

Financial Services Authority

# Conflicts of interest between asset managers and their customers:

## Identifying and mitigating the risks



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# Contents

- 1 Our message to industry
  - 1.1 Why conflicts of interest matter in asset management
  - 1.2 Our expectations of firms regarding the management of conflicts of interest
  - 1.3 Our findings: too often, conflicts of interest are poorly managed
  - 1.4 Next steps: action against specific firms and a general request for firms to attest to the FSA that they properly manage conflicts of interest
  
- 2 How firms identified and controlled conflicts of interest
  - 2.1 Firm culture is central to identifying conflicts of interest
  - 2.2 The best control frameworks were designed jointly by business and compliance functions.
  - 2.3 Monitoring of conflicts is more effective when conducted by both business and compliance functions
  - 2.4 Monitoring of conflicts is more effective when boards receive adequate management information
  - 2.5 Conflicts were better managed when UK boards had committees dedicated to conflicts of interest management
  
- 3 How firms managed the purchase of research and trade execution services on behalf of customers
  - 3.1 Too few firms adequately controlled spending on research and execution services
  - 3.2 Firms did not regularly review whether services were eligible to be paid for using customers' commission
  - 3.3 Firms with strong controls over commission were better able to demonstrate control over the execution of customer orders
  - 3.4 Some firms did not observe our requirements to disclose to customers details of commission payments

- 4 How firms managed gifts and entertainment
    - 4.1 Firms had not taken care to consider whether the value and frequency of gifts and entertainment would give rise to actual or perceived conflicts of interest
  5. How firms ensured customers have equal access to all suitable investment opportunities
    - 5.1 Some firms do not allocate trades between different clients in an equitable manner
    - 5.2 Some firms could not show that cross trading between customers was always in the interests of both customers
    - 5.3 We took enforcement action against a firm which traded for one fund to ease the liquidity problems faced by another fund
    - 5.4 Some firms had inadequate controls and oversight over the allocation of investment research ideas between customers
  6. How firms managed personal dealing by employees
    - 6.1 Most firms had satisfactory arrangements for managing conflicts arising from employees' personal dealing but application to staff was inconsistent
  7. How firms allocated the cost of errors between themselves and their customers
    - 7.1 Most firms had clear arrangements for handling errors but some placed too much reliance of contractual limitations to avoid reporting the cost of errors to clients
- Appendix 1:** Wording for firms to use when attesting to the FSA on the effectiveness of their arrangements to manage conflicts of interest

# 1

## Our message to industry

### 1.1 Why do conflicts of interest matter in asset management?

Asset managers act as agents for their customers, making investment decisions in financial markets on their behalf. Confidence in the integrity of asset managers when acting on behalf of customers is central to the relationship of trust between the industry and its customers. This means that when making investment decisions, or buying products and services for customers, asset managers must always act in customers' best interests and put customers' interests ahead of their own. Similarly, asset managers must treat all their customers fairly.

Acting as an agent for customers may create conflicts between the interests of a firm and its customers or between the interests of different customers. Policies to properly manage conflicts of interest mean customers avoid unnecessary costs and have fair access to all suitable investment opportunities. Properly managing conflicts improves the returns earned by customers and enhances general confidence in the UK asset management industry.

### 1.2 Our expectations

Principle 8 of our Principles for Businesses requires that a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another customer. SYSC 4 and SYSC 10 require the boards of directors at asset management firms to establish effective frameworks to identify, control and review conflicts of interest. The Conduct of Business Sourcebook (COBS) contains detailed rules governing the purchase of goods and services using customers' money and the allocation of investment opportunities between customers.

We expect firms to demonstrate that our principles and rules are embedded in their businesses and that they are taken into account when considering new products, processes or business models. We expect boards of firms to regularly review their practices to ensure compliance with our requirements.

### 1.3 Our findings

Between June 2011 and February 2012, we conducted thematic reviews of asset management firms, assessing their arrangements for managing conflicts of interest. The review was prompted by evidence from our other supervisory work that some firms no longer saw conflicts of interest as a key source of potential detriment to their customers and had relaxed controls that we had considered to be well-established market norms.

We identified that many firms had failed to establish an adequate framework for identifying and managing conflicts of interests. We also identified breaches of our detailed rules governing the use of customers' commissions and the fair allocation of trades between customers. We concluded that most of the firms visited could not demonstrate that customers avoid inappropriate costs and have fair access to all suitable investment opportunities.

We found that the attitude towards customers established by senior management best explained why some firms managed conflicts well and others badly. 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 to customers or even that they had reviewed or updated their arrangements for conflicts management since 2007. In these firms, employees too often lacked awareness of situations where short-term business goals conflicted with the long-term interests of customers.

### 1.4 Next steps

We have given detailed feedback to the firms visited during the project and, where we believe firms have not complied with relevant principles or rules, we have asked them either to justify their approach or, where necessary, required them to take remedial action. In some cases, we required skilled person reviews under s166 of FSMA and in more serious cases we are considering enforcement action against firms.

We have concluded that the findings from this thematic review need to be communicated to the wider asset management sector. We have also concluded that the seriousness of the issues identified requires us to take action to ensure firms comply with the various FSA rules relating to conflicts of interest (including, but not limited to, those cited in this document). We therefore expect the board of each asset management firm to discuss this document and each firm's CEO to complete and return the 'attestation' in Appendix 1 by 28 February 2013.

We plan a second round of thematic visits on conflicts of interest and will use the responses received to inform our selection of firms for follow up assessment visits.

# 2

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## Summary of key findings

### How firms identified and controlled conflicts of interest

#### 2.1 Firm culture is central to identifying conflicts of interest

We saw a strong correlation between a firm's culture and its ability to recognise conflicts of interest. At some firms, the management was aware of the possibility of conflicts and trained staff to look for and report them. Formal checks within product development and change management processes forced the firm to consider whether new activities created new conflicts or undermined the mitigation of pre-existing conflicts. Other good practice included firms conducting periodic reviews of operations to look for evidence of new conflicts, using discussions involving operations staff (who understand how processes actually work) and legal and compliance staff (who facilitate discussions and often have a better understanding of how conflicts arise). This 'bottom-up' approach to identifying conflicts is in addition to separately considering the inherent conflicts that most asset managers face.

#### 2.2 The best control frameworks were designed jointly by business and compliance functions

We found that firms achieved better controls and standards when both business line management and second line teams – such as the legal or the compliance department – designed conflicts management controls. Firms doing so tended to have standards that were relevant to the nature of the conflict, and were operationally effective and accepted by business staff. Many of these standards were also aligned to our expectations and good market practice.

### **2.3 Monitoring conflicts is more effective when conducted by both business and compliance functions**

We found that the most effective monitoring of conflicts of interest involved separate reviews by both business line management and compliance staff. Firms that relied on monitoring performed by the compliance department as the only form of control over conflicts were unable to demonstrate to us how compliance staff credibly challenged investment and trading decisions made by senior investment professionals.

### **2.4 Monitoring conflicts is more effective when boards receive adequate management information**

We found that some firms had developed sophisticated monitoring programmes, based on automated management information (MI). Review work didn't just consist of routinely checking specific procedures; it also looked at whether controls continue to meet their objectives and whether compliance standards used to manage conflicts reflect developments in market practices and new regulations. We found that the highest standards resulted from reviews performed by a governance committee or working group involving independent business staff, rather than by compliance staff in isolation. An example of such an approach working well is the review of broker usage and brokerage commissions.

### **2.5 Conflicts were better managed when UK boards had committees dedicated to conflicts of interest management**

We found that only a small number of firms had an effective governance committee to ensure that the firm's appetite for reputational risk was reflected in the design of new controls and standards. Such governance bodies challenged and approved conflict identification and controls design work undertaken by others, defined the MI they wished to receive and reviewed the implications of materials presented to them. The best example was a committee chaired by an effective, independent non-executive director, which provided a forum for legal and compliance teams and those with day-to-day responsibility for operating the firm's conflicts practices. We found that such committees could demonstrate a positive influence on the firm's arrangements for managing conflicts of interest and improve the firm's culture of serving customers' best interests.

We saw evidence that firms operating as UK subsidiaries of overseas parents had governance arrangements that did not meet our requirements regarding conflicts management. In some cases, UK boards did not exercise meaningful control and overseas staff who are not Approved Persons were making decisions on core practices. In other firms, there was a blurring of responsibilities between the UK Board and its committees and those of the overseas parent. The result was that the board of the FSA-authorized firm did not take overall responsibility for compliance with our rules.

# 3

## How firms managed the purchase of research and trade execution services on behalf of customers

### **3.1 Too few firms adequately controlled spending on research and execution services**

Firms regularly spend millions of pounds of their customers' money buying research and execution services from brokers. Only a few firms we visited exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources. One firm had carefully considered which services represented valuable inputs to its investment process and challenged brokers about why it should pay for other services. Another firm set a maximum spend on research services and, once these limits were reached, switched commission rates for the brokers concerned to execution-only rates for the remainder of the commission period. These firms could show us that they were both acting in their customers' best interests and putting customers' interests before their own.

Poor practice we identified included no central organisation of commission payments where individual fund managers paid for research services by directing business to particular brokers on a trade-by-trade basis. It was unclear to us how firms using this approach monitored whether they were acting in customers' best interests.

### **3.2 Firms did not regularly review whether services were eligible to be paid for using customers' commission**

COBS11.6.3R limits what can be purchased to 'execution' or 'research' services. COBS11.6.5E provides evidential standards to determine what constitutes research. We found that few governing bodies regularly reviewed whether the products and services purchased using client

commissions were eligible to be paid for with customers' funds. In particular, various firms were using commissions to pay for market data services and were unable to demonstrate how these met all of our evidential standards for research services. Firms were also unable to demonstrate how brokers arranging for access to company management<sup>1</sup> or providing preferential access to IPOs, constituted research or execution services.

### **3.3 Firms with strong controls over commission were better able to demonstrate control over the execution of customer orders**

Firms with poor controls over how they spend customers' commission put at risk their ability to execute transactions by directing them to counterparties or venues that might not provide best execution. We found that firms with the strongest controls over commissions also tended to have the best monitoring over execution. Good practice we observed in this area included a designated management committee, using transaction cost analysis to assess and challenge the performance of dealing desks.

### **3.4 Some firms did not observe our requirements to disclose to customers details of commission payments**

We found one firm that claimed to comply with the Investment Management Association's (IMA) Pension Fund Disclosure Code (the Code) regarding commissions when, in fact, it was not fully compliant. The firm was not able to explain to our satisfaction why it had chosen not to comply with the Code, nor how it believed it had met our commission disclosure rules through other means.<sup>2</sup>

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1 Access to company management (sometimes also referred to as 'corporate access') means, in this context, the practice of third parties (typically investment banks) arranging for asset managers to meet with the senior management of corporations in which the asset manager invests, or might subsequently invest, on behalf of customers. It does not refer to any research services that might be provided by the third party alongside providing access to company management.

2 COBS 11.7.17G states that in assessing the adequacy of periodic disclosures a firm makes to comply with COBS 11.7.15R, the FSA will have regard to the extent to which the firm adopts disclosure standards developed by industry associations such as the Investment Management Association.

# 4

## How firms managed gifts and entertainment

Firms had not taken care to consider whether the value and frequency of gifts and entertainment would give rise to actual or perceived conflicts of interest

We were concerned to find that most of the firms we visited applied limited thinking to how accepting gifts and entertainment could compromise their duty to act in their customers' best interests. Many firms set their policies simply by reference to market practices. We saw examples of entertainment taken by firms' staff that, if fully disclosed to the firms' customers, might have caused concern about the objectivity of decisions taken on their behalf. Examples of policies we saw that contained controls over gifts and entertainment practices included:

- The policy imposed limits on both the value of any one gift or event and on the frequency with which multiple gifts/events can be accepted within a certain time period. It required gifts/events to be valued on the basis of cost incurred by the provider or its market value, not the face price of the ticket.
- The policy applied to both broker and issuer-sponsored conferences and research trips, including the entertainment provided during these trips, and did not permit travel and accommodation to be accepted.
- The policy extended to frequent, low-level entertainment (such as drinks and dinners) as well as occasional, expensive events. The policy also covered gifts and entertainment paid for by a member of a broker's staff personally. The policy also recognised that some events might have much greater value to particular individuals than others (for example, when the entertainment is a ticket to a sporting event) and that donors might structure their entertainment based on their knowledge of a particular individual recipient's interests.
- The policy treated events not attended by the donor firm's staff as gifts, not entertainment, and subjected them to tighter monetary limits applied to gifts. The policy also required

events that are attended by the recipient's partner, friends or family to be treated as gifts and subject to the same tighter monetary limits.

- In some cases, the policy required the firm to reimburse the donor for the full cost of staff attending an event, even if a valid business purpose justified attending. Where no valid business purpose could be demonstrated, the policy required staff to pay.
- The policy required both line managers and compliance staff to approve gifts and entertainment.
- The policy covered gifts and entertainment provided by trustees, depositories and parties providing services to the asset manager under outsourcing contracts (such as fund accountants and transfer agents). The policy highlighted the risk that staff may be influenced in carrying out their responsibilities under SYSC 8 to oversee outsourced activities effectively.

# 5

## Ensuring customers have equal access to all suitable investment opportunities

### 5.1 Some firms do not allocate trades between different clients in an equitable manner

Our rules require prompt and accurate recording, allocation and documentation of trades. Our rules also require firms to allocate transactions fairly when they conduct transactions involving several clients in the same security at the same time.

We found that most firms had satisfactory procedures to allocate the completed transaction fairly between clients. But in one case, a firm exempted various senior fund managers from trading through the central dealing desk, and allowed them to delay allocating trades until several hours after execution. When challenged to justify this practice, the firm implemented a review, which found evidence that late allocation of trades allowed fund managers to favour some customers over others. Another example of poor practice involved allocating to the same customer all trades where pro rata allocation was not applied (mainly because of board lot rounding or minimum allocation sizes).

### 5.2 Some firms could not show that cross trading between customers was always in the interests of both customers

Many firms transfer securities between customers' portfolios (cross trades) and in most cases had adequate controls to ensure such trades were beneficial to both customers and were executed at a fair price. But in one case, we challenged a firm to justify how regular and significant cross trading was beneficial for all customers after we became concerned that some funds might be improperly providing liquidity support to others. In other cases, we found that investment staff did not record reasons for cross trades between customers,

or that where reasons had been recorded, senior management did not carry out any meaningful review of them.

### **5.3 We took enforcement action against a firm which traded for one fund to ease the liquidity problems faced by another fund**

We took enforcement action against a firm that purchased a security for one customer, the proceeds of which allowed another customer to redeem a different, illiquid security, issued by the same group. This connected transaction enabled the second customer to meet redemptions it could not otherwise meet.

### **5.4 Some firms had inadequate controls and oversight over the allocation of investment research ideas between customers**

We found that most firms emphasised the role of team-based research and sharing ideas in their marketing material. But we identified that some firms employed investment processes that were not based on a team approach and where individual portfolio managers were given significant leeway in investing their portfolios, with no requirement to share information and ideas. Too often these firms had not disclosed that research ideas were not shared between portfolio managers.

# 6

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## How firms managed personal dealing by employees

### **Most firms had satisfactory arrangements for managing conflicts arising from employees' personal dealing but application to staff was inconsistent**

- 6.1** We found variable standards among firms for controls over employees dealing for their personal accounts (PA trading). Firms with good controls over PA trading took care to: explain to employees the conflicts of interest created by PA trading; set out clear procedures; and impose significant restrictions, such as an expectation that staff would trade only as long-term investors, with minimum holding periods and maximum trading frequencies. These firms monitored PA trading activity, and focused attention on staff conducting extensive personal trading or judged to be in particularly sensitive client portfolio handling roles. Good practice involved a governance committee overseeing personal trading activity and reviewing all aspects of the policy to ensure it remained appropriate. One example of poor practice arose where a firm exempted senior staff from some of the firm's PA trading rules, without good reason.

# 7

## How firms allocated the cost of errors between themselves and customers

**Most firms had clear arrangements for handling errors, but some were too reliant on contractual limitations to avoid reporting the cost of errors to customers**

**7.1** Most firms recognised that, when an asset management firm makes a mistake in the handling of a customer's account, a conflict exists between the firm and its customer over who should bear the cost of that error. They also recognised that the conflict is exacerbated because the customer is often unaware of the mistake and does not become aware unless told by the firm. We found that some firms had explored this issue in great detail and good policies included the following:

- The policy required firms to report errors internally and establish systems to capture error information. It encouraged staff to admit errors (rather than conceal them) and the compliance department and a relevant governance committee of the board reviewed error-handling decisions.
- The error correction policy did not allow counterparties to accommodate the costs of an error by the firm.
- The policy required customers to be returned to the position they would have enjoyed had the error not occurred. The policy allowed clients to keep the profits from any errors, except:
  - where these can be reasonably netted against loss-making errors of the same type, or
  - where the error trade has been fully disclosed to the customer who then makes an informed decision to reject the trade.

We noted that some firms – mostly hedge fund managers – relied on clauses in their contracts with customers to remove the liability for the costs of errors and omissions other than in the case of gross negligence. We found that some firms used these clauses to justify not reporting errors to customers and to avoid systematically collecting information about the costs of errors incurred by customers. These firms had not considered whether repeatedly making the same or similar errors might in itself amount to gross negligence.



## Appendix 1

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Wording for firms to use when attesting to the FSA on the effectiveness of their arrangements to manage conflicts of interest

## ATTESTATION TO THE FSA

The board of {*name of firm*} ('the firm') has received a copy of the FSA paper, *Conflicts of interest between asset managers and their customers: identifying and mitigating the risks* ('the Paper').

The Paper has been considered at a board meeting(s) held on {*date(s)*}. Following an assessment of the firm's arrangements in light of the Paper's findings, the board resolved that the firm's arrangements are sufficient to ensure that the firm manages conflicts of interest effectively and in compliance with FSA rules

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Chief Executive Officer

Date:

A pdf of this attestation should be returned to the following address:

Conflicts-attestation@fsa.gov.uk



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