Managing conflicts of interest in the alternative investment industry

By Michael Sakala and Daniel New

Today the US Securities and Exchange Commission (SEC) is focused on rooting out conflicts of interest in the asset management industry. The SEC’s National Exam Program (NEP) publishes its examination priorities each year to communicate to investors and registrants areas that are perceived to carry heightened risk – and conflicts of interest continue to be a key issue.

A conflict of interest is a set of circumstances that creates a risk that an individual's or organization's professional judgment or actions regarding a primary interest will be unduly influenced by a secondary interest.
It is critical that asset managers, given their fiduciary duty to clients, identify and implement proper procedures and controls to eliminate or mitigate any real or perceived instances where the firm, an employee or affiliate of the firm gains an advantage over a client, or fails to put the interests of the client first. The asset manager must also eliminate or mitigate any circumstance wherein one client is given an advantage over another client. It is important to note that the SEC has made it clear that potential conflicts of interest that are not removed or alleviated can signal other regulatory problems inside a firm.

Conflicts of interest are a particularly important challenge for large financial institutions and asset managers with complex structures. Due to these firms’ extensive affiliations and the dynamic nature of their businesses, conflicts are constantly arising and changing. The NEP will focus on the specific steps registrants have taken to mitigate conflicts, as well as the sufficiency of disclosures made to investors. Examiners will also review a firm’s overall risk governance framework put in place to manage potential conflicts on an ongoing basis.

However, small and midsize firms also need to be vigilant when it comes to conflicts. Fortunately for them, many of their conflicts tend to be easier to identify. On the other hand, they face the same level of scrutiny from regulators as their large, global brethren but may have fewer resources to invest in building and maintaining a strong governance framework.

Conflicts for hedge funds

There is some overlap in the types of conflicts to be found among different alternative asset management firms. But for hedge fund managers, there are particular conflicts that regulators have highlighted as priorities when conducting examinations:

- Conflicts in valuation represent one critical area of concern. Given that the calculation of management and performance fees are based on the value of the underlying fund assets, regulators will look for potential conflicts around the valuation process. Examiners are on the lookout for weak or fraudulent valuation practices, as well as firms that fail to adhere to their stated valuation policies. Asset managers should make certain that they can show there are no conflicts of interest with third-party valuation sources and that these external sources provide independent market-based values.

- The SEC requires managers to eliminate and/or mitigate any conflicts around investment opportunities and allocation. If a firm offers more than one product to its clients, the firm must have detailed procedures for how it allocates the assets it purchases in the funds, with particular scrutiny if the investments are not allocated pro rata across all like funds.

- When it comes to personal activities by managers or staff and their immediate family members, a firm should have a clear code of ethics that covers the need to eliminate potential conflicts when it comes to such activities as personal trading, insider trading, receiving gifts and entertainment, making political contributions and conducting outside business activities.

- Side letters and preferential terms for clients is an important issue on the regulators’ radar screen. Examiners are looking for proper disclosure. They are also scrutinizing any potential conflicts of interest among investors who are not receiving side letters or preferential terms.

- Many hedge funds may use a third party to assist in drafting the compliance manual or Form ADV Brochure. Third parties may sometimes use “boilerplate” language in these documents, so it is critical to ensure any language related to conflicts of interest is accurate and applicable to the firm.

Conflicts for private equity funds

In addition to the preceding personal activities and compliance outsourcing outlined, for private equity (PE) managers, there are a number of areas of potential conflict that regulators will be especially cognizant of:

- The first is marketing to investors and raising capital during the fund-raising stage. Examiners will be on the lookout for any preferential access given to certain investors for co-investment. They will also be concerned with the consistency and comparability of valuation methods, as well as a firm’s disclosures around pricing methodology and unrealized performance.

- During the investment stage, managers must eliminate and mitigate any conflicts around investment opportunities and allocation. One area of concern involves the potential for insider trading, especially when a PE firm invests in a public company. This means a manager must carefully monitor employee access to any material non-public information through the firm’s dealings.

- Regulators are also watching for potential conflicts when it comes to allocating investment opportunities between multiple funds that have overlapping strategies. By the same token, managers must be on guard if they manage multiple funds with conflicting investment strategies that invest in the same portfolio company at different capital levels. Finally, regulators will closely examine any evidence of a manager pursuing deals that are driven by fees or the desire to lower expenses, rather than the best interest of the investors.

Challenges for newly registered firms

One of the outcomes of the Dodd-Frank Wall Street Reform and Consumer Protection Act is the requirement for many firms that were not previously registered to do so with the SEC. With registration comes the requirement to identify, mitigate and disclose conflicts of interest. In many cases, this mandate marks the first time these firms have had to put such a high level of focus on the subject.
When it comes to managing the fund, one potential problem involves charging questionable fees to portfolio companies for management services. Firms should also be careful when it comes to charging expenses to the appropriate fund. Although this is an ongoing risk throughout the life of the fund, this can especially be a potential pitfall during fund-raising. Another trouble spot can cause conflicts between different business lines: that is, public and private sides of a PE firm that require an information barrier between the two but have either weak or nonexistent controls.

During the exit stage, conflicts can arise when winding down a fund. Regulators will be looking for any risk of a manager harboring an ulterior motive to increase fees by extending the life of the fund to divest it of its remaining assets. These so-called zombie funds are under increased scrutiny, as their numbers have grown rapidly over the past few years.

Liquidity events can present a potential pitfall when a firm sells portfolio companies to other funds, or does not sell them simultaneously. In the exit stage, conflicts in valuation can also be a concern with respect to management fees or if there are opportunities to misuse valuation to distort past performance.

Other areas that present potential conflicts of interest for PE managers include opportunities for fund professionals to either co-invest with clients or take on roles inside portfolio companies. Regulators have noted that these types of actions are not inherently wrong but are recurring sources of some of the conflicts mentioned above.

The current enforcement climate
For alternative asset managers, their potential conflicts of interest are being scrutinized more closely than at any time in recent memory. Recent cases and investigations suggest that regulators view conflicts of interest as a potentially overarching issue that can be tied to other types of violations. Evidence of unaddressed conflicts can lead examiners to question the presence of additional problems such as fraudulent valuations, concealment of assets and quid pro quo side letters.

As a result, firms must have in place strong compliance programs to mitigate potential abuses by individuals.

Consequences of failure
A firm that does not adequately detect and/or mitigate conflicts of interest may face severe penalties. Results of recent SEC investigations show that individuals found in violation have been barred from the industry, forced to disgorge ill-gotten gains, ordered to pay civil penalties and even recommended by the SEC for jury trials. Attorneys found in violation have been barred from appearing before regulators.

From a practical standpoint, even if managers are not formally implicated in such cases, they often face major investor redemptions and lasting reputational damage.

Mitigation steps
Given the intense pressure on managers to implement more effective measures for mitigating conflicts of interest, identifying useful policies and procedures is near the top of the agenda.

Managers must make certain that conflict mitigation is part of a strong and effective compliance and risk management program. This begins with establishing an overarching culture of compliance within a firm, with the tone set at the top. Executives must be clear that a firm provides zero tolerance for conflict-of-interest violations, and hire and support a knowledgeable chief compliance officer who is adequately resourced, is fully independent, and has the necessary standing and authority to make staff, even senior staff, take notice.

Tactically speaking, there are important items that should be on the list of any conflict-mitigation strategy. Following are some best practices for alternative asset managers. These include, but are not limited to, the following:

• Create a matrix view of potential conflicts regarding new funds and products that can be updated dynamically.
• Maintain an ongoing, documented compliance training program to educate all personnel as to the critical importance of these efforts.
• Confirm the true independence of compliance, allocation and valuation committees, and the segregation of duties of all committee members.
• Also confirm the independence of third-party service providers, including administrators and auditors.
• Make certain that all conflict disclosures to investors are sufficient and adequate.
• Institute a safe-reporting policy for whistle-blowers.
• Establish procedures and systems for reviewing correspondence and emails, including technology for keyword searches.
• Similarly, set standards for review of transactions, trading and follow-up communications.
• Create a process for reporting exceptions to conflict-policy variances.

Conclusion
While fund managers are taking their regulatory and fiduciary duties more seriously, establishing a strong and effective compliance and risk management program with enforceable procedures to mitigate conflicts, is more critical than ever before. The level of regulatory scrutiny is unprecedented and the consequences of any violation can be brutal. It would befit any alternative asset manager to take a step back and evaluate their current framework more strategically, top to bottom.

About the authors:
Daniel New is an executive director in the Financial Services Office of Ernst & Young LLP. Dan is based in Boston and can be reached at +1 617 585 0912 or daniel.new@ey.com.

Michael Sakala is an executive in the Financial Services Office of Ernst & Young LLP. Mike is based in Boston and can be reached at +1 617 375 4567 or michael.sakala@ey.com.
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