Fund governance and conflicts of interest survey 2013

Carne Global Financial Services

About Carne Group

Carne is a leading global provider of independent fund governance and oversight solutions for investment funds of all kinds. Carne serves its clients by providing solutions which help them to meet the increasingly stringent demands of investors and regulators for high quality corporate governance within the asset management industry. We provide independent directors for fund boards in both offshore and onshore locations and we are recognised as thought leaders in the debate on higher oversight standards in the asset management industry.

www.carnegroup.com

John Donohoe
CEO, Carne Group

Why fund governance is more important than ever

The topic of fund governance has been rising steadily up the agenda on both sides of the Atlantic in the past few years. While issues like the relative independence of directors sitting on the boards of hedge funds in the Cayman Islands has garnered plenty of media attention, the wider asset management industry is also being asked to address governance issues by regulators and investors.

The guidance and research contained in this study were prompted by the 'Dear CEO' letter published by the then Financial Services Authority (now the Financial Conduct Authority) last year, which drew specific attention to the sometimes inferior management of conflicts of interest at UK-regulated fund management firms, as well as the SEC's public statement that it is a key focus area for them. Anecdotal evidence collected by Carne from institutional allocators in the last 12 months has also demonstrated an awareness on the part of operational due diligence professionals that more should be done to manage conflicts of interest at long only fund management firms.

Conflicts of interest within the fund management business are many and varied, and not always easy to define. The Financial Conduct Authority requires as part of its principles that a fund manager must manage conflicts of interest fairly, both between itself and its customers, and between the customers themselves.

Speaking last year, SEC Director for the Office of Compliance Inspections and Examinations, Carlo di Florio, warned financial firms to be aware of conflicts:

"Conflicts of interest exist throughout the commercial world. They are a particularly important challenge for large and complex financial institutions, which can have affiliations that lead to a host of potential conflicts of interest. If these are not carefully managed, this then leads to failure to protect the client's interests, with attendant regulatory and reputational risks that could be disastrous." [1]

It is important that funds and their boards, as customers of the investment manager, are aware of what conflicts of interest procedures are in place within the investment manager, how they are managed and how they are reported to the funds. Funds themselves, their boards and their directors also have conflicts of interest which should be identified, documented and managed. Boards should be taking a proactive approach by engaging with the fund manager and helping the manager to demonstrate to regulators and investing clients that conflicts management is a high priority.

Ultimately, fund boards can independently document conflicts management processes and demonstrate that the fund and the investment manager are being held to high levels of governance and transparency.

[1] Conflicts of Interest and Risk Governance, speech to the National Society of Compliance Professionals, 22 October 2012.

The first part of this study contains the results of a survey conducted by Carne of major allocators to long-only and alternative funds in H1 2013. With this research we have sought to define investor opinion, including the thoughts of pension funds, consultants, funds of funds and sovereign wealth funds, on the critical topic of conflicts of interest. The findings represent a clear indicator of investor opinion on conflicts within asset management firms and the role fund boards should be playing to mitigate these risks.

The second part of this study helps to define some of the conflicts that can commonly occur within funds and the investment management business and offers some advice on how these can be managed, both by fund managers themselves as well as by fund directors and investors.

Much has been done over the last few years to improve fund governance, but investors currently rate fund governance as 5's and 6's out of 10 in most regions rather than the desired 8 to 9 (see page 11).

The clear majority of investment managers should want to demonstrate excellence in fund governance both within their firms and within the funds they promote. This survey should provide guidance on how this can be achieved.

Asset managers should also consider if a global governance code should be developed by the industry as suggested by investors (see page 14). Investors have clearly stated that they would prefer industry solutions rather than more regulations.

I would like to thank all the investors who gave of their time to provide us with their valuable feedback, including **Aon Hewitt, CalPERS, BBC Pension Trust, Cambridge Associates, Florida State Board of Administration, Future Fund of Australia, Mercer, Royal Bank of Scotland Pension Fund, SEB, Skandia Group and Towers Watson.**

October 2013

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Part One: Conflicts of Interest Survey

Key Findings

- 71% of those interviewed felt fund governance had become more of an issue in the last four years.
- 90% of investors interviewed would like fund boards to consider and address conflicts of interest as a matter of routine.
- A lack of independent fund directors on fund boards and a lack of experienced fund directors are seen as the two primary failings in fund governance arrangements.
- Investors rate governance in the broader funds industry at 5's and 6's out of 10 rather than a desired 8 or 9 out of 10.
- A majority of independent fund directors and fully independent service providers are regarded as the best means of managing conflicts of interest at the fund level.
- 83% of investors would like fund boards to have a majority of independent directors and 62% to have an independent chairman.
- 95% of investors would like to see a fund industry global code of governance in place. Most investors want the industry to provide the solution and do not want more regulation.
- A risk management background is now considered the most sought after professional skill for independent fund directors, according to investors. This is in contrast to two years ago when a premium was placed on directors with a legal background.

Research Objectives

In the first half of 2013, Carne interviewed major allocators to both long only and alternative funds on the issue of conflicts of interest at the fund level. The issue has become an increasingly important area of focus for global regulators and is a topic of growing concern for investors.

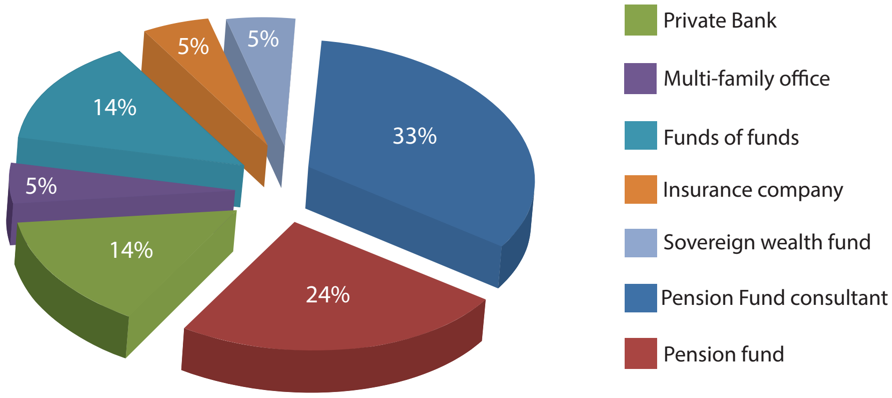
By conducting this research, we were seeking to discover what investors' views were on potential conflicts of interest at the fund level, and how investors expect fund boards to play an active role in identifying and managing those conflicts. As fund governance has moved up the regulatory and allocator agenda, so the role of fund boards and the directors sitting on those boards has come under scrutiny.

The results provide a road map for fund boards and investment managers, indicating what investors expect to see, including their preferred board composition and activities.

Carne interviewed a range of different major institutional investors in regulated and unregulated funds, including pension funds, pension consultants, funds of funds, private banks and sovereign wealth funds. Together they comprise over $9.5 trillion in assets under investment / advice.

The respondents allocate to a wide range of funds, including long only and alternative strategies managed in various types of structures in domiciles including Luxembourg, Ireland, US, domestic European jurisdictions such as the UK and other EU countries, and offshore centres such as the Cayman Islands.

Respondent by Type



Total assets under investment / advice: US$ 9.5 trillion

Section One: Importance of fund governance

Q1: As an investor, how important is fund governance to you?

Fund governance remains an issue of great importance to fund investors. Allocators interviewed for this study were asked whether they viewed governance as:

- Extremely important
- Important
- Not important

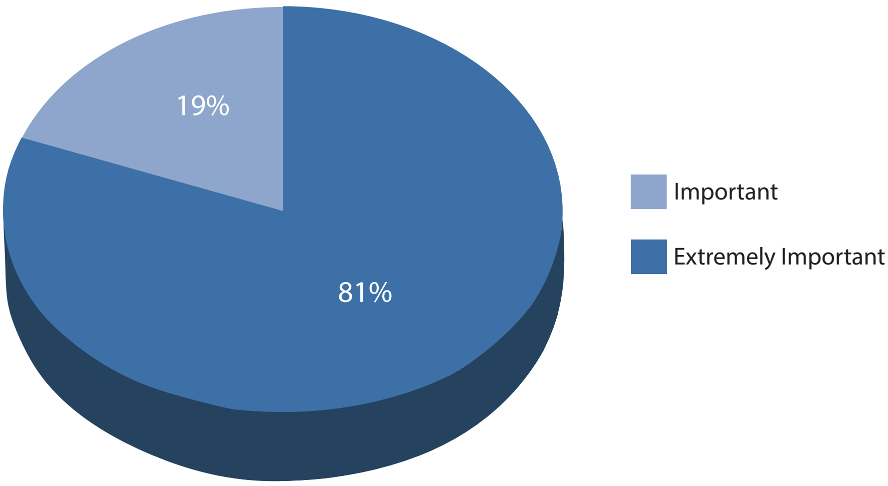


Figure 1: Importance of fund governance to institutional investors

Q2: Has fund governance become more of an issue over the last four years?

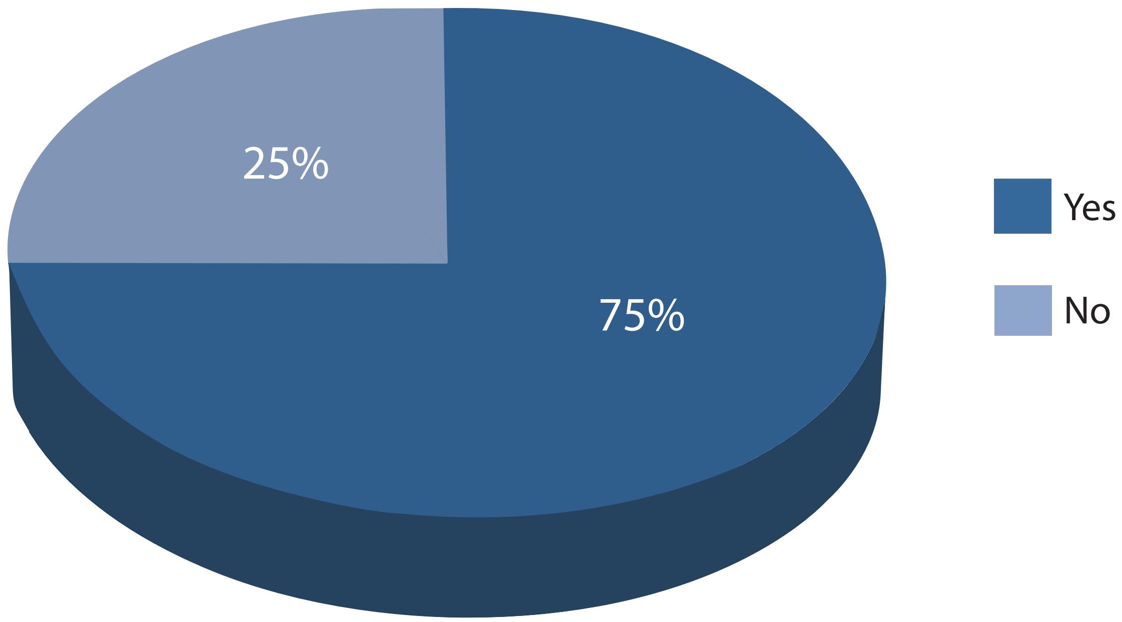


Figure 2: Fund governance has increased in importance

Fund governance has continued to grow in importance since the 2008 financial crisis. While for some investors it has always been a critical issue, the bulk of allocators are now much more focused on this issue. One of the contributors to this survey described it as "an undiversifiable risk factor."

The investors interviewed for this study felt that governance was an extremely important issue for fund boards, and that the events of 2008-09 had demonstrated that experienced fund board directors were needed to help to protect investors' interests.

A number of respondents, particularly pension funds and sovereign wealth funds, voiced their desire to see improved governance in the asset management industry. Some of the respondents expressed a desire for better education of institutional investors relating to corporate governance issues and structures.

Increased volatility in the markets and the enhanced complexity of governance as a legal and regulatory issue are also important factors causing institutional investors and consultants to focus more attention on governance.

Q3: Which key areas of fund governance require improvement?

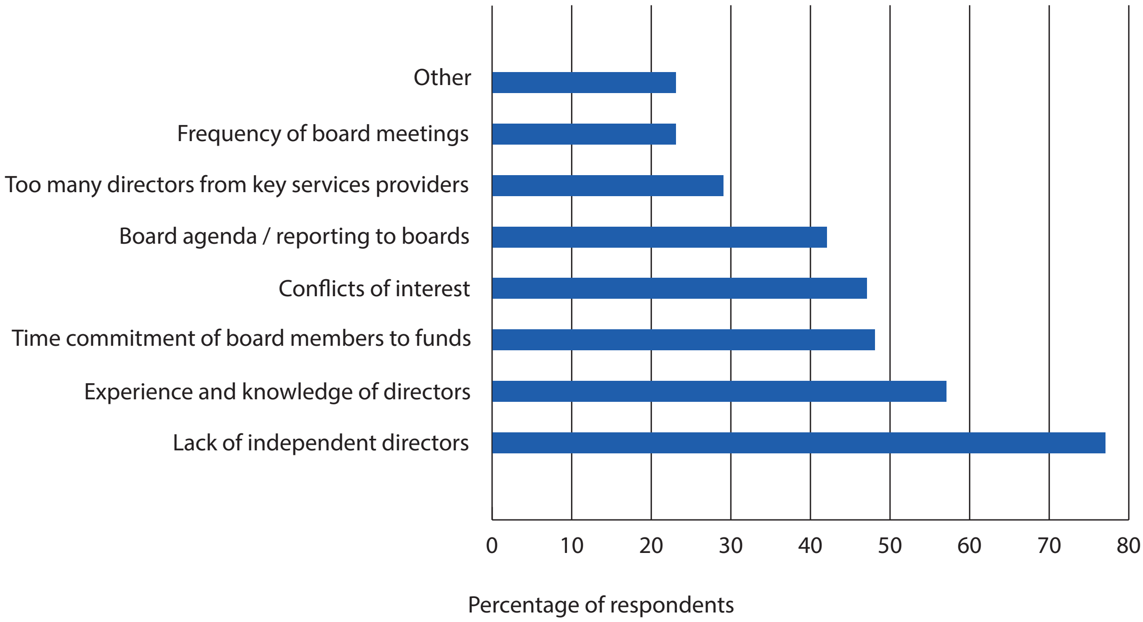


Figure 3: Governance areas requiring improvement

Investors are extremely focused on the role played by fund boards and see the lack of experienced independent directors as a critical governance failing for both long only and alternative funds. Investors pointed out that many fund domiciles such as the US (for non-40 Act funds), Luxembourg, Cayman Islands and the UK do not require any independent directors on a fund board.

Other concerns expressed also include:

- Very broad investment mandates in offering documents.
- Authorised Corporate Directors in the UK generally do not have independent directors.
- Inadequate independent oversight of funds where the investment manager owns a large stake in the fund.
- Lack of transparency over how many directorships are held by individual fund directors.
- Lack of proper governance across the entire fund structure. Some master-feeder funds only have proper governance at a master or feeder level rather than both.

We also asked investors to rate the perceived overall level of governance for funds out of 10, with 10 being the highest. Investors only provided feedback for those regions where they had operational due diligence experience of managers and funds. Of most significance is that while funds managed by continental European managers (excluding Switzerland, which was rated separately) score higher on average than US managers, they still lag UK managers by a significant margin.

Q4: Rate the quality of governance in funds managed by managers from these regions / countries out of 10.

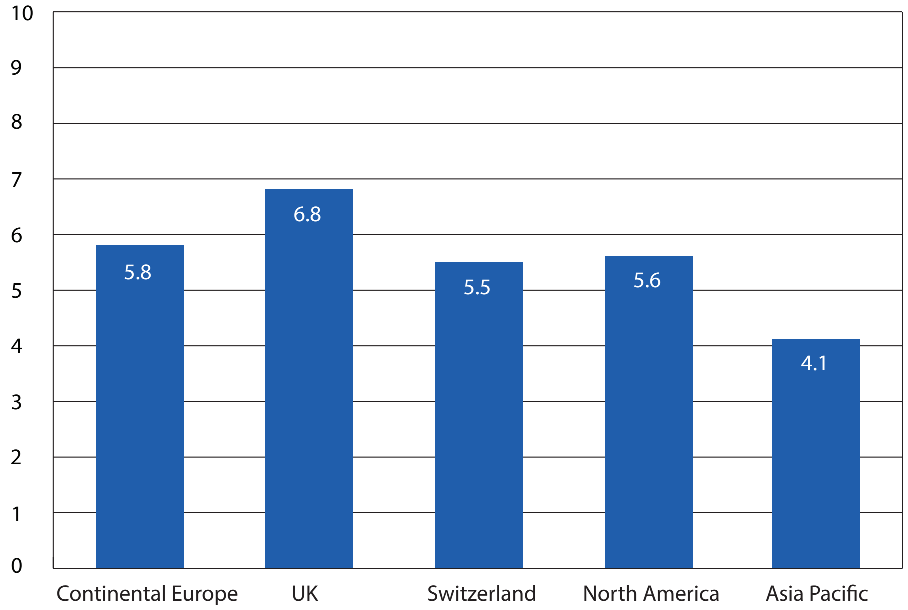


Figure 4: Quality of fund level governance (by home/domicile of investment manager)

Feedback from investors indicated that they would like to see governance levels improved to 8 to 9 out of 10.

Section 2: Conflicts of interest

Conflicts of interest within investment management firms and on fund boards alike has become an area of closer scrutiny for regulators and investors. But what areas are investors focusing on, and how do they see fund boards playing a role in helping to manage these?

Q5: Do you consider any of the following as a potential conflict of interest?

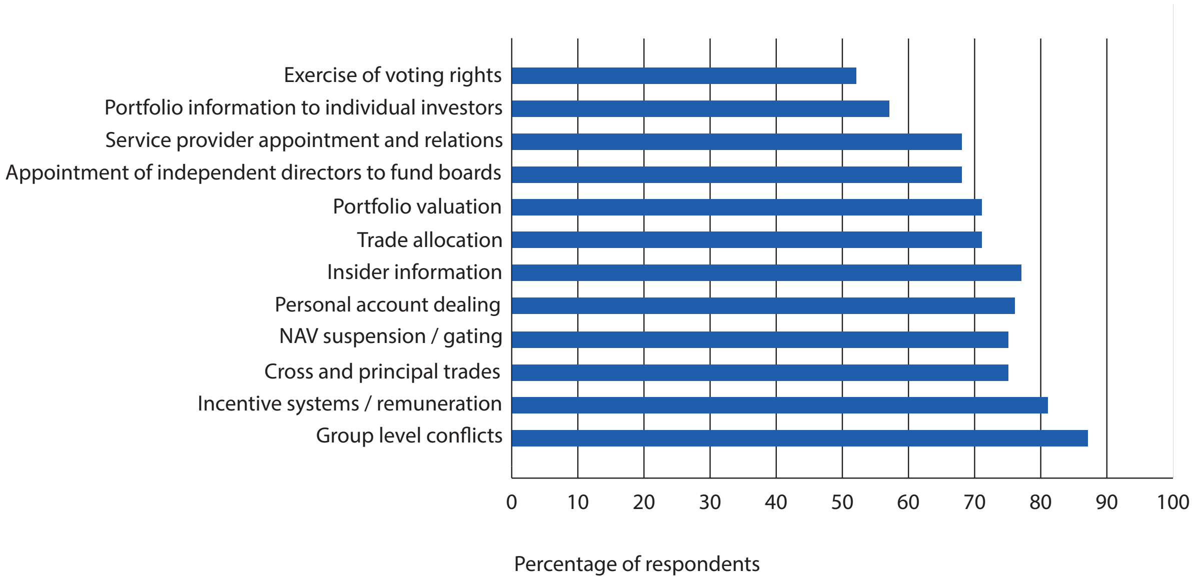


Figure 5: Perceived areas of most likely conflict

Conflicts can occur at all levels of an organisation. For this survey, we were focusing in particular on fund level conflicts and the role that fund boards should be playing in managing these. Group level conflicts – for example the appointment of service providers for a fund from within the same financial group – are seen as the most likely source of conflict of interest.

Other areas of conflicts cited by many investors include:

- Trading error identification and reporting to fund boards
- Investment or other guideline breaches by investment manager
- Deviation from promised investment strategy and investment risk, including portfolio diversification, eligible assets and liquidity, especially when investment opportunities are scarce or managers are overly optimistic about an investment opportunity.

Q6: What do you feel is the best way to address conflicts within funds?

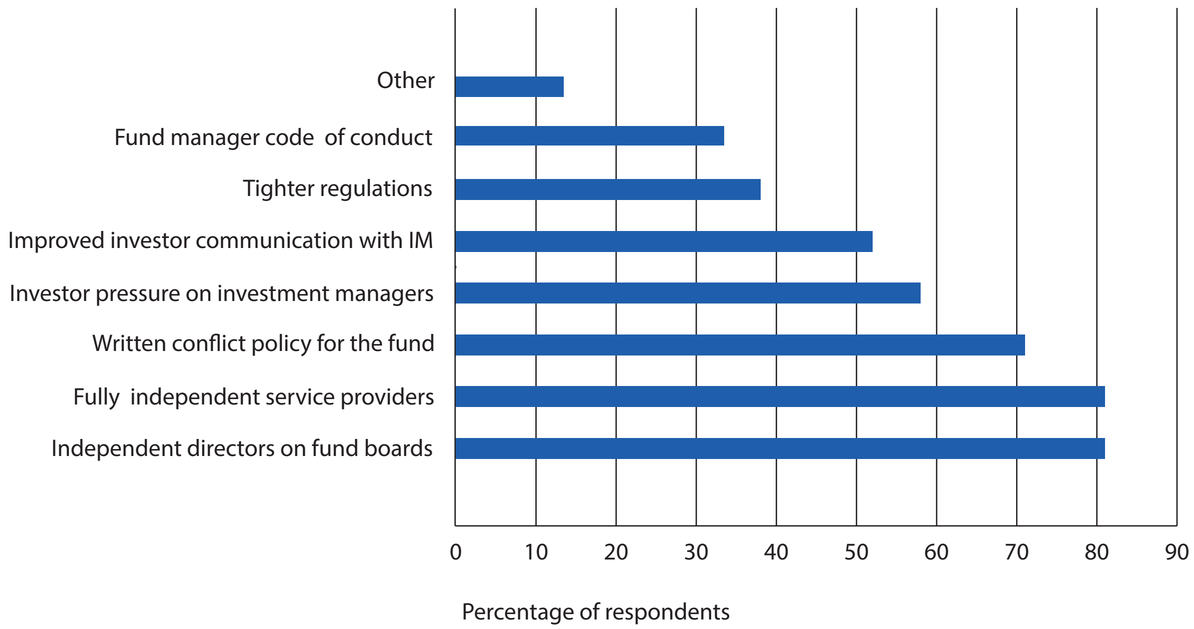


Figure 6: Best ways to manage conflicts of interest

Investors commented that they look to the fund's board as one of the best ways to manage conflicts at the fund level. Keeping service provider relationships as independent as possible is also regarded as good practice. There is less confidence or demand for regulatory intervention. "People will always find ways to get around regulations," one investor observed.

Other solutions suggested by investors included a fund manager code of conduct, to be applied industry-wide, while several investors felt higher levels of transparency would be of great help.

Q7: Should the asset management industry implement a code of conduct on corporate governance?

On the subject of an industry code of conduct, while this was not seen as the best way to manage conflicts of interest, most investors would like to see one implemented, combined with other actions (see Fig 6 above):

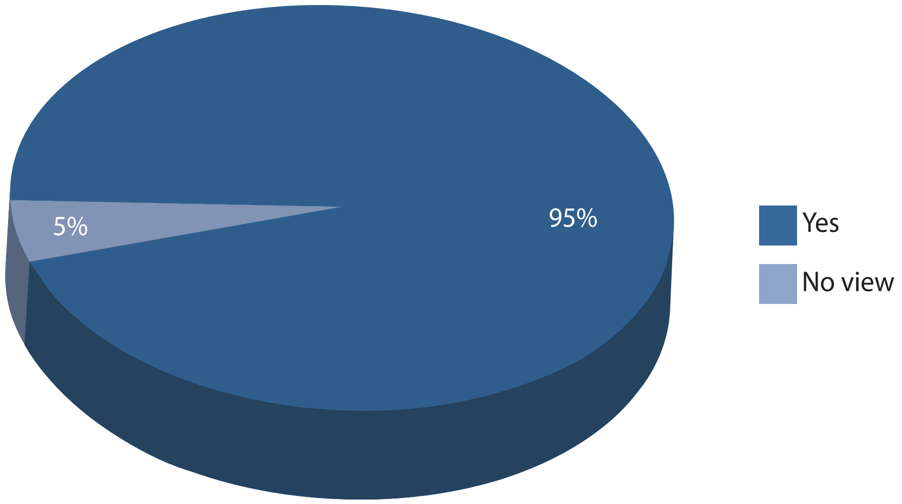


Figure 7: Should there be an industry code of governance?

Q8: Should there be a standardised approach to governance?

The vast majority of investors are supportive of an industry governance code for funds to adhere to. The majority (76%) of investors interviewed for this study are in favour of a standard governance template. Contributors stated that any industry code will still need to be flexible, and should be applied at a high level.

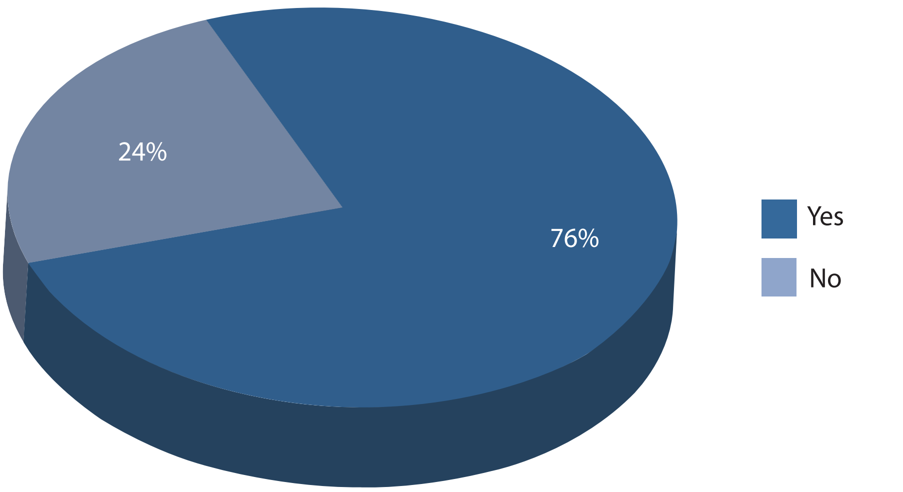


Figure 8: Should there be a standardised approach to governance?

Q9: What should an industry code of governance cover?

Given the enthusiasm for an industry code of governance, we also asked allocators about what they actually wanted to see covered by such a code:

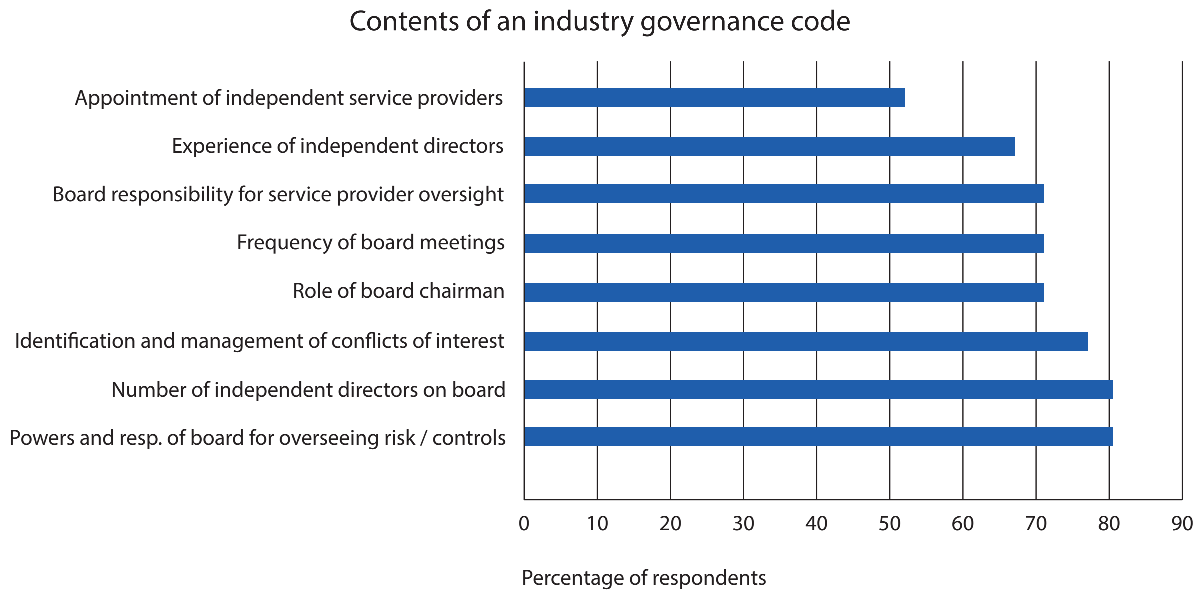


Figure 9: Suggested contents of industry governance code

The biggest concern remains the lack of independent directors on fund boards. Investors would also like to see some kind of formalised code covering the powers and responsibilities of the board and proper identification and management of conflicts of interest.

Apart from the above, it was also suggested that a definition of independence including factors to be considered, be introduced in an industry governance code, enabling judgement of whether or not a particular director is sufficiently independent to be designated an independent director.

Section 3: Constitution of fund boards

Q10: Would you like to see an independent director on a fund's board?

Given the importance attached to fund boards and independent directors in particular in helping to manage conflicts of interest, we asked investors whether they would like to see independent directors sitting on the boards of the funds they invest in, and what proportion of the board should be independent:

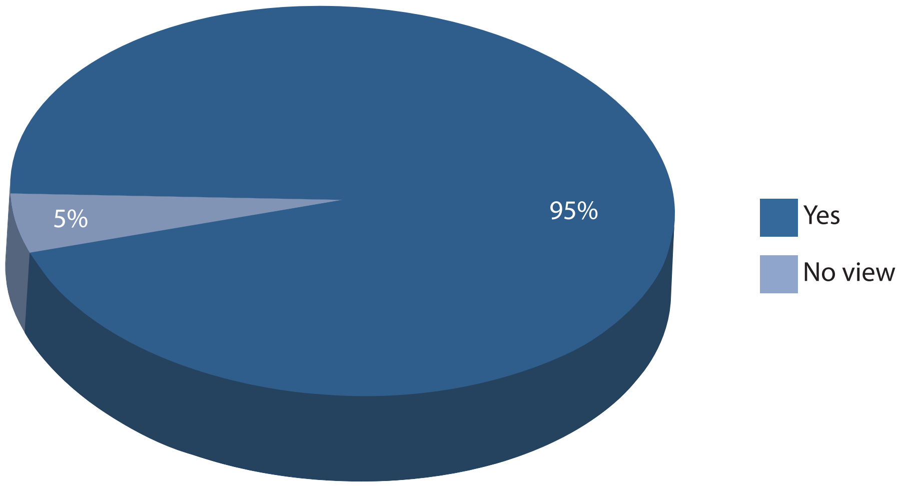


Figure 10: Would you like to see an independent director on the fund's board?

Q11: What is your preferred balance of independent directors on a fund's board?

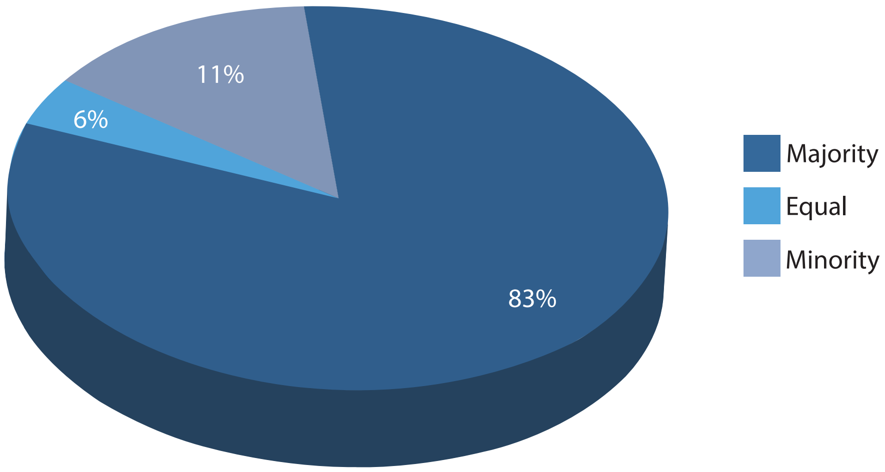


Figure 11: Preferred proportion of independent directors on fund board

Q12: What is the minimum number of directors / independent directors you would like to see on a fund's board?

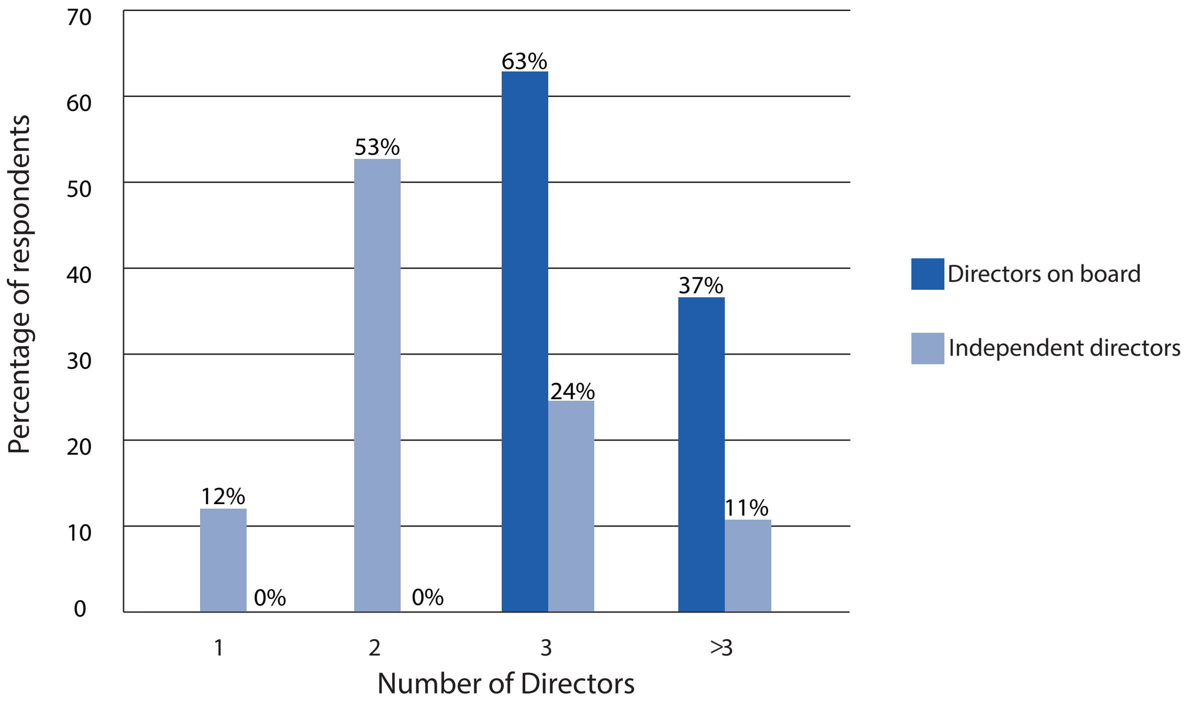


Figure 12: Minimum number of directors and independent directors required

Investors want a fund board ideally composed of at least three directors, with a minimum of two independent directors.

Q13: Is it important that the chairman of the fund's board be an independent director?

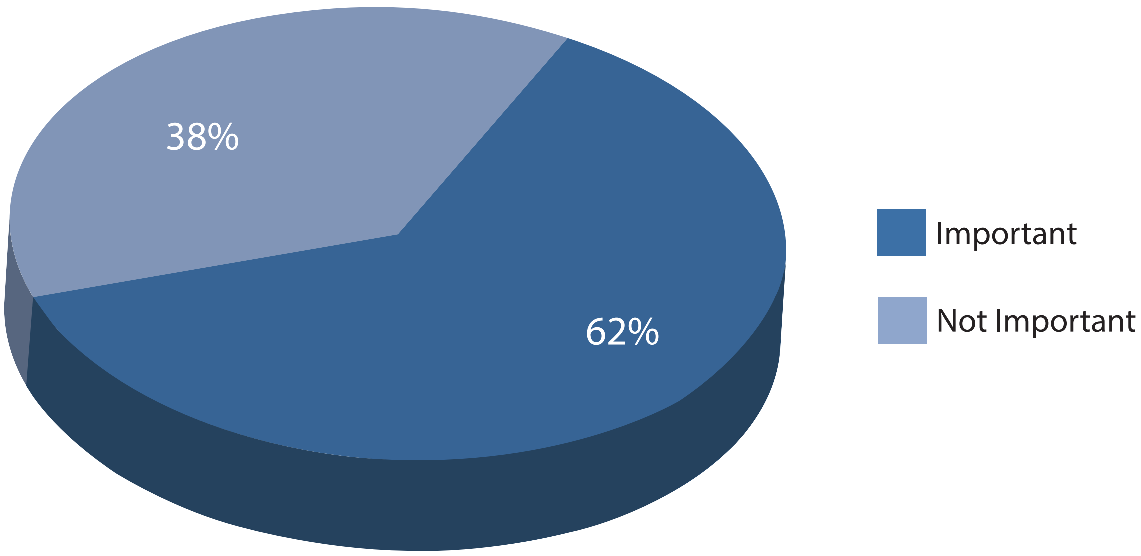


Figure 13: Is it important that the chairman of the board is an independent director?

Two thirds of investors believe that the board's chairman should be independent. As the chairman leads the board's work, including the delegation of powers, board reporting and the identification, monitoring and management of conflicts, then investors believe it would be better governance if this person was independent.

Q14: What is your preferred number of board meetings?

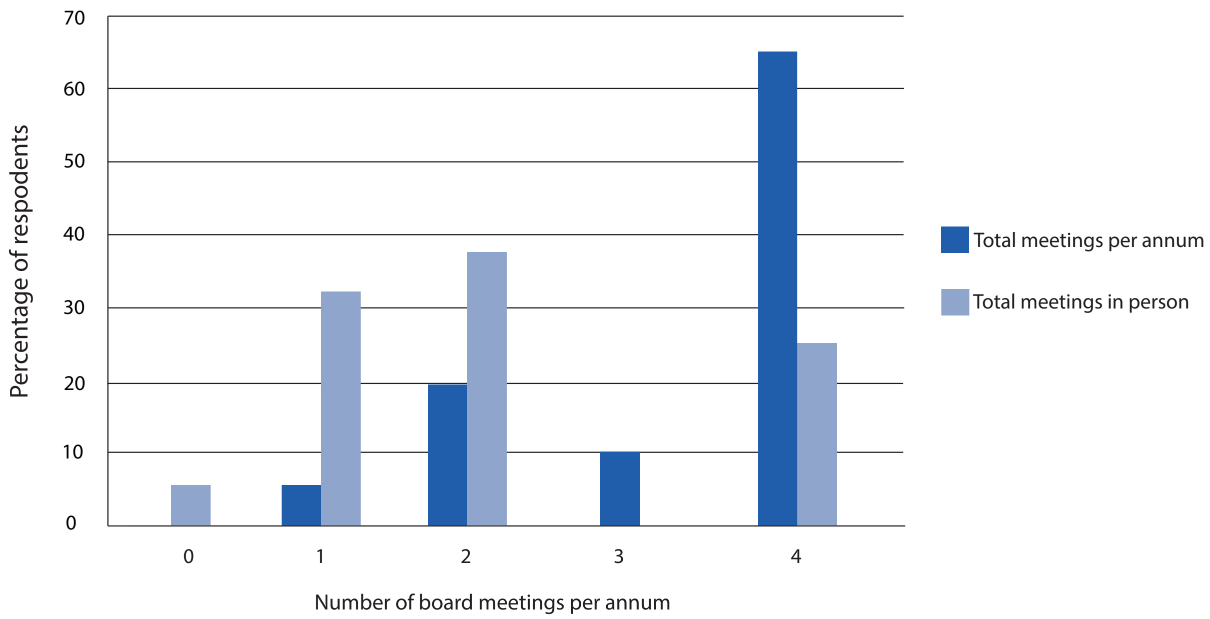


Figure 14: Preferred number of board meetings

Q15: What items should a fund board routinely consider?

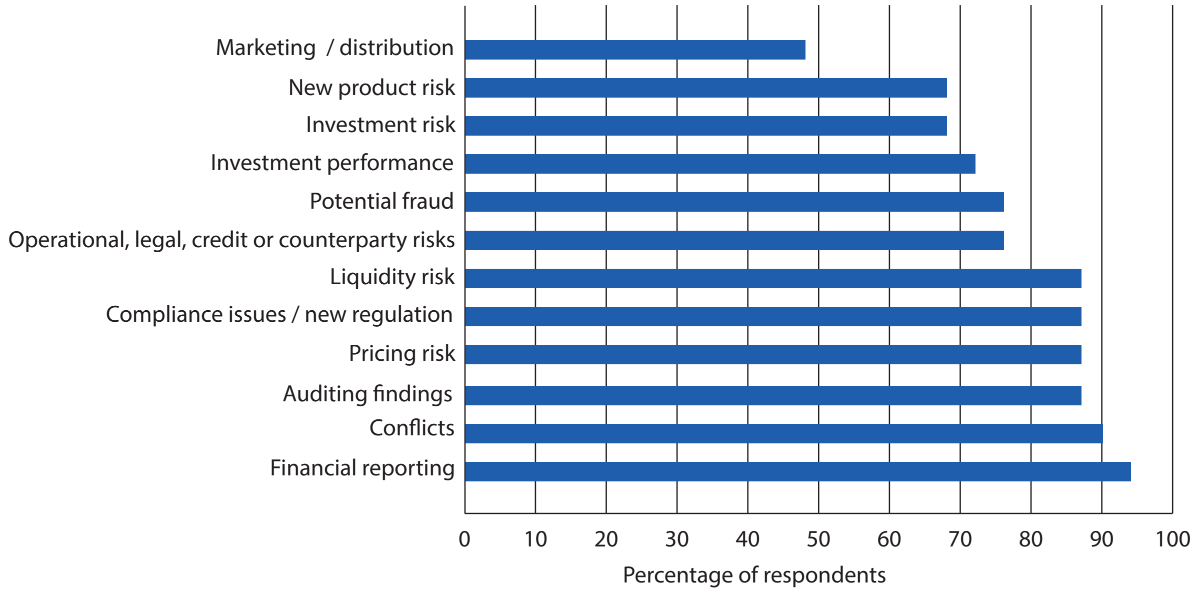


Figure 15: Items a fund board should consider

While fund boards are expected to consider financial reporting and audits as a matter of course, it is also interesting to note that 90% of investors will expect a board to also discuss and resolve possible areas of conflict. Pricing and liquidity – which can also be a potential source of conflicts – should be high on the agenda for fund boards and are considered more critical than investment performance or investment-related risk as agenda items.

Section 4: Who are the fund directors?

Q16: What do you consider to be the advantages of having an independent director on a fund board?

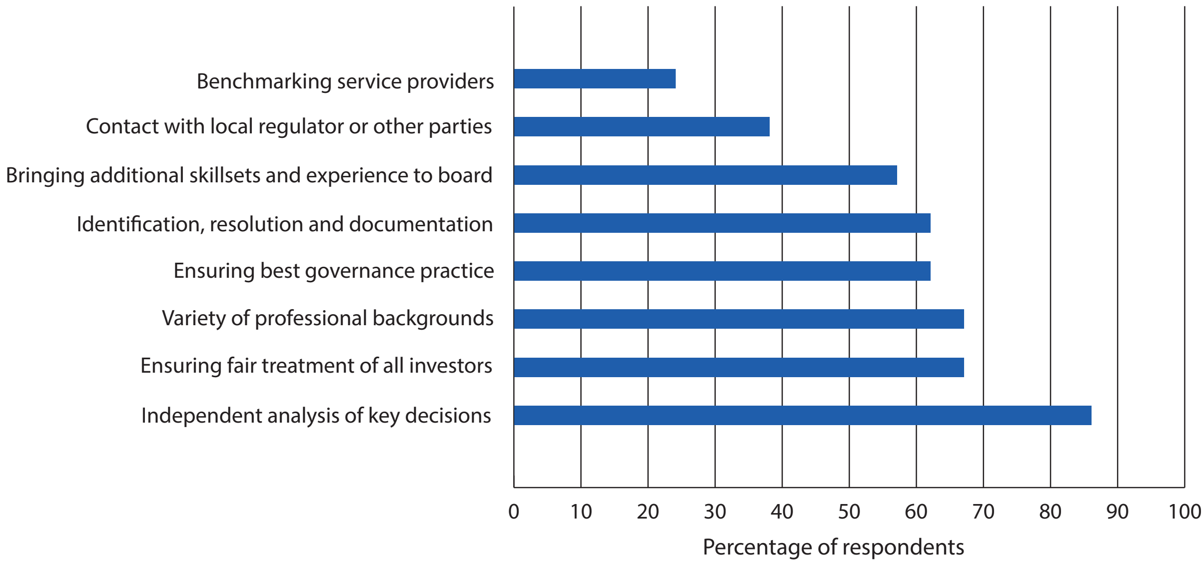


Figure 16: Advantages of independent directors

Investors wanted to see independent directors who are capable of representing investor interests on fund boards, for example by providing a layer of independent analysis of key decisions. They look to the independent director to ensure fair treatment of investors. Allocators interviewed overwhelmingly favoured fund boards with a majority of independent directors for just this reason.

Investors felt that independent directors should be able to provide "an effective challenge", particularly to key decisions that might be detrimental to the interests of one or more investors. Resolution of conflicts is also seen as a typical role for independent directors and the examples of security prices, liquidity, error resolution and the calculation of performance fees were cited as areas where directors can play a key role.

Q17: What key skills would you like fund directors to possess?

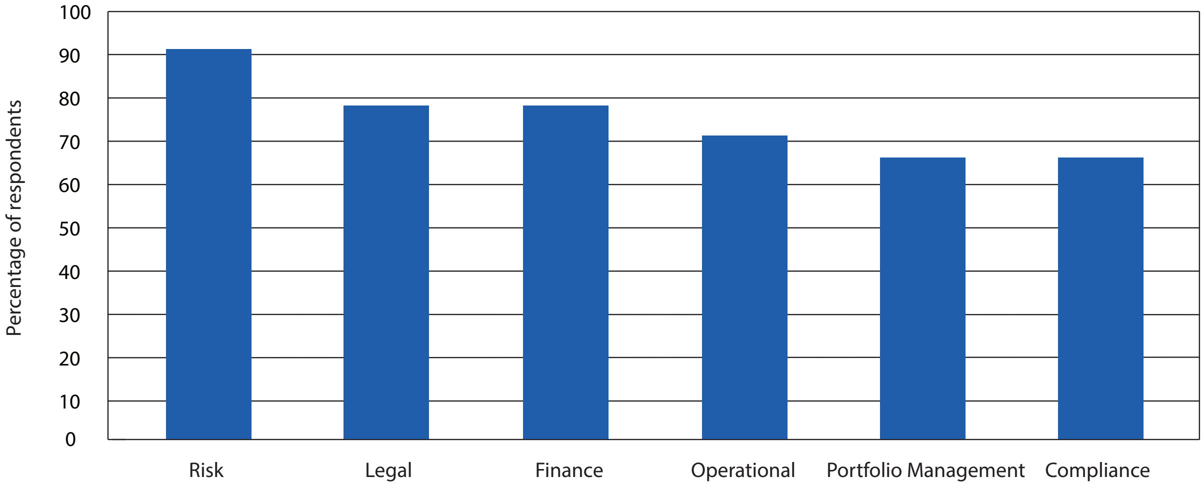


Figure 17: Key director skills preferred

Respondents wanted to see a broad range of skills represented on fund boards. A balance of skill sets is considered advantageous, as is a track record in the funds industry.

It is particularly interesting to note that since our original survey on fund governance in 2011, risk management has replaced legal as the most sought after professional background for fund directors. Finance has also assumed more importance.

Q18: Do you consider any of the following to be independent directors?

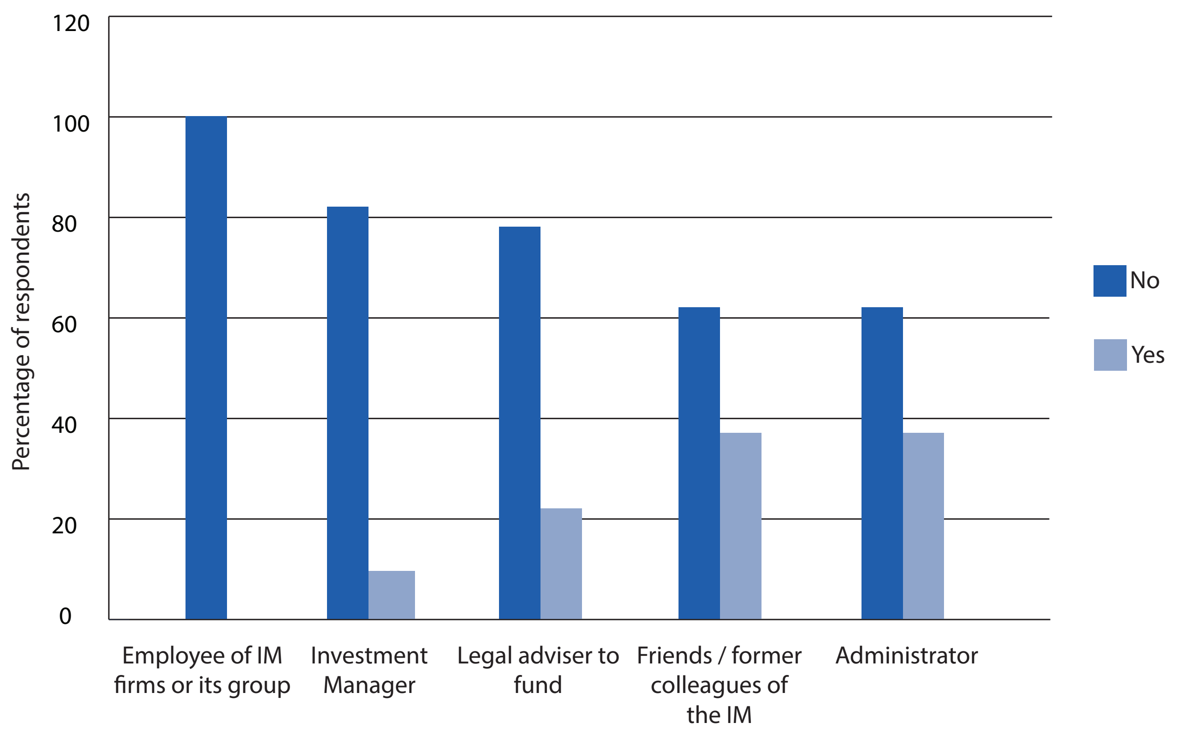


Figure 18: Do you consider any of the following to be sources of independent directors?

Investors felt some kind of definition of independence for directors should be included in any industry governance code. However, of enormous importance to investors was the issue of transparency: many complained that often relationships between the investment manager and some independent directors remained too opaque.

Q19: Should a senior executive of the investment manager sit on the fund board?

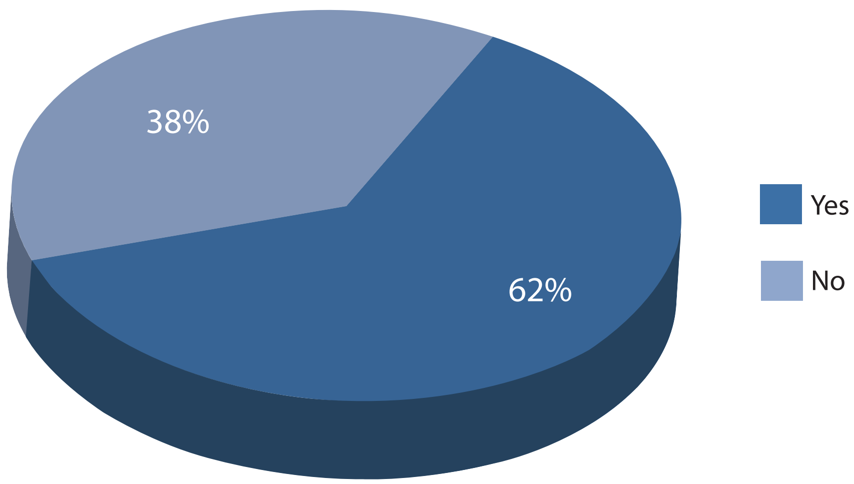


Figure 19: Should a senior executive of the investment manager sit on the fund board?

Even though employees of the investment manager are not considered independent directors by investors, 62% of those interviewed would still like to see a senior executive from the investment manager on the fund's board.

Q20: Do you prefer fund directors to be full time or part time?

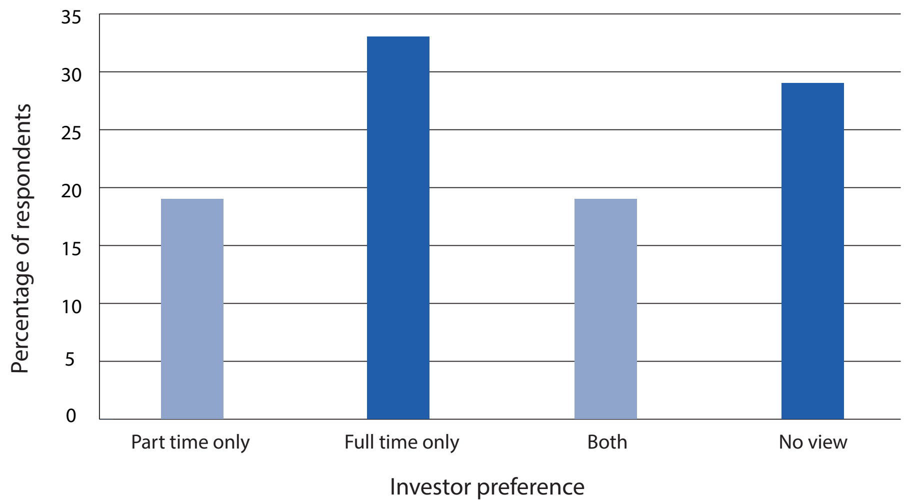


Figure 20: Full time vs part time directors

We define full time fund directors in this context as directors for whom sitting on fund boards is their entire professional role. Part-time directors can include those who have additional professional responsibilities elsewhere or are semi-retired.

Q21: What is the minimum amount of funds industry experience you would like to see from independent directors?

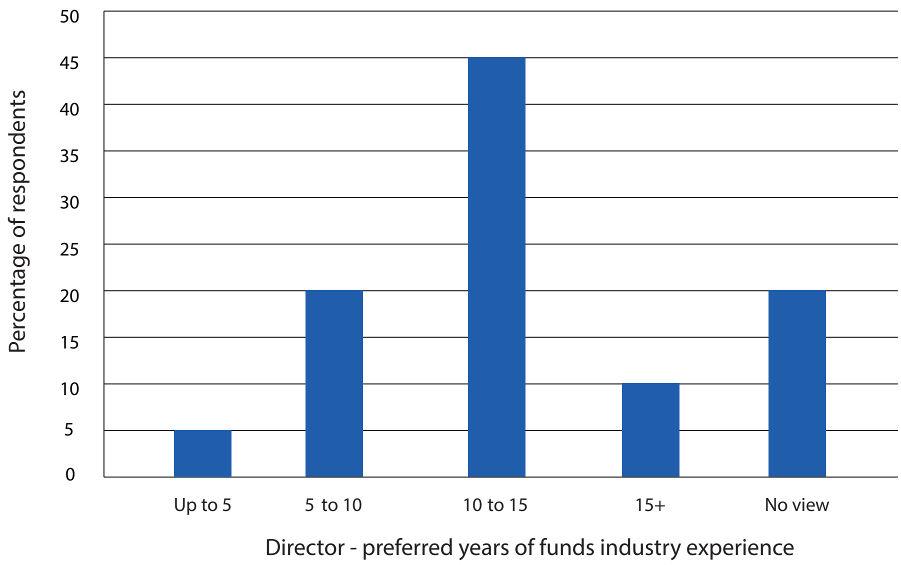


Figure 21: Directors - funds industry experience

Most investors would like to see independent directors with a minimum of 10 years of funds industry experience.

Q22: Should at least one fund director be resident in the fund's domicile?

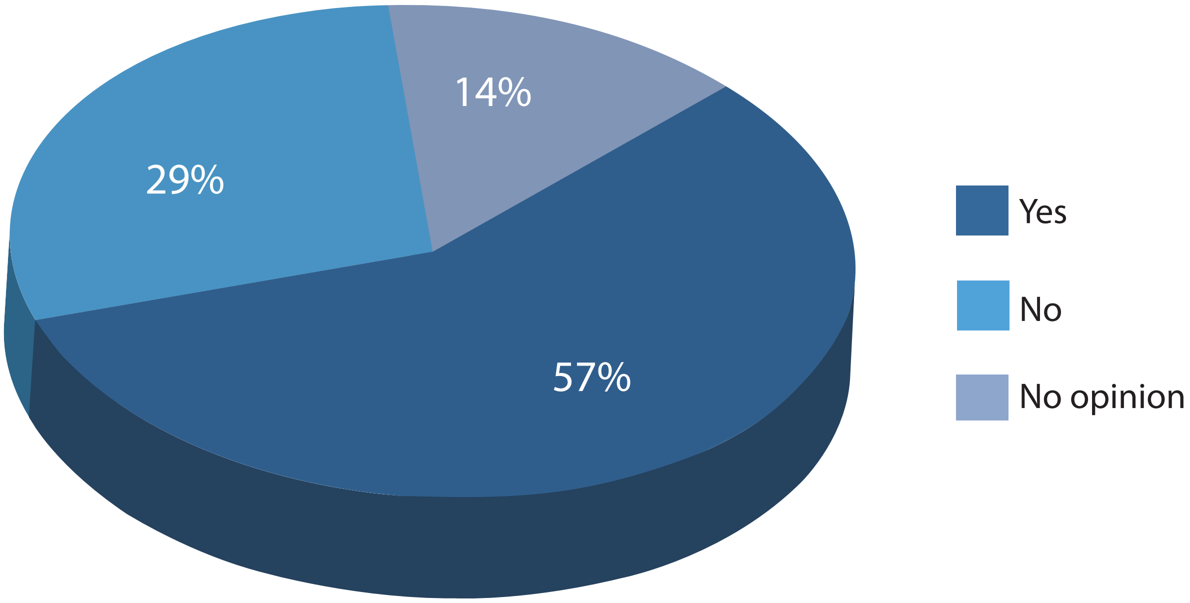


Figure 22: Should at least one fund director be resident in the fund's domicile?

Conclusion - Part One

As fund investors have become more aware of potential conflicts of interest occurring within funds, they are looking to the fund board, amongst others, as a key platform for protecting their interests as stakeholders.

Active fund boards with a majority of independent directors are viewed as evidence that asset managers are taking corporate governance seriously at a time when regulators are also focusing attention on the issue. Investors expect that fund directors themselves be experienced individuals with the time and resources available to execute their roles properly. Investors would like to see more established guidelines surrounding conflicts of interest and a clear set of factors to identify whether fund directors are sufficiently independent.

Taking the funds industry as a whole, there remains considerable scope to improve fund governance in the eyes of investors. Overall governance satisfaction rates of 5's and 6's out of 10 is too low, and the industry must strive for 8's and 9's. This concurs with the findings of regulators on both sides of the Atlantic.

This study also helps to outline clearly some of the steps the industry should be addressing to improve governance at the fund board level.

Amongst these are:

- Appointing fund boards where the majority of directors are independent, and can be clearly identified as such;
- Ensuring there are four board meetings per annum, of which at least two are in person;
- Appointing independent directors with at least 10-15 year funds industry experience;
- Demonstrating awareness of conflicts at fund and investment manager level with a written conflicts policy to be maintained for each fund.

Part Two: Guidance on Addressing Conflicts of Interest At The Fund Level

Conflicts of interest among fund managers, their clients, other affiliates and key service providers, represent a key concern for many fund investors. To allay investors' concerns and to engender goodwill with prospective investors that may be looking to deploy capital, many fund managers are aiming to implement best practices to manage conflicts that could detrimentally impact their investors and their businesses. In addition, for fund managers, the risk of legal action by investors is greater than ever, and therefore, fund managers that can demonstrate that they have implemented and followed policies and procedures designed to address such conflicts of interest go some way towards demonstrating their commitment to fulfilling their fiduciary obligations in the course of defending their actions in court.

On the regulatory front, regulators are increasingly expressing their desire to evaluate how fund managers are handling conflicts of interest. Speaking at a seminar held at the New York City Bar Association, Norm Champ, Deputy Director of the SEC's Office of Compliance Inspections and Examinations, said "Advisers of pooled investment vehicles also have a duty to disclose material facts to investors and prospective investors, and failure to do so may constitute fraud."

The SEC has indicated that it intends to scrutinize fund managers' handling of conflicts of interest in the course of "presence examinations" of newly-registered fund managers to be conducted in the next two years. In June 2013 it settled civil charges against eight former directors of Morgan Keegan for failing to properly police the portfolio managers they oversaw, thereby allowing toxic mortgage assets to be overvalued. While the regulator only issued a cease and desist order, the action has been seen as a significant step by the SEC, announcing its intention to pursue cases against board members who fail to carry out their legal obligations.

In addition, the UK's Financial Services Authority has expressed its own concerns with asset managers' handling of conflicts of interest by penning a "Dear CEO" letter to asset managers identifying areas where it has particular concerns. In June 2013, the FSA's successor, the Financial Conduct Authority (FCA) proposed banning and fining a UK non-executive director of two mutual societies for failing to disclose conflicts of interest, saying that even when some doubt exists as to whether there is a conflict, full disclosure should still be made.

The specific conflicts of interest that confront a firm will vary depending on the business, operational and structural characteristics of a fund manager's operations. Nonetheless, this guide surveys many of the principal conflicts of interest common to numerous fund management businesses. Fund managers should use this list to identify whether such conflicts exist in their businesses and to determine how they will address such conflicts. This section of the guide also provides fund managers and fund boards with practical guidance on how they can appropriately handle such conflicts.

Cross Trades and principal transactions

The trading of securities between two or more funds or between a fund and a fund manager must be closely monitored as such trades can result in price manipulation or the placement of unwanted securities in client portfolios. A conflicts policy can cover both cross trades and principal transactions, outlining how transactions between funds will be managed and priced so that investors in one fund are not disadvantaged. Some managers have adopted an advisory committee to vet these transactions. Such an advisory committee is often comprised of disinterested individuals, often including independent directors who sit on the boards of the offshore funds that the fund manager advises. Such an advisory committee is typically charged with reviewing all such transactions to ensure, among other things, that such transactions are effected at a fair market price; that the investments are appropriate to the structure they are being transferred to; that the rationale behind the trade is clear and reasonable; that no party to the transaction appears to be disadvantaged; and that the allocation of securities is consistent with the fund manager's general trading policies. By documenting processes to mitigate such conflicts ensure that they are adopted before trades are completed and acting consistently on the recommendation of the advisory committee, managers can demonstrate that they are dedicated to ensuring the equitable treatment of all of their clients.

Side by side management/trade allocation

Conflicts of interest can arise when a fund manager is managing multiple funds, particularly where those funds have different fee structures or the level of the fund manager's proprietary interest differs among the funds. A fund manager may, for example, direct more favourable liquidity allocations or investment opportunities to a fund with a more favourable incentive fee structure because the fund manager profits from higher fees. A clear allocation policy advocating a rational basis for the allocation of trades, with certain exceptions to deal with normal risk parameters, assists in the demonstration of an equitable allocation. Further, in cases where some clients are paying more performance-based fees than others (perhaps through a different class of shares), all investors should still be treated fairly – there should not be preferential treatment of bigger fee payers, for example, in the case of an allocation in an initial public offering (IPO).

In the case of an individual portfolio manager managing multiple funds, the fund manager's conflicts policy should clearly outline how trades are being allocated to the funds by the central dealing desk to ensure that no fund is being disadvantaged in any way. Securities acquired ought to be allocated on a pro-rata basis according to the size of the original orders, unless there is a clear and demonstrable rationale for differential treatment. In cases where there is an allocation of shares to funds in an IPO, the conflicts policy should also ensure fair treatment between all participating portfolios.

Manager pricing

The potential for conflicts of interest in the pricing of securities is perhaps the most obvious area where a fund manager could be subject to accusations of bias, particularly if compensation structures are aligned with performance. As such, it is best practice to avoid any perception of bias in the valuation of assets. This can be achieved by implementing a valuation policy which requires that the administrator provide independent pricing for the portfolio. Where this is not possible (e.g., in highly illiquid investments where the fund manager is often best placed to value the assets), additional checks and balances should be used to provide an element of independence where possible. For example, the rationale for the pricing method or model used by the fund manager might be approved by the board of directors, and any departure from that model would require further approval. A published valuation policy that is available to and approved by the fund's directors or advisory board will further reassure investors that the portfolio is being appropriately priced. To take this a step further, some fund managers are asking independent directors to attend internal valuation committee meetings to ensure that the policies are being consistently applied. Fund boards should also receive regular price reporting from the administrator on securities which are hard to value or may have a higher level of uncertainty (e.g. single broker quotes, manager marks, stale pricing).

Incentive systems

Policies should exist that govern the incentive systems within the fund manager's business. In particular, performance-based compensation could cause portfolio managers to take disproportionate risks in order to achieve better performance and thus, generate more income for the fund manager. Performance-based compensation is a fundamental characteristic of the fund industry, and it is integral to the remuneration framework for fund managers. However, such compensation structures can create conflicts unless they are properly managed. An internal risk management framework is essential and should include the monitoring of investment decisions and procedures for notification of portfolio managers if risk guidelines are breached.

The board of directors should be monitoring any departures from the risk parameters of the fund which may signify that consistent excessive risk is being taken, and they should seek to ensure that senior executives of the fund manager are appropriately monitoring such style drift and cautioning offenders. One mechanism to manage these conflicts is to align the compensation structure of the portfolio managers and other senior executives with investors' medium- to long-term goals, focusing on long-term appreciation rather than rewarding short-term risk taking. Investors generally take comfort when investment personnel managing their assets have "skin in the game," particularly if an investment is a longer-term investment.

Onshore/offshore governance gap

In the classic master-feeder fund structure, it is generally accepted today that, although independent directors are an investor requirement at the offshore fund level (habitually the offshore feeder fund and the master fund), no such mechanism for independent governance is built into the onshore fund, which is usually under the control of the fund manager through the fund general partner entity or managing member entity. Although there has been some discussion recently among investors about the governance gap this creates along with a limited push to implement structures in the onshore fund to address this (e.g., by implementing an advisory committee charged with certain powers analogous to those of the board of directors in an offshore fund), the current status quo allows certain potential conflicts to arise between the offshore and onshore funds by virtue of their commingling of assets at the master fund level. Most obvious and most frequently seen is the potential for there to be a potential conflict of interest where a side letter entered into by the onshore fund results in unfavourable outcomes for the offshore fund investors, perhaps by the granting of more favourable liquidity terms to certain onshore fund investors. [1]

1. SEC v Falcone et al, US District Court, Southern District of New York, No 12-05027; and SEC v Harbinger Capital Partners LLC et al in the same court, No 12-05028.

Director level conflicts

The research in Part One of this guide demonstrates that investors have a preference for independent directors on fund boards, as well as an independent director acting as chair of board meetings. Fund managers seeking institutional mandates are being asked increasingly to appoint independent directors to fund boards. The key question here is the extent to which board directors are independent or conflicted. The traditional practice of appointing friends or family to the board is now frowned upon, and the appointment of directors from key service providers or within the same financial group as the investment manager is also becoming less acceptable. Investors are now seeking assurances that fund boards are able to act independently and in the best interests of investors, and it is accordingly a best practice to comprise a board with a majority of independent directors who have sufficient skills and time to perform services on behalf of the fund. A register of relevant directors' interests including other board memberships and other related interests is recommended to identify potential conflicts vis-à-vis the fund and help to manage them.

Order bundling/allocation

While many fund managers now utilise a multi-broker model for transaction allocation, driven in part by a desire to locate more competitive pricing within the market, conflicts can arise where broker selection is premised on factors other than commission rates. Soft commission elements ("Soft Dollars") have been a cause for concern for the investing community for some time. Where applicable, the conflicts policy needs to address order bundling, including the fact that orders should only be bundled when it is unlikely to disadvantage all of the fund manager's funds and their investors. The aggregation of different orders can be disadvantageous for individual orders. Large buy orders can lead to increasing prices which are then allocated pro-rata to smaller orders. Daily monitoring by the compliance department can ensure that best execution requirements are being satisfied.

Broker relations (e.g., selection, research, transaction costs)

The selection of brokers should be based on objective criteria; no distinction should be made between external brokers and brokers affiliated with the fund manager. The fund manager should follow a documented best execution policy, applied across all trading for the fund(s). Again, with research offered by the broker to the trading desk or portfolio managers, the fund manager should follow best execution factors first and foremost, and only then consider other factors, such as the receipt of research or brokerage services or products. This situation is rendered more difficult in cases where a prime broker has provided seed capital to the fund or even has an equity stake. Still, in the interests of securing additional investment and growing the fund as a business concern, a level playing field for broker relations must be maintained.

Investment management

There is also the issue of consistency of implementation of the investment strategy. The fund manager is mandated to execute the strategy in a manner consistent with the parameters established in the offering document or marketing material pertaining to each structure. Yet, there have been many cases of managers departing from these parameters for various reasons, including, in many instances, a lack of opportunity in the stated strategy. However, the prevalence of opportunity in an alternative strategy does not release the investment manager from managing the investors' capital in accordance with the parameters set forth in the fund governing documents. Such parameters may include security types, the fund's liquidity profile and other investment characteristics.

In addition, there have been cases of fund managers deviating from the established investment management mandate to make 'personal investments' – for example to support businesses owned by friends, family members or the fund manager himself. A process of periodic monitoring by the board of directors of the investment style utilised in managing the portfolio can also assist in ensuring that the strategy is implemented as stated and offers the board the opportunity to address any style drift that may occur and ensuring that corrective action is taken.

Group level conflicts

Wider group level conflicts are an increasing concern for investors when a fund vehicle is being advised by an investment management entity that is a wholly- or partly-owned component of a larger financial services group. This is particularly the case where the fund is making use of other services within the same group (e.g., custody, fund administration, or broking). Preferential agreements can obviously benefit a fund, but they can also work against a fund's interests if the services offered are not of the same quality as that offered by outside vendors. A conflicts policy should demonstrate the criteria that are evaluated for selecting service providers. The presence of service providers from within the same financial group may not necessarily constitute fully independent governance or oversight.

Liquidity Risk

A key component of portfolio management in the context of a co-mingled investment fund is the management of liquidity in the portfolio. Investment managers are bound to ensure that the portfolio is constantly positioned with a liquidity profile that is appropriate given the redemption parameters established in the offering document and relied upon by investors when considering withdrawing capital from such funds. However a potential area of conflict arises for managers where the opportunity set available to them is more appealing, and thus returns higher, in longer term investments which may not possess the required liquidity. In the extreme such investments could prevent managers from aligning the liquidity of the portfolio as a whole with that which is required to ensure that investor redemptions are fundable at any given redemption date.

Such practices expose investors to liquidity risk which could cause problems in the liquidity management of their own businesses, particularly for pension funds and fund of hedge funds who have funding requirements of their own. The risk here can be mitigated by a board of directors regularly reviewing the liquidity and ensuring that the manager is being overseen by someone that is economically independent from the results of the management of the portfolio. As boards owe a fiduciary duty to the investors it is key that they evaluate the liquidity in the portfolio on a regular basis to ensure that the portfolio is positioned to honour redemption requests.

Trading and operational errors

It is natural in any business that errors occur and in the investment management industry some of the most common errors are those occurring around trading errors (the infamous 'Fat Finger' for example) and administrative errors (an incorrect posting or valuation error perhaps). As in most areas of life, errors are generally forgiven so long as the manner of dealing with the consequences of the error are commercially acceptable and it is here where independent boards can help to assure investors that the steps that will be taken when errors will occur will be equitable. The most obvious illustration of conflict with respect to errors is where trade losses result from an error. In this instance it is usual in the industry for errors, in the absence of fraud or gross negligence (or the appropriate equivalent terminology depending on jurisdiction), to be attributed to the account of the investment fund, and this can perhaps lead to a more laissez-faire attitude to trading errors. An independent board can work with managers to better structure the provisions around errors to ensure that investors are better served.

Contractual terms can be arranged such that, although trade losses may be for the account of the fund, these potential losses are mitigated through the requirement for the manager to maintain insurance coverage to cover significant trade error losses. In addition the fact that the independent board is reviewing trade error logs and the resultant trade losses (and gains) acts as a catalyst for a more vigilant approach to trading and thus tends to reduce incidences of error.

In the case of operational errors the installation of an independent board to oversee the operations of an investment fund and therefore review on a regular basis the performance of the investment manager, prime broker, administrator, auditor and other service providers also constructs a forum for reporting on the key performance indicators for each provider. A board of independent directors with a diverse skill set will generally be well prepared to quiz each service provider on the services they have provided in each review period and will likely require formal reporting to be delivered to each director on a regular basis which will allow the board to form an opinion on the quality of service being provided. At the first sign of a downturn in service or indeed an indication of a service issue with a particular aspect of any service offering it is normal that directors would ask for enhanced reporting to highlight issues. In effect this will 'put on notice' the appropriate service provider that performance issues are being looked at, acting as a motivator to correct the problem. It is often the case that the early identification of issues will prevent further problems, or in those cases where there is no improvement, can lead to earlier discussions as to who an appropriate replacement may be. It is of course important to note in this respect that professional independent directors are well placed to grade service providers as they encounter numerous providers across the funds that they act for, and as such are often aware of the strengths and weaknesses of various providers, particularly in their respective specialist areas.

Legal document and contractual conflict

In this case it is important to note that there are areas of conflict that are contractually embedded in the constitutive documents and material contracts of an investment fund and as such the installation of an independent board of directors well in advance of the launch of a fund should be encouraged by investors. Such potential areas of conflict are many and various, ranging from signing authorities over cash and custody accounts to preferential redemption terms that may be put in place at the inception of a fund for the benefit of certain key investors. Although some of these factors are a reality of life, in many parts of the investment fund world terms such as preferential liquidity can be material to the operations of the fund and potentially detrimental to other investors and as such should at the very least be disclosed in any offering document of the fund.

An independent board, constituted well in advance of the launch date and performing a substantive and constructive review of the draft documents, can help to ensure that such conflicts are identified, discussed and mitigated prior to launch. Managers should be aware that such a review process can materially benefit the fund in the initial marketing phase as, if the board is comprised of experienced directors who are in tune with investor needs, many of the points that often arise in the course of initial investor due diligence will be dealt with prior to launch. This leads to a more appealing product being presented to investors which in turn requires less negotiation and thus a potentially contracted timeline to investment. A further benefit of such early action is often a significant reduction in requests for side letters addressing investor concerns.

Conclusion - Part Two

The asset management industry is fraught with potential conflicts upon which regulators, investors, directors and fund managers are increasingly focused. However, through the application of consistent, practical and documented policies, it is possible for fund managers to demonstrate a culture of conflict management that is much admired in today's investment community.

A transparent approach to investor inquiries on the issues which have the potential to give rise to conflicts will undoubtedly reassure investors who are reluctant to take on the additional risk that such conflicts create.

Furthermore, although the involvement of independent directors in the monitoring, escalation or effecting of actions that give rise to conflicts cannot eliminate these risks, it does give further assurance that fund managers are willing to surrender decisions impacting investors to those directors who are not only economically disinterested in the decision, but also bound by their fiduciary duty to act in the interests of the shareholders.

There is little doubt that fund managers who are focused on managing and mitigating conflicts to the benefit of investors will be more likely to appeal to and reassure institutional investors and attract more capital. That should be a sufficiently compelling reason for fund managers to adopt best practices for managing such conflicts.

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