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Managing conflicts with independence

Sabrina Foster of Athena International Management outlines the ways in which independent directors can help manage potential conflicts of interest.

Conflicts of interest exist everywhere, in everyday life and in all types of businesses. However, when you are operating an investment advisory business, the issue of conflicts of interest is at the heart of so many things that an investment adviser does. Getting it wrong can result in serious reputational damage, not to mention major fines and penalties. The management of conflicts of interest is both a regulatory issue and a fiduciary one, imposing duties on investment advisers to act in the best interests of its clients and to make full and fair disclosure to its clients of all material facts relating to the advisory relationship.

This article will identify key areas in investment funds operations where conflicts most commonly arise. We explore how professional independent directors can assist investment advisers in building and maintaining a robust governance framework for managing conflicts of interests and offer some best practice considerations for funds in mitigating and reducing exposure to common conflicts.

Regulators' view

Global regulators, including the US Securities and Exchange Commission (SEC) and the Financial Conduct Authority of the United Kingdom (FCA), have made the management of conflicts of interest a key focus in investment advisory firm examinations over several years and their focus on this continues to be heightened.

In June 2020, the SEC issued a risk alert[1] highlighting 'conflicts of interest' as one of the areas of deficiencies in examinations of private fund advisers. The report highlighted deficiencies under the Advisors Act Rule 206(4)-8 and inadequate disclosure of conflicts in areas related to: (i) allocation of investments; (ii) multiple clients investing in the same portfolio company; (iii) financial relationships between investors or clients and the adviser; (iv) co-investments; (v) service providers; (vi) fund restructurings; and (vii) cross-transactions.

The FCA is also paying greater scrutiny to conflicts of interest, but the focus by the FCA is less on disclosure and more on avoidance. From the FCA's perspective, the obligation on an investment advisory firm is not just to identify and disclose its conflicts but to try and avoid them, and if they cannot be avoided then the investment adviser needs to manage and monitor its conflicts. Disclosure is seen by the FCA as a matter of last resort, thus placing heavy reliance on investment advisory firms to ensure that their conflicts of interest policies and practices support the prevention and management of its conflicts.

Investors' view

Conflicts of interest are one of the areas of greatest concern for investors. Much of this concern comes out of experiences of investors who have been negatively affected by many issues and who are now heavily scrutinising the fiduciary duties owed to them. As a result, investors are interested in more than just disclosure of conflicts; they want to know how the investment adviser is going to manage conflicts of interest and whether it will affect their bottom line. Unsurprisingly, investors are looking closely at the investment adviser's framework for managing conflicts of interest at, not only the firm level, but also at the board level of the funds in which they invest. They are looking at board composition and particularly the extent to which the board comprises non-executive professional independent directors, who, as 'gatekeepers', provide independent oversight and supervision over the activities of the investment adviser and who can influence the strength of the

fund's governance framework. As part of an investor's due diligence analysis on an investment adviser, they will routinely interview directors to assess the strength of the governance framework in place.

The use of independent directors

Many leading investment advisers agree that independent non-executive directors are vital to building a robust framework for managing conflicts. Independent directors are a good sense check and bring fresh insight into how investment advisers should be running their business and how fund boards should be operating. It follows, therefore, that the first step in tackling conflicts is to get it out of the hands of your compliance department and into the hands of your firm's governing body making the management of conflicts a firm issue and not just a legal and compliance issue, thus creating a top-down compliance culture for your firm.

The use of independent directors has become an integral part of establishing a sound control framework for identifying, disclosing, monitoring and mitigating conflicts. Having a robust control and governance framework, separate from legal, compliance and fund administrator teams, allows you to objectively identify potential breaches.

This brings us to the topic of 'independence' and the value of a truly independent board. In selecting your non-executive independent directors, it is important to understand the professional experience, skills and background of your directors to develop a well-balanced board with a diversified skill set. Depth of perspective on boards with varying backgrounds and gender balance provides a valuable range of perspectives and enables you to draw upon a wide set of experiences and thus make more effective decisions.

An important function of the board is to make sure that the investment adviser (and the fund) has an effective monitoring framework in place to identify and monitor conflicts of interests (generic and more specific ones) that may arise in all parts of the fund and advisory operations. This framework should include the recording of identified existing or potential conflicts and the steps taken to mitigate or manage them, and of course disclosure, where the conflict cannot be avoided. The board should have an opportunity through reporting and meetings to review, consider and approve the funds management of conflicts policies and procedures and any proposed updates or changes to these on an ongoing basis.

In addition to monitoring adherence through reporting and regular board meetings, there are several key areas where involvement by the board can offer a first line of defence in conflict management. It is strongly recommended to include your board of directors in the review and approval of side letters and to keep a record of all material side letter terms in a matrix for your business team and your board. It is also best practice to include your board in the approval process of all service providers (including affiliated service providers) to the fund and in all decisions regarding 'exceptions' (capital activity and cross-trades/co-investments) outside of the ordinary disclosed parameters.

A quality board can provide a filter system and board-led approach to managing conflicts. A strong board that asks good, smart questions and tests assumptions can greatly improve investor confidence and reduce exposure for all parties. Promoting a 'good conduct' culture, can help to ensure that there are effective systems in place to safeguard that proper disclosures are made and that the disclosures made are consistent with the firm's actions.

Conclusion

Establishing the right framework to manage conflicts of interests, both within the investment adviser and within the underlying fund's board of directors, is key to having a well-run asset management business, avoiding scrutiny by regulators and investors, and avoiding reputational damage. Embedding conflicts of interests into your company culture benefits the entire organisation. By making it the entire firm's responsibility, and not just the legal and compliance teams, you will improve your firm's ability to identify and flag new potential conflicts of interests. Do not underestimate the value that independent directors can bring to your organisation and the increasingly important role they play in operational due diligence sessions. Think deeply and collectively about managing conflicts and remember that, as internal and external factors of businesses change, as regulation changes and as investor expectations change, so too should your approach to effectively managing conflicts of interest change to meet the ever evolving expectations of the industry.

[1] *https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf*