CFA Society
United Kingdom

CONFLICTS OF INTEREST

Position paper

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This paper describes CFA UK's views on the conflicts of interest that are either inherent, or that arise within the investment profession and the actions that investment professionals (and their firms) should take to manage and mitigate those conflicts.

The purpose of the paper is to give members guidance on the type of conflicts that can arise, in order that they can work with their firms to manage or mitigate these conflicts. Further this papers gives guidance on how they might do so. This document is also intended to help clients and consultants to understand the conflicts that investment management firms face and thereby to encourage the maintenance of high ethical and professional standards in relation to conflicts of interest.

There are many examples of conflicts within underwriting and research in investment banking; auditing and consulting at accounting firms; credit assessment and consulting in rating agencies and at universal banks. However, this paper is focused largely on conflicts arising within investment management firms.

PREFACE

Professions deliver social value. They give the public access to specialist skills and knowledge and offer them protection from exploitation through the ethical and professional standards to which practitioners must abide. Practitioners also benefit: from the reputation of their profession and the consequent business based on their clients' trust.

Investment is a profession, not a business. Investing involves clear responsibilities and a duty of care to clients which is not true of the generality of business relationships. The understanding that the clients' interests must always come before our own is a fundamental tenet for CFA Institute and CFA society members. Holding to that belief requires the proper management of all actual and potential conflicts of interest between clients and their managers and, where the conflict cannot be avoided or resolved in the clients' interest, the full disclosure of the conflict. The importance of professional behaviour and the proper management of conflicts are also reflected in the Principles of Business listed in the FSA Handbook (specifically, principles 1 and 6 to 8, inclusive) and in the content of the Conduct of Business Obligations .

The professional relationship between an investment manager and a client gives rise to a principal-agent problem. The principal (the client) is less well-informed than the agent (the investment manager). There is an information asymmetry. In addition, the situation is complicated because the interests of the principal and the agent are not perfectly aligned. The optimal outcome for the principal is unlikely to be exactly the same as the optimal outcome for the agent as they do not necessarily share precisely the same objectives. As a result, there are likely to be conflicts of interest within the relationship and clients may not have access to sufficient information to be aware of and protect themselves from the possible effects of these conflicts.

'A few boards had defined and embedded in their business a credible, long-term commitment to serve their customers' best interests and had established robust arrangements to identify and manage existing and new conflicts of interest. But, in most cases, senior management failed to show us they understood and communicated this sense of duty...'
FSA, November 2012.

This paper is designed to provide insights into the range of conflicts that exist within the investment management profession and to deliver advice on how to manage conflicts (including their avoidance), how to talk to clients about conflicts and how to mitigate the effects of those conflicts that are unavoidable.

As Charles Ellis, CFA, notes in the July/August 2011 issue of the *Financial Analysts Journal*: 'There is a continuing struggle between the values of the profession and the economics of the business. We must be successful at both to retain the trust of our clients and to maintain a viable business, and in the long run, the latter depends on the former.' Full conflict disclosure is required if investment professionals are to earn and maintain client trust.

'The whole investment management area is cluttered with conflicts of interest and agency problems. When we choose a manager or invest in a fund, we want people side-by-side with us rather than as agents, which means people who put the interest of the investors front and centre...Ability is important...but overcoming agent/principal conflicts is overwhelming.'

David Swensen, CIO, Yale University Endowment Fund.

SUMMARY

Some conflicts of interest are inherent to the investment profession; others arise as a function of investment activity. All need to be managed and communicated to clients and their impact on client outcomes should be minimised.

PRINCIPAL – AGENCY RELATIONSHIP: BENEFIT AND FLAWS

All of us are regularly exposed to principal-agency problems. We benefit from the development of specialist knowledge and capabilities in a range of areas such as medicine and engineering. For instance, we appreciate the enormous good that effective healthcare can provide, but we often have to take medical advice on trust because we simply do not have the capacity to assess it beyond a basic level. The information asymmetry between us and physicians is immense. The good news is that there are few reasons for physicians to want to exploit that asymmetry (though relationships with pharmaceutical companies have been a cause for concern). In addition, medical professionals understand the clear duty of care that they have to patients and there are disincentives for a failure to act in accordance with that duty.

Principal-agent relationships deliver value, but do so best if the information asymmetries and accompanying conflicts of interest to which the principals are exposed are properly identified and managed.

TYPES OF CONFLICT

Conflicts of interest arise within the investment manager/client relationship in a number of ways. One way to think through the conflicts that may need managing is to consider which conflicts might fall into each of the following categories:

» Conflict arising as a result of differences in objective between an employee and the investment management firm

» Conflict arising as a result of differences in objectives between a firm and its client

» Conflict arising as a result of different objectives between an employee and a client of the firm

» Conflict arising between the different interests of a firm's clients

» Conflict between any party and the law

» Conflict between an employee's profession and their firm

Another useful taxonomy was provided by Ingo Walter in 2003. He suggested that conflicts could be characterised as type 1 conflicts – between the economic interest of the agent and its clients – and type 2 conflicts – arising between the interests of a firm's clients, placing the firm in the position of favouring one at the expense of the other.[4]

CASE STUDY 1

One financial services group[5] has described the situations around which it has most concern about potential conflicts of interest as follows:

Where the group or an employee:

» is likely to make a financial gain (or avoid a loss) at the expense of a client that is contrary to the client's interest;

» has an interest in the outcome of a service provided to a client, or of a transaction carried out on behalf of a client, that is contrary to the client's interest in the outcome;

» has a financial or other incentive to favour the interest of one client over another;

» carries on the same business as the client; or

[1] http://fsahandbook.info/FSA/html/handbook/PRIN/2/1
[2] http://fsahandbook.info/FSA/html/handbook/COBS/2
[3] Peter Bernstein, Capital Ideas Evolving (2007, pp 161-2)
[4] 'Conflicts of interest and market discipline among financial services firms', Ingo Walter, NY University, 2003.

- receives from a person other than the client an inducement in relation to a service provided to the client other than a reasonable commission or fee for that service.

CASE STUDY 2

A recent example of the failure to manage a conflict between clients emerged in May 2012. In this case, the investment management firm was fined by the FSA and SEC for its failings.

The conflict of interest arose when the firm caused one client (Fund B) to enter into an ill-advised transaction which rescued another client (Fund A) from serious liquidity concerns. Both Fund A and Fund B focused on making investments in the China market, and were managed by the same firm from its Shanghai office.

In April 2009, the investment manager caused Fund B to invest around £15 million in an unlisted bond issued by an offshore Chinese firm. The firm failed to ensure that the bond's valuation or the rationale behind the investment were properly scrutinised atthe time of the transaction, and it proved to be a poor investment for Fund B, halving in value over the next two years.

While the investment was detrimental to Fund B, it had significant advantages for Fund A. In 2009, Fund A was facing serious liquidity concerns due in part to its exposure to illiquid investments in a single offshore Chinese entity. Fund A's liquidity problems were solved by Fund B's investment, because nearly half of the proceeds of the bond issue were used to repay these illiquid investments. This in turn helped the investment manager to avoid any reputational damage which may have arisen if Fund A's liquidity problems had continued and it had been unable to meet pending redemptions by investors.

The transaction gave rise to a clear conflict of interest between Fund A and Fund B. The investment management firm was slow to identify this point and failed to manage the conflict fairly. The firm did not disclose the conflict to Fund B and failed to ensure that Fund B understood that the transaction proceeds would be used to repay an investment made by one of the firm's other clients.

Investment professionals should inform clients or prospective clients of potential conflicts, including but not limited to the following[7]:

TRANSACTIONAL CONFLICTS

Recommendation of products and services

Where fund distributors receive commission for sales of those funds, there is a clear conflict between their ability to provide independent advice to their clients and their self-interest (in the form of commission payments). Standard VI C of CFA Institute's Standards of Professional Conduct makes it clear that 'any compensation, consideration, or benefit, received from, or paid to, others for the recommendation of products or services' must be disclosed.

However, there may be conflicts of interest surrounding product recommendations that are more subtle than disclosed commissions. For example:

- Recommending a higher fee product over a lower fee product to improve firm revenues (potential conflict between firm and client)
- An objective to raise capital for a new fund launch which might encourage marketing of the fund to clients for whom it is not the most suitable product or even using capital from discretionary mandates to seed such funds (potential conflict between firm and client)
- Where maintaining a product may be detrimental to a client, but the business requires the assets to be maintained (potential conflict between both employee and firm and client and firm)
- An individual being given a remit to promote or defend products whose strategies they believe to be flawed or questionable (potential conflict between employee and firm)

CASE STUDY 3

In September 2012, the Securities and Exchange Commission instituted a settled administrative proceeding against two Oregon-based investment advisory firms and their owner regarding the failure to disclose a revenue-sharing agreement and other potential conflicts of interest to clients.The SEC's investigation found violations in three areas: notably, the advisory firm did not disclose to customers that it

[5] © Schroders, September 2010 Page 5 of 7 Group Conflicts of Interest Policy
[7] Many of these examples are taken from IOSCO's report on the conflicts of interests affecting collective investment scheme operators from May 2000.

was receiving revenue-sharing payments from a brokerage firm that managed a particular category of mutual funds being recommended to one of the firm's clients. The SEC noted that, because the advisory received a percentage of every dollar that its clients invested in these mutual funds, there was an incentive to recommend these funds over other investment opportunities in order to generate additional revenue for the firm. Without admitting or denying the SEC's charges, the firms and their owner agreed to pay a combined $1.1 million to settle the case.

The potential for conflicts is also clear when a predominantly advisory firm offers products. Traditional investment consultancy firms face a potential conflict of interests if they can enhance revenue by selling their fiduciary management services. Any investment consultant has a conflict to manage when they have an asset management arm and can hence recommend their own product.

'An institution with securities of its own to sell cannot be looked to for entirely impartial guidance. However ethical its aims may be, the compelling force of self-interest is bound to affect its judgment.'

Ben Graham, economist and professional investor (1894-1976)

Even traditional investment consulting services are not without conflict. Fees are generated by advising a client to change their investment manager or adjust their strategy, which can place an incentive to advice to do so even if it is unnecessary or even harmful. More complex strategies may not be in a client's best interests but will increase the need for advice and on-going monitoring.

TRANSACTIONS WITH AFFILIATES

Possible conflicts arising include the purchase (or sale) of securities from (or to) an affiliate at an inappropriate price.

CASE STUDY 4

Recent research[8] of affiliated fund of mutual fund families in the US between 2002 and 2008 suggests that funds within those families provided liquidity support to one another at times of distress, though prevented from doing so by law (the Investment Company Act of 1940).

Offsetting severe liquidity shortfalls at funds within the fund family reduced investment performance at the fund providing the liquidity – at a cost to that set of investors – but benefited the fund family (and investors in the family) in aggregate by removing the need for fire sales of assets.

TRANSACTIONS USING AFFILIATES

There is clear conflict management required when an investment management firm undertakes transactions using affiliates. Possible conflicts arising include:

» Paying excessive commissions or fees for brokerage or custodial activity

» Use of an affiliated party for brokerage or custodianship at less favourable rates than available elsewhere

» In the absence of effective Chinese walls, the creation of the potential for front-running

TRANSACTIONS ALONGSIDE AFFILIATES

Possible conflicts arise when an investment management house carries out transactions on behalf of clients alongside transactions by affiliates. Possible conflicts include:

» The opportunity for the affiliated party to negotiate the terms of a joint transaction to their benefit

» The opportunity for the affiliated party to receive a preferential allocation

» The scope for the creation of a false market in the joint holding leading to an overvaluation of the holding to the detriment of incoming investors

These potential conflicts will also arise with client transactions alongside or with capital of the Investment Management Firm.

TRANSACTIONS WITH BROKERS

Commission payments for trades made to brokers may generate 'soft dollars' under which the broker provides research services to the investment manager in return for the commission business. The commission payments are charged directly to client accounts, but the 'soft dollars' are directed to the investment manager. This creates a conflict of interest as the investment manager might generate excessive

[8] *Conflicting family values in mutual fund families', Bhattacharya, Lee and Pool, 2012.*

charges on the client's account in order to receive more research or other services from the broker. Regulators have sought to minimise this conflict by limiting strictly the services for which soft dollars may be used and by insisting that the benefit of those services must be experienced by the client.

CFA Institute published specific guidance on soft dollar standards in November 2004[9], but the standards of practice handbook has long provided direction on the use of commission. However, this remains a difficult area and was the subject of a 'Dear CEO' letter from the FSA to investment management firms in November 2012. The FSA found evidence to suggest that fund managers regularly spend clients' money to buy research and execution services from brokers without checking that the services were eligible to be paid for in that way.

'We concluded that most of the firms visited could not demonstrate that customers avoid inappropriate costs'.

CONFLICTS ARISING FROM SERVING MULTIPLE RELATIONSHIPS

Firms managing assets for multiple clients

It should be borne in mind that transactions relating to assets in one client's account may have on an impact on the assets held in a separate client account. Such potential for conflicts is all but unavoidable when a manager has a range of funds or investment styles. The need to manage such conflicts well increases where a firm has a number of internal clients (i.e. invests assets on behalf of the parent or affiliated bodies) as well as external clients.

Brokers providing advisory services to companies and brokerage to investment managers

Brokers serving companies as well as acting on behalf of investment management clients need to maintain Chinese walls between their advisory and brokerage arms, but also need to be clear about the conflict to which they are exposed as a result of their dual duties to promote their corporate client and to provide independent, objective advice to their investment firm clients. The potential for conflict may be even greater where the brokerage advice is being offered to an affiliate asset management house and a client is promoted as an investment for third party mandates.

As noted by the 2003 report *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*:

'A conflict of interest arises between research and underwriting because the investment bank attempts to serve the needs of two client groups – the firms for which it is issuing the securities and the investors to whom it sells these securities. These client groups have different information needs: issuers benefit from optimistic research, whereas investors desire unbiased research…When the potential revenues from underwriting greatly exceed brokerage commissions, the investment bank has a strong incentive to alter the information provided to both types of clients so as to favor the issuing firms' needs.'[10]

Conflicts are not restricted to the relationship between research and advisory work within the same financial services firm.

Where a firm offers both investment banking advice and asset management under the same brand – and where Chinese walls break down – conflicts of interest could see the asset management unit encouraged to take larger stakes than they might otherwise do in an IPO in order to support the investment banking arm's leadership of a transaction – enabling the investment banking business to benefit at the expense of the asset management unit's investors.

Similarly, an investment banking unit working on a transaction for a client might seek to influence its associated asset management arm to vote its proxies in such a way as to favour the client, whereas the asset management business has a duty to act solely in the interests of its own clients.

CASE STUDY 5

In August 2003, the Securities and Exchange Commission charged a US investment management firm, the investment advisory unit of a European bank, for failing to disclose a material conflict of interest in its voting of client proxies for the 2002 merger between Hewlett-Packard Company (HP) and Compaq Computer Corporation. The Commission's Order Instituting Proceedings found that, unbeknownst to the

[9] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n1.40057
[10] Crockett, A., Harris, T., Mishkin, F. and White, E. 2004. Conflicts of Interests in the Financial Services Industry: What Should We Do About Them? Geneva Reports on the World Economy 5. London, Centre for Economic Policy Research. http://www.cepr.org/pubs/books/P163.asp

investment management firm's advisory clients, the bank's investment banking division was working for HP on the merger, and had intervened in the investment management firm's proxy voting process on behalf of HP.

Elsewhere, the practice of one part of a financial services firm providing finance to a company bidding to acquire a company for whom another part of the same financial services firm is providing advice, has fallen away after lawsuits criticising the practice as representing a conflict were settled.

TRADING/INVESTING AS PRINCIPAL AS WELL AS AGENT

When a firm acts as a principal in addition to acting as an agent it creates substantial scope for conflicts of interest, most obviously clients could be encouraged to buys securities in which the firm already holds a long position or to sell securities in which the firm is short.

CONNECTED PERSONS (RECOMMENDATIONS, TRADES)

Agents need to ensure that any transactions with or services offered by connected persons (family members or corporate bodies to which the agent is connected) are properly disclosed as the close relationship may create an indirect conflict.

VOTING

There are multiple potential conflicts of interest between the investment manager and the client relating to voting:

» It may be in the interests of different clients for the manager to vote in different ways if they are following different investment strategies. The ability to exercise all shares in one client's interest causes a potential conflict

» A conflict arises when a manager has the right to vote shares on clients' behalf in the securities of an affiliate or in the securities of a firm which an affiliate is advising or has some other interest

» While typically acting as an agent, investment firms may also act as principals. There is the potential for conflicts if they hold their own interest in firms in which they advise clients on how to vote their shares

» Individuals at an investment management firm may hold the same securities as their clients in their personal accounts and may find themselves conflicted and unable to exercise voting rights in a genuinely independent manner

TRANSACTION ORDERING AND ORDER ALLOCATION

If transactions in a specific security for a number of client accounts occur at different times and prices, there may be an incentive to favour one client over another in terms of order allocation.

Equally, a manager may be subject to a conflict where there are limited opportunities to access an attractive investment opportunity. In particular this will occur in less liquid securities and in portfolios dealing with heterogeneous assets (e.g. property). In that instance, there may be an incentive to favour one client over another.

Transaction ordering and order allocation was a further area of weakness identified in the FSA's November 2012 paper on conflicts of interest.[11]

The reports key findings were that:

» firm culture is central to identifying conflicts;

» the best control frameworks were designed jointly by business and compliance functions;

» monitoring conflicts is more effective when conducted by both business and compliance functions;

» monitoring conflicts is more effective when boards receive adequate management information; and

» conflicts were better managed when UK boards had committees dedicated to conflicts of interest management.

CORRECTING TRADING ERRORS

It is often difficult for a client to ensure mandate compliance. Investment professionals are, therefore, in a position to protect their own interests by failing to acknowledge errors and omissions; thereby avoiding having to compensate their client for a loss (or so as to hold onto a gain).

[11] *Conflicts of interest between asset managers and their customers: identifying and mitigating the risks', FSA, November 2012.*

CONFLICTS ARISING FROM DIFFERENT BUSINESS OBJECTIVES

Investment management firms are businesses. Some are publicly quoted companies with responsibilities to their shareholders as well as to their clients. Almost all require the achievement of a certain level of a profitability to remain in business[12]. It is difficult to hold the interests of a client ahead of a firm's interests at all times and, thereby, to forego potential immediate gains in order to build and/or maintain the client trust that will support longer-term revenue generation. Among the business conflicts that firms can face are:

Asset growth

As most mandates/funds operate under an 'ad valorem' fee structure, in which the fee payable is calculated against the value of the assets under management, there is an incentive for investment managers to grow the size of their funds. Of course, over the longer term, managers are incentivized to perform well in order to encourage asset growth. However, growth in business tends to directly impact short-term rewards more than performance does. Past a certain point a fund will almost certainly hit capacity constraints in terms of additional performance generation because of the size of the funds applied to the strategy.

'Size is the enemy of (fund manager) performance. If you limit assets under management, you have a much better chance of beating the market. But asset gathering improves profits. So what happens? Almost invariably, managers are out there gathering assets, trying to increase profits, and it comes at the expense of generating investment returns'

David Swensen, CIO, Yale Endowment Fund

Capacity limits in this sense are only one part of the problem. With too many clients an asset manager may find that they are spending too much of their time servicing clients and not enough time as an investor. The portfolio manager may also become distanced from the management of the portfolio/fund by their marketing and communication activity in an effort to grow assets size.

At this point, where there is a trade-off between asset accumulation and performance, the firm may wish to restrict the size of the fund/portfolio in order to maintain the alignment of interests between the firm and their clients.

CASE STUDY 6

A 2004 paper from Khorana and Servaes[13] looked into conflicts of interest between fund families and investors. They found a positive relationship between market share and fees charged directly for marketing and distribution of funds. They performed several tests to determine whether this could be beneficial for the fund's current shareholders, but did not find that this is the case. Second, there was no evidence of sensitivity of market share to fees for low-cost families. This suggested that low-cost families could increase fees without losing assets under management, as long as the fee increase was not 'too high'.

Several aspects of product differentiation also had a positive effect on market share. First, families with a greater diversity of product offerings had a higher market share, even after controlling for the contemporaneous relation between market share and product diversity. Second, two elements of performance enhanced market share: (i) the industry-adjusted returns earned by the family, and (ii) the presence of a star performer in the family. Third, families that innovated more than the competition and introduced a more differentiated product were able to attract a larger share of the market.

There was an incentive for fund families to launch additional funds in search of star performers (to support the marketing of the entire family of funds) and there was an incentive for the fund family to spend resources on marketing and distribution though these expenses – while borne by the fund investors – did not benefit the end investor.

The pursuit of asset growth might cause other detrimental behaviours. For example, to make a product or fund appear more attractive, an investment manager might set it an unrealistic performance target. Attracting assets through the prospect of unrealistic returns rewards individual investment managers by fee generation, but is unethical and reduces client trust in the profession.

[12] *Though some firms established on behalf of families or individual pension funds may not seek to generate formal profits as they are able to rely on funding from their founders.*
[13] *'Conflicts of interest and competition in the mutual fund industry', Ajay Khorana and Henri Servaes, July 2004.*

Fee risk and performance risk

Well-designed client fee structures and manager compensation structures can align the interests of the client and the manager, but poorly-designed structures can encourage behaviour that is not in the client's best interest.

Performance related fees are often intuitively appealing to clients. Clients feel better when their manager underperforms if they are paying less for their services and are more willing to pay higher fees to a performing manager. However performance fees giving asymmetric participation are often an incentive to act against the client best interests. This is not purely a theoretical risk. For instance, research Andrew Clare and Nick Motson of Cass Business School[14] found that hedge fund managers whose performance was insufficient to trigger fee payment increased their risk-taking to close that gap, whereas managers who had achieved performance sufficient to trigger fee payment then reduced risk. While these actions may ex post have been shown to be in the client's interest (but just as easily may have damaged performance), ex ante the actions may have represented a change to the fund's stated investment philosophy and were taken to benefit the manager, not the client.

The incentive to take risk beyond client tolerance in order to hit return targets may therefore be magnified by performance related fees .

Investment managers may also have an incentive to keep transparency of fees and charges low, in order that they can charge as much as they can, rather than charging what would be a fair rate. This criticism does not stop at investment managers and can be applied to all agents in the investment chain.

Cost reduction

Asset management businesses strive for profitability and will therefore have a focus on costs as much as revenue. There is a potential for conflict where the optimal resource to deliver client performance is inconsistent with the resources available to a business seeking to manage its bottom line. This is not purely a conflict between client and firm, but also introduces the potential for conflict in the allocation of scarce investment resources across client mandates.

Some conflicts will arise because of the specific business models. For example a multi manager whose clients are on a fixed investment management fee (inclusive of third party manager fees) has to manage the conflict between appointing an expensive third party investment manager deemed most likely to perform versus an alternative, but cheaper, fund manager. Fiduciary and diversified growth fund managers who are able to use their own or third party funds face a similar challenge in making the best fund selection for their clients.

Use of soft dollars is another such example but has been dealt with above.

Fads and fund launches

Investor, and particularly retail investor enthusiasm for get rich quick stories such as the dotcom boom offer the opportunity for investment management firms to gather assets quickly (or at least to protect them from being captured by other firms), but firms need to be bear in mind their responsibility to bring to bear an independent, objective viewpoint and to hold the client's interests above their own at all times. This is particularly important given investors' tendency to mistime investments by buying towards peaks in valuation and selling in troughs.[15]

This conflict is not restricted to retail clients. Investment managers may have a similar incentive to develop and distribute product or strategies in institutional space because of client demand, even where they know that this product is not suitable or does not have sustainable investibility. Where the recommendations are coming from an investment consultant, it can be doubly difficult for a manager to keep the client's interests in mind, due to the dependence of investment manager firms on the investment consulting community for business.

CASE STUDY 7

The NASDAQ composite – taken as a proxy for US tech stocks – rose from 1,770 on January 31 1998 to 4,696 exactly two years later, an increase of 165%. According to a newspaper article from August 2000[16] (by which time the index had fallen 28% in the four months to late April before rebounding 24% in the following four months) the number of technology unit trusts available

[14] Clare, Andrew D. and Motson, Nick E., Locking in the Profits or Putting it All on Black? An Investigation into the Risk-Taking Behaviour of Hedge Fund Managers (November 26, 2008). Journal of Alternative Investments, Vol. 12, No. 2, 2009. Available at SSRN: http://ssrn.com/abstract=1307713

[15] Working paper Do UK retail investors buy at the top and sell at the bottom? Clare, Andrew D. and Motson, Nick E. Centre for Asset Management Research, Cass Business School, September 2010. http://www.cass.city.ac.uk/__data/assets/pdf_file/0003/69933/Do-UK-retail-investors-buy-at-the-top-and-sell-at-the-bottom.pdf

to UK investors had increased four-fold (from five to more than 20) in the space of no more than 18 months.

While the managers of those funds launched early in 1998 could make a case that they observed fundamental value in the sector, those launching funds into the boom should have borne in mind the likelihood of mean reversion. The index closed on January 31 2002 at 1,731.

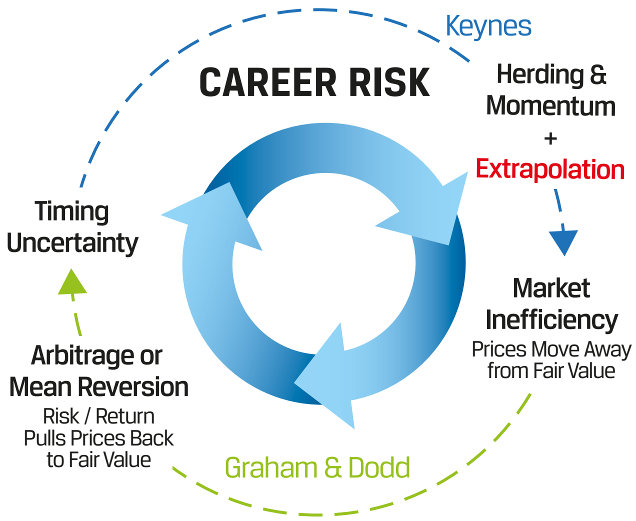
CONFLICTS ARISING FROM DIFFERENT PERSONAL OBJECTIVES

In common with the potential conflicts that arise from compensation structures, there are conflicts of interest that are generated from individuals concern about putting their careers in the investment profession at risk.

Jeremy Grantham of GMO has this to say about career risk[17]:

'Career risk drives the institutional world. Basically, everyone behaves as if their job description is 'keep it.' Keynes explains perfectly how to keep your job: never, ever be wrong on your own. You can be wrong in company; that's okay. For example, every single CEO of, say, the 30 largest financial companies failed to see the housing bust coming and the inevitable crisis that would follow it. Naturally enough, 'Nobody saw it coming!' was their cry, although we knew 30 or so strategists, economists, letter writers, and so on who all saw it coming. But in general, those who danced off the cliff had enough company that, if they didn't commit other large errors, they were safe; missing the pending crisis was far from a sufficient reason for getting fired, apparently. Keynes had it right: 'A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him.' So, what you have to do is look around and see what the other guy is doing and, if you want to be successful, just beat him to the draw.'

To illustrate his point, Grantham uses the following graphic to show the role that career risk plays in creating cyclical market behaviour.



While Grantham's concerns about career risk have not yet been the focus of academic research, it is telling that he can draw from Keynes' General Theory of Employment, Interest and Money (which was first published in 1936) to support his argument.

MANAGING CONFLICTS

Investment managers and other providers of investment services must seek to protect clients by:

- reducing and where possible, eliminating the potential for conflicts;
- requiring agents to act in a certain manner and using guidance to mitigate conflicts; and
- where conflicts cannot be altogether mitigated, through full disclosure.

The direct prohibition of activities generating conflicts of interest tends to be limited to those instances where the conflict would be clearest and most egregious. Regulators recognise that many of the activities that give rise to possible conflicts often provide benefits to clients and that, so long as appropriate mitigating measures are in place, mitigation is the appropriate response.

Most regulatory regimes also impose requirements on agents to manage conflicts appropriately, such as those imposed on asset managers in the European Union under MiFID. As described in Marc Kruithof's

[16] http://www.telegraph.co.uk/finance/4460614/Twists-and-turns-of-technology.html
[17] Speech at the Annual Benjamin Graham and David Dodd Breakfast (Columbia University, October 7, 2009), quoted in his January 2011 letter.

paper[18] 'MiFID requires an investment firm to 'act honestly, fairly and professionally in accordance with the best interests of its clients', and under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, comparable requirements exist for collective portfolio management.' The duty of loyalty is a mandatory component of asset management contracts and compliance with the principle can be supervised, with any breaches followed up by enforcement action by the national regulator.

Beyond loyalty, MiFID makes specific demands of asset managers relating to conflicts. All firms covered by MiFID must ask themselves where conflicts may arise, develop an appropriate conflicts policy and record any conflicts arising. Firms must also maintain effective organizational arrangements to prevent conflicts of interest from adversely affecting clients and, where these arrangements are not reasonably likely to prevent conflicts, the firm must disclose the potential conflict to the client before working on their behalf.

ORGANISATIONAL ARRANGEMENTS TO COMBAT CONFLICTS

Many of the conflicts relating to transactions undertaken by agents for their clients (or that arise because of the agent's duty to serve the interests of multiple clients with differing needs) can and often are managed away through the application of specific, detailed policies and processes such as:

» Best execution

» Trade allocation

» Internal trading

» Personal account dealing restrictions,

» Errors and omissions

» Side by-side management

» Proxy voting

In addition, the segregation of duties, the operation of gift registers and a requirement to disclose external directorships and interests can do much to prevent conflicts and limit the impact of potential conflicts.

There are some commonly accepted principles of effective organisational structures. First, there should be barriers (Chinese walls) in place to prevent the exchange of information between employees where such an exchange might lead to behaviour that would harm client interests. Secondly, people working on behalf of different clients whose interests might conflict should be separately supervised. For these purposes, the firm itself should be seen as a client. Third, there should be no direct link between the remuneration of a person working on one activity and someone working on another where there may be a conflict if that was to be the case. Fourth, there should be measures in place to prevent anyone from inappropriately influencing someone else (against a client's best interest). Fifth, nobody should be involved in so many steps within an investment chain that conflicts are likely to emerge and it might prove difficult to demonstrate the proper management of conflicts.

Chinese walls, the segregation of duties and avoiding inappropriate pay structures can all help to prevent potential conflicts from becoming actual conflicts that might materially damage a client's interests.

Most importantly, a firm's general culture and policies should also make it clear that the client's interest are paramount and that conflicts – which are likely to arise – should be properly managed and, if unavoidable, fully disclosed. Specific policies are necessary and useful, but the investment professionals working for a firm need to see that the firm's senior management care about conflicts management and the proper execution of the firm's policies. Firms should have an overriding conflicts policy (under which the specific, detailed policies sit) and should ensure that staff receive appropriate training on adhering to the policy and that staff sign off on the policy (and supporting policies as appropriate) regularly.

HOW SHOULD FIRMS ACTUALLY DEVELOP AND OPERATE POLICIES GOVERNING CONFLICTS?

Managing conflicts of interest – through their identification and the application of policies to avoid them and, where that is not possible, their full disclosure – should be a concern across the firm. The Board should ensure that business line managers work with their colleagues from compliance to develop policies that are relevant, appropriate and in line with regulatory requirements. These policies should be

[18] *Kruithof, Marc, Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate? (December 2005). Ghent University Financial Law Institute Working Paper No. 2005-07. Available at SSRN: http://ssrn.com/abstract=871178*

reviewed and approved at Board level – as should any significant changes.

Firms should establish a conflict committee or at the very least ask an existing committee responsible for operational and legal reviews to take on responsibility for the development and implementation of conflicts policies. All business heads should report to the committee regularly on conflicts arising and their management. The committee should be responsible for maintaining a record of all conflicts managed or mitigated by the firm. Where a line manager is unclear about how best to manage a conflicts arising, they should ask the committee for advice. The Board should request a report from the committee at least every six months and should review the conflicts record in full annually.

Line managers should hold regular discussions with their teams to consider possible conflicts and should make sure that staff are aware of all policies relating to conflicts management as well as the firm's general commitment to manage conflicts effectively.

While the conflicts relating to transactions or managers' relationships with multiple clients may be relatively simple to manage through the application of appropriate processes and checks, managing the conflicts relating to different objectives between the principal and the client is a more complex task, as is the management of conflicts emanating from people's perception of their career risk.

The conflicts committee should regularly consider potential conflicts relating to capacity management within existing funds, should review all anticipated fund or product launches to consider potential conflicts inherent in their development and should encourage all line managers to review individual performance closely to check that the firm's investment process is being followed and that a manager is taking on levels of risk appropriate for the client.

CASE STUDY 8

One firm's approach to capacity management[19]

We employ a combination of quantitative and qualitative techniques to help measure and manage capacity. Using quantitative tests, we forecast product capacity based on such factors as the number of days trading volume and consider that holdings overlap across multiple products. We also monitor investment style and transaction costs on an ongoing basis to ascertain whether asset inflows have caused unintended style shifts and whether increasing assets are making the strategy more expensive to implement. In terms of qualitative factors, portfolio manager style and input on capacity are important. Anticipated portfolio manager non-investment responsibilities that would be created by new business are also considered.

We seek to maximise value added for our clients by using institutional portfolio managers and institutional product managers to support the client base so that portfolio managers are able to focus properly on managing investments. Diversification of our business across multiple strategies and investment teams is another important consideration in evaluating the capacity of individual investment strategies as we believe that diversification translates into long-term stability for the firm.

Finally, based on ouranalysis of these quantitative and qualitative factors, we implement product closures at appropriate asset levels to protect the interests of our clients.

DISCLOSURE

While other parts of CFA Institute's Code of Ethics and Standards of Professional Conduct cover aspects relating to conflicts of interest (such as the need for members to place the client's interests ahead of their own personal interests), Standard VI[20] is directly and exclusively related to conflicts. The standard makes it clear that members and candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity, or interfere with their duties to their clients. The disclosure must be prominent, delivered in plain language and communicated effectively. The standard goes on to restate the requirement for investment transactions for clients to have priority over those in which the member or candidate is the beneficial owner and notes the need for any referral fee to be disclosed to clients or potential clients.

[19] June 2012, MFS Capability Focus, 'Capacity Management is Integral to Client-Centred Business'
[20] Code of ethics reference

Disclosures assist conflict management in several ways.

First, disclosure of a conflict to a client or potential client allows that client to make an informed decision about whether or not they wish to engage in the transaction or relationship. The client has the opportunity to assess the potential costs of the conflict (and to review the additional mechanisms that have been put in place to manage the conflict) and to weigh those against the benefits. In short, disclosure helps to minimise the information asymmetry between the agent and the principal.

Second, conflict disclosure allows scrutiny by both client and regulatory bodies. The acknowledgement of potential conflicts enables clients and regulators to follow up and seek reports on the frequency with which the conflict arose and the depth of the conflict.

As noted earlier, European regulation does not impose rules preventing conflicts from arising – it acknowledges the near impossibility of doing so – but seeks to prevent those conflicts from hurting clients. Disclosure is a key tool. As Louis Brandeis wrote in *Other People's Money* (1914) 'Sunlight is said to be the best of disinfectants'.

However, disclosures can carry their own dangers. An interesting (though not directly related example) is that increased disclosures of executive compensation in the US in the last decade coincided with an increase in compensation, which some observers suggested came from the additional information to which executives had access about their counterparts' compensation. A more immediate danger is that investment managers may take comfort from the fact of disclosure alone without following up to seek information about how conflicts arising were managed. It is also the case that where conflict disclosures are primarily written to satisfy legal advisers' concerns about potential liability to a firm, rather than in order to explain clearly the existence of the conflict to a client, then the disclosure may be ineffective as it may fail to close the information asymmetry. Recent research also suggests that disclosure can be dangerous as it may provide the disclosing party with a moral license to allow the conflict instead of adhering to professional standards.[21]

What we know for sure is that putting processes in place to identify and manage conflicts is important and, broadly, effective. Without proper processes, we are dependent on judgment and susceptible to behavioural bias as a recent research project[22] demonstrated.

For the study, the researchers surveyed a mix of physicians, financial planners and a comparably educated control group who were randomly assigned to provide their reactions to a conflict of interest policy that was presented as applying either in a medical context, involving relationships between physicians and the pharmaceutical industry, or in a financial context, dealing with relationships between personal financial planners and companies that market investments. After reading the proposed policies, participants rated how reasonable they thought the policies were. Then, they were presented with objections to the policies and asked to evaluate those. Finally, in light of the objections they had seen and evaluated, they were asked whether their views on the original policy had changed.

The results revealed a strikingly consistent pattern of motivated bias for both physicians and financial planners. Physicians evaluating a conflict of interest policy in a medical context evaluated it negatively, and perceived objections to the policy as largely reasonable. However, when examining the same policies in a financial planning context, physicians were supportive of policies to limit conflict of interest. Financial planners displayed a similar pattern, reacting negatively to the policy that would affect them, but positively when examining the restrictions in a medical context. Finally, the control group with no vested interest evaluated both policies positively, and dismissed the objections as being unreasonable.

THE WAY FORWARD

Some conflicts of interest are inherent to the investment profession; others arise as a function of investment activity or corporate structures. All need to be avoided where possible and managed where they cannot be avoided. The existence of an unmitigated potential conflict should be communicated to clients and their impact on client outcomes should be minimised.

[21] *'The limits of transparency: pitfalls and potential of disclosing conflicts of interest', by Loewenstein, Cain and Sah (2011).*
[22] *'Bias in the evaluation of conflict of interest policies,' by Sharek, Schoen and Loewenstein (Journal of Law, Medicine and Ethics, Summer 2012).*

If this is to occur, CFA UK members should encourage investment management firms to develop appropriate operational structures to identify, avoid and manage conflicts, extend their conflicts policies (in order to address transactional, relational and general business activities), review them regularly and may want to consider submitting an annual conflicts report to clients. A conflict report could describe:

» situations that have arisen relating to any of the types of conflict specified within the conflicts policy and couldcomment on how the conflict was managed; and

» any changes to the conflicts policy that have been made during the period.

CFA UK is keen to work with asset owners and their representatives to develop frameworks for questioning managers about their mechanisms for managing conflicts, reviewing conflict policies and conflict reports and for recognising the value of good conflict management and mitigation structures in awarding mandates and selecting advisers. The publication of conflicts policies and conflicts reports only has value if they are used by clients – management and/or disclosure alone are not enough. Clients need to use information about conflicts management and conflicts disclosures to make informed decisions as to whether or not conflicts have been properly identified and addressed.

Investment professionals must put their clients' interests ahead of their own and should do all that they can to manage and mitigate conflicts. Where conflicts cannot be properly avoided, they must be disclosed. Clients should value that activity so that there is some relative reward for those firms that work hardest to build trusting relationships with their clients.

Five questions about conflicts that a client or its investment consultant should ask an investment manager:

1: **Tell me about the organisational model that you have in place for handling conflicts of interest. What reports about conflicts does your Board receive?**

What you should hear – Conflicts management is a concern for everyone across the firm – from the front office to the back office and up to the Board. Our conflicts policies are recommended to the Board by our compliance department and/or conflicts committee and are based on input from managers, analysts, traders and marketers and take account of all relevant regulatory requirements. Those policies are implemented across all business teams. If a specific conflict emerges that appears unavoidable, the business team manager and the compliance manager will discuss whether the firm should not undertake the activity or can manage the conflict through an independent panel and/or disclosure. The notes from such meetings are included in the conflicts record. There is an annual meeting between all staff members in a team (led by the business team manager and attended by a compliance manager) at which issues around which conflicts may be explored and any possible additions or amendments to the conflicts policy can be discussed. The Board reviews the conflicts record and conflicts policy annually and must approve any changes to the policy.

What you should not hear – We have an excellent conflicts of interest policy that reflects the regulatory requirements to which we are subject. We regularly email all staff to confirm that they are aware of the policy and to make sure that they are complying with it.

Your follow up question – Which Board committee has specific responsibility for the policy?

2: **How often do you review your conflicts policy? (This allows you to check that a policy exists and the answer to the question should give an indication of whether this issue is often considered by the firm)**

What you should hear – Our conflicts policy is a dynamic document that can be updated as we learn about the conflicts that we face and how they can best be managed. There is a formal opportunity each quarter to propose changes to the policy – and it would only be formally amended on the approval of the Board – but any member of staff could make a recommendation to their line manager and the head of compliance at any time.

What you should not hear – We review our policy rigorously every year.

Your follow up question – What changes have you made to the policy in the last two years?

3: **Can I see a copy of your conflicts record? (This allows you to check that a record exists. If a record exists, it would be helpful for you to know if it was updated reasonably frequently by people across the firm)**

What you should hear – Yes, I can give you a copy of last year's that has already been edited for confidentiality purposes. Although we can provide you with a copy of the current record it may take a while as compliance will need to take out the client names and transaction details for confidentiality purposes.

What you should not hear – We maintain a conflicts record, but we can't share that with clients for reasons of confidentiality.

Your follow up question – Were there any areas of conflict that cropped up more often than others last year and, if so, what were they?

4: **Is management of conflicts a factor in managers' performance appraisals?**

What you should hear – People's contribution to the firm's ethical and professional culture is certainly a consideration in appraisal and that feeds through into remuneration. Active management of conflicts would positively influence the appraisal. A failure to manage or disclose conflicts would have the opposite effect.

What you should not hear – We do not disclose details of our staff appraisal structures.

5: **Do you encourage staff to undertake training on ethics and professional standards that helps them to understand conflicts of interest, their management and disclosure?**

What you should hear – Yes. We encourage our people to study for professional qualifications and to maintain their continuing education around ethics and professional standards. We also offer specific training on the application of our conflicts policies and why they matter to the firm.

What you should not hear – Our people have years of experience at the coalface and have learnt at the school of hard knocks how best to work for their clients.