pay back borrowed funds. The manager can also just make less use of shorts and gearing in his portfolio.

Currency hedging can be done if needed through forward contracts.

The hedge fund should estimate the cost of, and likelihood of a future increase in borrowing costs as a part of its investment analysis. Obviously it might be suitable for the hedge fund to borrow at a fixed rate if there is little chance of the hedge fund needing to repay the loan early. The hedge fund would seek to borrow moneys with a minimum of restrictive covenants thereby reducing the refinancing risks.

(iv) If management does not act, the hedge fund could go hostile and start a proxy fight. The hedge fund would try and gain the support from other shareholders and ask for a shareholder vote on the issues. The hedge fund could also aim to get some representation on the company board in order to influence board decisions directly. The hedge fund could also continue to build their stake in the company and then make an offer to buy any of the outstanding equity, thus gaining full ownership. Alternatively, if the hedge fund feels they are unlikely to create change in the company, they have the option to get out and sell their share holding.

(v) Evaluate operational and technology risk, i.e. the risk of direct or indirect loss at the hedge fund resulting from inadequate or failed internal process, people and systems or from external events. You should check the existence of disaster recovery plans, checking internal procedures and controls are documented and adhered to, fund valuation outsourced to an administrator, check agreements with third parties, clear segregation of roles (front and back office), adequate back office support, presence of a compliance officer, go through audited accounts, do reference checks / background checks on key staff. Check prospectus for exit clauses, redemption frequencies, lock-up periods, fee structures, reporting frequency. Also check if the hedge fund has adequate insurance arrangements in place.

These risks may be made worse by any lack of transparency from the hedge fund.

Compliance / legal risk — check compliance of the hedge fund manager and also if the pension fund is allowed to invest in this fund. Where is the fund domiciled and what is its legal structure.

Reputational risks — will the pension fund get bad publicity if this hedge fund fails due to, say, fraud.

(vi) The aim is to align the interests of the hedge fund with that of the client. The current performance fee structure is effectively a call option that the manager has against the client. The manager participates when returns are positive, but not when returns are negative. The manager can increase the value of this call option by increasing the volatility of the underlying assets. This may not be in the best interests of the client.

Possible suggestions: Add a cap on performance fee — this will mean the manager is not incentivised to aim for excessively high levels of performance. Add a provision that a manager must first make good any past losses before he can start earning performance fees again (called a high water mark). This means the manager is less likely to follow a strategy with high downside volatility as this will jeopardise future performance fees.

The one year time horizon could be seen as too short term and may encourage the manager to pass on opportunities that would deliver better returns over the long term.

Suggestion: a rolling 3 or 5 year performance window can be used in order to average out short term volatility.

Under the current structure the manager can be rewarded for taking systematic market exposure (beta) by passively investing in equities or cash. As market exposure can usually be bought quite cheaply, the performance fee should aim to only pay the manager for adding value through active management (alpha). Suggestion: add a hurdle rate the manager has to beat first before they can earn a performance fee. The hurdle rate should be high enough so that it could not be beaten "easily" through passive investments.

END OF EXAMINERS' REPORT