EXAMINATION

1 October 2007 (am)

Subject SA5 — Finance
Specialist Applications

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*

2. *You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.*

3. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*

4. *Mark allocations are shown in brackets.*

5. *Attempt all 3 questions, beginning your answer to each question on a separate sheet.*

6. *Candidates should show calculations where this is appropriate.*

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.

In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator.

1 You are the compliance officer of a listed UK investment management firm.

(i) List the principles which UK financial services legislation seeks to impose on regulated firms. [5]

(ii) Explain the purpose of a compliance officer. [3]

The internal compliance procedures of your firm require intended market transactions where the firm is a principal to be pre-approved by the compliance department.

(iii) Explain the advantages and disadvantages of this procedure. [4]

(iv) For each of the two proposed trades outlined below explain:

(a) What you believe the motivation behind the proposed trade is.

(b) Whether you believe the proposed trade is consistent with current regulatory principles.

(c) Whether you believe any action is required by your firm in respect of the proposed trade.

(d) Whether the proposed trade should be approved by the compliance department.

Proposed Trade 1: Your firm currently owns a large number of shares in Company X. The dealing desk proposes to issue a public statement claiming that it is considering transferring the Company X shares held into a trust from where they cannot be sold for a period of time. Two days after issuing this statement the dealing desk then intends to try to sell a large tranche of your firm's Company X shares off-market. You are not aware of any plans to create such a trust.

Proposed Trade 2: A portfolio manager in your firm has informally obtained information from a source within a competitor firm. He has been told that the competitor firm intends to purchase a large amount of shares of Company Y next week. The portfolio manager proposes to purchase shares of Company Y immediately.

[18]

The FSA has invited consultation from regulated firms on whether the rules regarding supervision of the UK financial services industry should be a system based on statute or one based on self-regulation.

(v) Discuss which of these alternatives you would recommend. [4]

[Total 34]

2 A financial services company is formulating its business continuity plans in the event of a disaster affecting its operations. The company's premises are located very near to a large oil depot, and the company's directors are concerned that a fire or explosion at the depot could occur.

(i) Explain what is meant by disaster planning. [3]

(ii) List the purposes of a disaster recovery plan. [2]

(iii) Describe a plan that the company could follow in the event of a disaster at the oil depot. [14]

[Total 19]

3 You work for a large pension fund that is looking to make a direct allocation to hedge funds. One of the Trustees has recommended an activist long short equity hedge fund.

This particular hedge fund manager's strategy is to identify companies where management is not creating enough shareholder value. The hedge fund manager will aim to build large equity stakes in each of these companies in order to have greater influence with company management and convince them to take remedial actions. The hedge fund has just presented to the board of a large conglomerate company in which it owns a large equity stake and made the following proposals:

Proposal 1 The company should sell off its highly profitable manufacturing division.

Proposal 2 The company should use the proceeds of this sale to buy back shares.

Proposal 3 The company should make an offer to acquire one of their largest competitors.

Proposal 4 The hedge fund manager is concerned about the poor corporate governance of the company board and recommends the appointment of more independent directors.

You are responsible for completing the due diligence on this hedge fund.

(i) Discuss the reasons why the hedge fund has put forward these proposals and highlight the main implementation issues where relevant. [16]

(ii) Describe the main investment related risks faced by the hedge fund. [6]

(iii) Describe how the risks identified in part (ii) can be mitigated. [6]

(iv) State the options open to the hedge fund if the company management does not want to implement the hedge fund's recommendations. [3]

(v) Describe the non-investment risks to which this hedge fund is exposed and the investigations pertaining to these risks which the pension fund should undertake before it decides to invest. [8]

The hedge fund charges a 2% annual management fee and an incentive fee of 20% of absolute performance. You have been tasked with negotiating a more appropriate fee structure.

(vi) (a) Explain the potential problems with the current fee structure.

(b) Suggest alternative structures that would address the problems you identify.

[8]
[Total 47]

END OF PAPER