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Financial Services and Markets

Asset managers and conflicts of interest: FSA calls for immediate action

On 9 November the FSA published a paper setting out its findings as to how asset management firms manage conflicts of interest and requiring firms to consider the issues raised and to confirm in writing that their conflicts arrangements are compliant. This follows the FSA's thematic reviews of firms conducted between June 2011 and February 2012, during which it had found significant shortcomings. **Firms are expected to complete the action required of them by 28 February 2013 at the latest.**

The significance of the paper for asset managers should not be measured by its relative brevity. It is a warning. The FSA has made it clear that it wants to see a change of culture within many firms and has signalled that it will conduct a second round of themed visits after 28 February 2013 to assess the level of improvement: it is clear that enforcement action is likely to be brought against firms found wanting at that stage.

What action is expected?

The FSA's expectation is that, by 28 February 2013, the governing body of each asset management firm will have:

- considered the FSA's paper at one or more governing body meetings;
- reviewed the firms' conflicts arrangements in the light of the paper's findings; and
- confirmed, by way of an "attestation" from the CEO to the FSA in prescribed form, that the firm's arrangements are sufficient to ensure that the firm manages conflicts of interest effectively and in compliance with FSA rules.

Bearing in mind that the Christmas and New Year period is approaching, firms only have a matter of weeks in which to address these issues.

Who needs to comply?

The paper is directed at asset management firms – and, more specifically, at the *governing bodies* of such firms (while the paper uses the terminology of a company with a board of directors, firms constituted as partnerships will obviously also be caught). Although not expressly titled as such, the paper is listed by the FSA on its *Recent Publications* page as a "Dear CEO" letter – and that is precisely what it is in substance. Every firm which undertakes discretionary investment management (whether for investment funds or for segregated portfolios) should therefore consider the paper – and this is not just a matter for the compliance or legal department.

Other firms should also take note. For example, firms which are part of investment management groups but which do not themselves take the investment decisions may need to confront similar issues. The formal attestation does not appear to be required of these firms, but a review of conflicts management arrangements would still be advisable. The FSA's comments about personal account dealing, reporting errors to customers and gifts and entertainment will be of interest to firms other than investment managers.

What issues were raised?

The full text of the FSA's paper can be found here.

At the heart of the FSA's findings is its perception that poor conflicts management results from an inherent cultural failing and not having the right attitude towards serving customers' best interests – the paper refers to senior management failing to convince the FSA that they understand that they have a "sense of duty".

Key points include:

- *Control and governance frameworks* – the FSA found insufficient governing body engagement in both the design and monitoring of conflicts management arrangements, particularly in international groups where key decisions may be taken by overseas staff. The conflicts management arrangements should be the subject of regular governing body review. Such arrangements should include staff training, new conflict escalation processes and new product and change management processes, as well as basic conflicts mapping. In addition to legal and compliance input, "on the ground" business staff should also be involved in the periodic review process as part of a "bottom-up" approach.

- *Management of the purchase of research and trade execution services on behalf of customers* – many firms do not exercise adequate control over the spending on such services, in terms of determining whether they are good value and whether they are really in the clients' best interests, rather than their own. In addition, not many governing bodies are involved in regularly reviewing whether the products and services purchased using client commissions are actually compliant with COBS 11.6 (which limits the services which can be bought using client commission to certain execution and research services) and it is clear that some firms are not able, when challenged by the FSA, to show that the goods and services are eligible execution or research services.

- *Gifts and entertainment policies* - many firms currently have simplified policies which rely on what is considered to be market practice in their sector. The FSA clearly expects to see a more thoughtful and calibrated approach to this topic, which recognises some of the wider conflicts which can be created by gifts and entertainment – it's not just a question of following perceived market practice or assessing how expensive the gift or entertainment is, but whether the objectivity of decision-making and the duty to act in the interest of the firm's customers might be compromised by the gift or entertaining. The FSA lists some examples of good practice.

- *All customers should have equal access to suitable investment opportunities* – in particular, firms should ensure that one client is not favoured above another, whether through greater access to limited investment opportunities, by means of allocation policies or in cross-trading between clients. The FSA also noted that where individual portfolio managers are given significant leeway in investing their portfolios this may result in information and ideas not being shared for the benefit of all clients. Firms should re-evaluate the extent to which there is a discrepancy between how they market their services for customers (for instance, by promoting the concept of "team-based research") and the reality of how portfolios are managed within their firm (for instance, where individual portfolio managers do not share their research and ideas with other managers for the benefit of other customers and this fact is not disclosed).

- *PA dealing* – although PA dealing arrangements were generally found to be satisfactory, care should be exercised to ensure that there are clear procedures in place with adequate restrictions on permitted trading and ongoing monitoring in compliance with the rules.

- *Allocating the cost of errors between firms and their clients* – the FSA singles out the hedge fund manager sector in particular as being one which tends to rely on contractual clauses in their customer contracts excluding liability on their part for any errors or omissions except in the case of gross negligence. The FSA frowns upon the use of such clauses to justify not reporting errors to customers or to avoid collecting information about the costs borne by customers in respect of such errors. Again, the paper lists some examples of what the FSA sees as good practices in handling errors.

Asset managers that are AIFMs

Although the paper – and the steps that are expected to be completed by the end of February – will be relevant to all firms which undertake discretionary investment management, the exercise will be particularly timely for those firms that will be AIFMs for the purposes of the Alternative Investment Fund Managers Directive. Amongst their preparations for implementation, such firms should be addressing the requirements of the Directive (and its implementing measures) regarding conflicts of interest.

For further information on how we can help you with questions arising out of the FSA paper, please contact one of the following partners in our Financial Services and Markets Department or your usual contact at Travers Smith.

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