The FSA issued a warning to asset managers to step up their compliance with FSA rules relating to conflicts of interest with the publication on 9 November 2012 a paper on conflicts of interest in the asset management industry. The key message given in the paper regarding the FSA’s expectations of the board of asset managers to embed the right culture of compliance regarding management of conflicts of interests, is entirely consistent with the broad approach that the FSA is taking in all areas of its supervisory work, and its continued focus on senior management embedding the right culture from the top.

The paper follows a thematic review conducted by the FSA of asset management firms between June 2011 and February 2012 that focused on their arrangements for managing conflicts of interest. The review was prompted by evidence from the FSA’s supervisory work that some asset managers were no longer concerned with preventing detriment to their customers through conflicts of interest and had relaxed certain processes that the FSA has viewed as market standard.

Whilst the FSA did found a number of poor practices at the firms it visited, it also found examples of good practice, and helpfully shares these in the paper. It is evident, however, that the FSA expects to see the asset management industry as a whole take action to improve its compliance with FSA conflicts of interests rules, action that the FSA believes is necessary to ensure confidence in the integrity of asset managers on the part of their customers. As such, the FSA requires CEOs of asset management firms to return an attestation in a form given in the paper to confirm the adequacy of their arrangements in light of the findings of the paper.

**Why are conflicts of interest an issue in the asset management industry?**

As the paper identifies, conflicts of interest are a particular concern in the asset management industry since asset managers act as agents for their clients when they make investment decisions on their behalf. A relationship of trust and confidence between an asset manager and its customers is therefore vital. As the customer’s agent, an asset manager is in the position...
of a fiduciary in relation to its customer, and therefore has as a matter of English general law certain fiduciary duties including:

> an obligation not to carry out proprietary trading (e.g. an where asset manager buys securities for its customers from its affiliated broker-dealer);

> an obligation not to make a secret profit (e.g. an asset manager “churns” a portfolio, i.e. buys and sells investments simply to generate commission for itself); and

> an obligation not to place itself in a position where its own interests conflict with those of its customers or whether there is a real possibility that will happen.

The asset manager’s position of agent to its clients means that conflicts of interest as between an asset manager and its customers, or between different customers of a firm, can arise. Firms therefore need to have policies in place to proactively manage any such conflicts, by avoiding conflicts of interest where possible (through the use of Chinese walls etc.), by full disclosure of the conflict and obtaining of the customer’s consent to it, or by declining to act where the other solutions for managing the conflict are not viable.

**FSA rules regarding conflicts of interest**

FSA rules on conflicts of interest largely follow the general law as described above. Principle 8 of the FSA Principles for Business require firms to manage conflicts of interest fairly. The rules in SYSC 4 and 10 impose requirements on the board of asset management firms to establish processes for identifying, controlling and reviewing conflicts of interest. COBS sets out rules on what goods and services may be purchased with customers’ money\(^1\), and how investment opportunities should be allocated between customers\(^2\), and compliance with these COBS rules received particular attention from the FSA in the paper.

**FSA’s key findings from its thematic review**

The FSA assessed arrangements for managing conflicts of interest in asset management firms and made the following observations:

> **Firm culture**: the FSA stresses in the paper the connection between a firm’s culture and its ability to spot and manage conflicts of interest. Whilst a few boards of firms were found to have embedded a commitment to serve their customer’s best interests and had robust arrangements to identify and manage conflicts of interest, “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 and updated their arrangements for conflicts management since 2007”. Good practice on the other hand included firms conducting periodic reviews of operations to look for new conflicts, and

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\(^1\) COBS 11.6

\(^2\) COBS 11.3
formal checks within product development to force a firm to consider if a new business area might create new conflicts.

> **Control frameworks**: whilst the FSA found a widespread failure to establish an adequate framework for identifying and managing conflicts of interest at the firms it visited, it did also find examples of good practice. For example, the best control frameworks were those that were developed jointly between business management and compliance or legal. Likewise, the most effective monitoring involved separate reviews by business management and compliance. Firms that relied on compliance alone were “unable to demonstrate to us how compliance staff credibly challenged investment and trading decisions made by senior investment professionals”. The FSA also found that the monitoring of conflicts was more effective where boards received adequate management information, and also that conflicts were typically better managed where boards had established committees that were dedicated to conflicts management. The FSA saw evidence in UK subsidiaries of overseas firms that the board did not exercise meaningful control over and

> **Purchase of research and trade execution services**: the FSA found that too few firms adequately controlled spending on research and execution services. Whilst many firms spent millions using customer’s money to purchase research and execution services, only a small minority of firms exercised the same control over this expenditure as they did over spending their own funds. Good practice included carefully considering which services were worthwhile, and challenging brokers as to whether other services were worth paying for. Poor practice included no central organisation of commission payments (e.g. fund managers paid for research services by directing business to particular brokers on a trade by trade basis). Few firms also regularly reviewed whether services and goods purchased using client commissions were eligible to be paid for with customer’s funds – an example given in the paper of a service that did not meet FSA evidential provisions for research was market data services. The FSA also found that the firms with the strongest controls over commissions also were the firms that had the best monitoring over execution.

> **Gifts and entertainment**: the FSA found that most firms that it visited had given minimal thought to how gifts and entertainment could interfere with their duty to act in the customer’s best interests. Good practice included policies that placed limits on the value of any one gift or event and the frequency with which multiple gifts/events could be accepted, and treated events not attended by the donor’s own staff as a gift, as well as requiring line managers and compliance staff to approve gifts and entertainment.

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3 COBS 11.6.3R limits what can be purchased to “execution” or “research” services, and COBS11.6.5E provides evidential standards to determine what constitutes research.
> **Equal allocation of investment opportunities to customers:** FSA rules require firms to allocate transactions fairly when they carry out transactions involving several clients in the same security at the same time. The good news is that the FSA found that most firms had satisfactory procedures to allocate the transactions fairly between clients. One example of poor practice was where a firm exempted senior fund managers from trading through the central dealing desk and allowed them to delay allocation for several hours after execution. Although most firms have adequate controls to ensure that when they carry out cross trades between customers' portfolios the trades are beneficial to both customers and executed at a fair price, the FSA did find in some cases though that staff did not record reasons for cross trades, or a meaningful review of reasons recorded was not carried out. In one particularly serious case the FSA took enforcement action against one firm that carried out a transaction in order to provide liquidity support to another customer (by purchasing an illiquid security that enabled the customer to meet redemptions it would have not otherwise been able to meet). The FSA also found some examples within firms that did not share research on a team wide basis and gave significant leeway to individual investment managers to invest their portfolios.

**Next steps**
The FSA has already provided detailed feedback to firms that it visited during the thematic review, and in some cases have required skilled persons reports under s166 of the Financial Services and Markets Act 2000. More widely, the FSA believes that this is an issue that needs to be considered by the board of each asset management firm and to evidence this, the FSA is requiring each firm’s CEO to return an “attestation” in the form given as an appendix to the paper, by 28 February 2013.

The FSA is also planning a second round of thematic reviews on conflicts of interest and will then select firms to receive follow up visits.
FSA paper on conflicts of interest between asset managers and their customers

Issue 01

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