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Alert

FSA Conflicts of Interest Safeguards: Immediate Action To Be Taken by All UK-Authorised Hedge Fund Managers

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Summary
The UK Financial Services Authority has recently published an important report that builds upon a series of late 2011 and early 2012 "thematic reviews" of FSA-authorised investment managers (the "Report").[1] The Report, which focuses (at length and with specific examples) on numerous failures to identify, monitor and mitigate conflicts of interest in ways that meet the FSA's expectations, is more direct in its tone and in its content than has been seen in such circulars previously and may presage a new era of vigorous FSA enforcement.

Weaknesses Cited by the FSA. The Report does not establish any new rules or substantive requirements. It does, however, as is discussed in greater detail below, highlight a number of areas where the FSA felt there was weakness or non-compliance with existing requirements, including the following:

- Failures to identify conflicts and to sensitise and train firm personnel to recognise them;
- Inadequate controls on research-related expenses and uses of customer dealing commission;
- Insufficient controls over the acceptance of gifts and entertainment;
- Inequitable trade allocations and cross-trading;
- Inconsistent application of personal dealing policies; and
- Improper treatment and non-disclosure of trade errors.

Special Issues Related to UK Subsidiaries. The Report also highlights a governance and organisational concern with FSA-authorised subsidiaries of non-UK managers. As discussed below, the FSA concluded (with disapproval) that in at least some cases where the authorised entity is a subsidiary of an overseas parent, compliance oversight and decisions on certain "core practices" were being taken outside of the FSA-authorised entity and outside of the United Kingdom.

Mandatory Self-Assessment. In addition, in a significant break with past practice, the Report requires all FSA-authorised hedge fund managers (and all other authorised investment managers) promptly to re-examine (and, if necessary, to revise) their conflicts processes and policies. In addition, those firms that receive a hard

[1] *Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks*, November 2012 — http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf.

copy of the Report,[2] addressed to them from the FSA in the form of a "Dear CEO" letter,[3] will also be required to provide a Chief Executive Officer's attestation of sufficiency and compliance by 28 February 2013.

Accordingly, anyone who operates or controls an FSA-authorised investment manager should begin a comprehensive review of their conflicts of interest policies and procedures *immediately*, using the Report as a guide. For many FSA-authorised hedge fund managers, from this point forward, it may well be that their conflicts policies will need to be significantly more considered and tailored than has been the case in the past and their supervisory reviews may need to be more structured and robust. In addition, subsidiaries or affiliates of non-UK entities should also confirm that their organisational lines, corporate governance and compliance oversight responsibilities all conform to the FSA's requirements.

The Backdrop: Existing FSA Rules on Conflicts of Interest

FSA rules impose a fiduciary standard on authorised managers; in other words, they generally require that when making investment decisions or buying products and services for customers, such managers must act in their customers' best interests and put their customers' interests ahead of their own. In particular, an FSA-authorised hedge fund manager must first take "all reasonable steps" to identify and record any conflicts of interest between itself and its customers or between one customer and another. Once conflicts are identified, hedge fund managers must, assuming the conflict is not a fundamental conflict that would require the firm not to act or to cease acting, take all reasonable steps to properly manage any such conflicts of interest so as to prevent them from constituting or giving rise to a material risk of damage to a customer's interests.[4] Where these measures are not sufficient to ensure, with reasonable confidence, the protection of the customer, the investment manager must make effective disclosures *before* undertaking business for a customer.

The Results of the 2011-2012 FSA Conflict Reviews

Between June 2011 and February 2012, the FSA performed "thematic reviews" of a number of FSA-authorised investment managers.[5] These reviews were, in the FSA's words, "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."

There were examples in the Report of both good and bad policies on conflicts issues; however, it is clear that — in the FSA's eyes — the bad generally outweighed the good. To quote the Report:

> "A few boards had defined and embedded in their business a credible, long-term commitment to serve their customers' best interests … *[b]ut 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" (emphasis added).

The Report was generally critical of investment managers who the FSA felt had not fostered a culture that was sensitive to conflicts of interest and who consequently had not spent the time and effort to create organisational, technological and procedural mechanisms to identify, challenge, mitigate and disclose conflicts. In the Report, the FSA discussed a number of good and bad practices in this area and — while no specific model or structure was endorsed — there are a number of steps that hedge fund managers should begin considering to demonstrate the kind of culture that the FSA expects:

[2] We understand from the FSA that only large FSA-authorised investment managers will be receiving hard copies of the report as a Dear CEO letter. However, at the current time there is no clarity on what the FSA means by "large" in this context.

[3] Although the Report itself states that chief executive officers of all FSA-authorised investment management firms must sign the attestation and return it to the FSA, the FSA's website makes it clear that it is *only* those firms that receive a hard copy of the Report as a Dear CEO letter that must comply with the attestation requirement. All other firms are not required to comply with the attestation requirement, but must still read and consider the Report's findings, review their conflicts of interest arrangements and policies and ensure that they are in compliance with FSA rules (http://www.fsa.gov.uk/smallfirms/your_firm_type/ims/conflicts.shtml).

[4] Principle 8 of the FSA's Principles for Businesses (http://fsahandbook.info/FSA/html/handbook/PRIN/2/1) as expanded upon in SYSC 10.1.3R and 10.1.7R of the FSA Systems and Controls Sourcebook (http://fsahandbook.info/FSA/html/handbook/SYSC/10/1).

[5] The Report does not specify the number, although a *Reuters* article commenting on the release of the Report by the FSA suggested that only 15 investment managers had been visited during the thematic reviews (http://uk.reuters.com/article/2012/11/09/uk-fsa-investments-conflicts-idUKBRE8A818W20121109).

- *Oversight.* The FSA favours the creation and empowerment of a governance committee, ideally chaired by an independent non-executive director of the investment manager and populated with a combination of legal, compliance and operational personnel. While such a governance committee might be appropriate for larger hedge fund managers, for the majority of hedge fund managers it is likely to be impractical. However, even if a hedge fund manager did not establish a governance committee, its senior management should still: (i) comply with their responsibilities and their obligations to ensure that the firm has appropriate systems and controls in place and (ii) be prepared to carefully map out their internal conflicts identification and management processes and systems and demonstrate to the FSA that they are in fact robust. In some smaller hedge fund managers where the chief executive is also the chief investment officer, the chief executive, in assessing the conflicts policies and conflicts risks of the firm, should ensure that these issues are assessed from his or her perspective as chief executive and not from an investment standpoint. Some of the key areas that should be considered may include, among other topics: (i) allocation and cross-trading — particularly where allocating across one or more funds and one or more managed accounts with different replication and *pari passu* obligations, (ii) the use of dealing commission, (iii) how trade errors are dealt with, (iv) whether gifts and entertainment could create a conflict of interest between the firm and its customers and (v) if the firm allows staff to deal in securities for their own account, whether their dealings may also lead to a conflict of interest.
- *Collaborative Identification and Monitoring.* The FSA has also urged investment managers to engage in a "bottom up" collaborative identification and monitoring effort, which not only means an interdisciplinary process involving both operations and compliance personnel, regular formal checks and periodic joint reviews, but which also encourages and expects the development and leverage of jointly developed automated "management information." UK hedge fund managers who have relied on the classic model of the legal and compliance team designing and using monitoring tools in isolation (sometimes in actual physical isolation and perhaps relying a bit heavily on manual processes and paper recordkeeping) will need to consider convening multidisciplinary evaluation groups to question, challenge and perhaps "reimagine" the monitoring tools and processes. For many hedge fund managers (particularly larger managers), a fair amount of training of operations and finance staff will be a precondition to such a process, and this may be a significant challenge given the tight compliance timeframe. Conversely, for smaller hedge fund managers, the challenge will be in satisfying the FSA using the human and fiscal resources available to an emerging or narrowly focused business.

Specific Areas of Concern Noted by the FSA
In addition, the Report highlighted five substantive areas for authorised investment managers to focus on when they are reviewing their overall conflicts policies:

Dealing Commission. The first specific area presented in the Report was the use of dealing commission by investment managers. FSA rules[6] limit the use of dealing commission to the purchase of "execution" and "research" services. Anything else must be paid for by the investment manager using its own funds.

The FSA noted that only a few of the reviewed firms exercised the same standards of control over the spending of customer money on execution and research that they exercised over payments made from the firms' own resources. UK hedge fund managers should review their dealing commission controls in light of a number of concerns and poor practices highlighted in the Report, including the following:

- *Tracking of Dealing Commission.* A sufficiently robust centralised tracking system is a predicate to any effective control system in this area. Without a means to effectively generate records of execution allocations, commissions paid and services purchased, it may be difficult to convince the FSA that this potential conflict is being monitored and controlled where execution commissions are directed to

[6] The FSA's rules on the use of dealing commission are set forth in Chapter 11.6 of the FSA Conduct of Business Rules (http://fsahandbook.info/FSA/html/handbook/COBS/11/6). In these rules, "research" has to be capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers' portfolios; it must represent original thought, in the critical and careful consideration and assessment of new and existing facts, and must not merely repeat or repackage what has been presented before; it must have intellectual rigour, not merely state what is commonplace or self-evident; and it must involve analysis or manipulation of data to reach meaningful conclusions (COBS 11.6.5E).

different brokers. Hedge fund managers who use dealing commission but who do not have a system that meets the FSA's expectations should consider creating or acquiring one as soon as possible.

- *Thoughtful Commission Policies.* The FSA had praise for those few reviewed investment managers who had carefully considered execution policies in advance, which policies varied from challenging brokers and requiring them to justify commission rates to a system of commission reductions triggered by pre-defined spending and activity levels. The Report makes clear that what the FSA wants to see in this area are investment managers who can demonstrate that they have given thought to designing controls and systems that protect customer interests.
- *Periodic Reviews.* The FSA found few firms whose governing bodies regularly reviewed (i) whether the selected brokers were actually providing best execution to customers and (ii) whether the products and services purchased using dealing commission were eligible to be paid for with customers' funds. Clearly, this is an area where UK practice will need to resemble the best execution analyses that investment advisers in the US generally undertake, often through designated "brokerage committees" or similar bodies. In the US, for example, firms frequently use a variety of objective and subjective metrics to measure best execution (e.g., "benchmarking" brokers trading similar products against each other, licensing specialised software to compare actual executions to VWAP prices or execution algorithms and instituting internal "broker votes" that allow researchers to allocate commissions according to estimates of value received) and undertake to review and confirm, on a periodic basis, that the services purchased satisfy the applicable laws, rules and policies governing the use of dealing commission.
- *Market Data.* The use of dealing commission to pay for market data services was specifically focused on in the Report. Hedge fund managers are now on notice that any use of commissions to pay for such data services requires an "unbundling" and allocation of these fees among execution, research and other services and a proportionate allocation; hedge fund managers should be prepared to explain and defend any allocation methodology to the FSA.
- *Disclosure.* The Report highlighted a reviewed firm that was not (contrary to its claims) compliant with the Investment Management Association's Pension Fund Disclosure Code (which has generally been viewed as being a good model for commission disclosure requirements[7]). While that was a specific case, its inclusion in the Report signals that all hedge fund managers should review their various offering documents and engagement agreements to identify all commission (and, frankly, all other) disclosure obligations and perform a so-called "gap analysis" to confirm that none are being overlooked or breached.

From the FSA's comments in the Report, it seems likely that the FSA will be conducting a further thematic review on investment managers' practices on the use of dealing commission (and other conflicts generally) — possibly in the new year. All FSA-authorised hedge fund managers should take this opportunity to place particular emphasis on a self-assessment in this area.

Gifts and Entertainment. The Report notes that few reviewed investment managers had considered how accepting gifts and entertainment could compromise their duty to act in their customers' best interests. Although hedge fund managers will have reviewed their gifts and entertainment policies in recent years in light of the implementation of the UK Bribery Act, firms should re-review such policies to ensure that the giving or acceptance of gifts or entertainment could not give rise to cause for concern about the objectivity of decisions taken.

[7] For example, see Section 9.3 of http://www.fsa.gov.uk/pubs/other/oxera_dealing_commission.pdf.

Among other measures, FSA-authorised hedge fund managers should specifically give thought to the following:

- Interpreting the concept of "valid business purpose" in the context of the investment manager's business;
- Setting maximum values for any gift or entertainment accepted by an investment manager's personnel;
- Imposing limits on the number of instances that personnel may accept gifts or entertainment within a given time period;
- Considering whether gifts and entertainment should be valued on a cost incurred, face value, fair market value, or other basis;
- Determining whether items such as travel, accommodation, entertainment and other services may be accepted in conjunction with conferences or research trips; and
- Creating workable yet robust pre-approval and review systems.

Equitable Allocation of Investment Opportunities. FSA rules require prompt and accurate recording, allocation and documentation of trades; investment managers should allocate trades fairly when they effect transactions for multiple customers in the same security at the same time. Generally, the FSA was satisfied with the reviewed investment managers' practices in this area, but the Report noted one example of questionable *ex post* allocations; upon FSA challenge, the investment manager in that case performed an analysis that showed some customers being favoured over others. In addition, the FSA disclosed that it had taken an enforcement action against a firm that traded for one fund to ease another customer's liquidity issues.

There are several relevant pieces of advice in this area that can be derived from the Report:

- *Written Policies and Contemporaneous Allocations.* As is recommended by FSA rules,[8] hedge fund managers should maintain a clear and documented allocation policy and generally should make trade allocations between the investment manager's customers contemporaneously with the execution of the relevant trade(s) (or as close thereto as is feasible). An allocation policy should also generally require that in the event that the allocation is not contemporaneously made or is not allocated in a timely manner after the trade is executed there should be a record made in the firm's compliance files as to why the investment manager considers: (i) the deviation from the policy to be in the best interests of the customers involved and (ii) that no customer suffers any detriment as a result of the allocation.
- *Cross-Trade Analyses.* If an investment manager engages in cross trades among customer accounts, the manager should be able to demonstrate that it has controls in place intended to ensure that the transaction is at a fair price.
- *No "Robbing Peter to Pay Paul."* In highlighting an enforcement action taken, the FSA presumably is warning investment managers that trading activity (whether by cross trade or market trade) in one customer account that only serves to benefit another customer is an actionable breach of FSA rules. Hedge fund managers should consider establishing monitoring procedures that would better prepare them to detect these kinds of trades.
- *Ideas Are also Subject to Equitable Allocation.* To the extent that different teams within the investment manager generate trading ideas, those ideas may also need to be fairly allocated among customers (although the example cited in the Report was linked to a specific disclosure, so this may not be a general issue).

Employee Personal Account ("PA") Dealing. PA dealing by a hedge fund manager's employees in any type of securities is frequently prohibited other than in circumstances where the employee has no discretion — such as where the dealing takes place in a stocks and shares ISA or where the account is managed by an

[8] COBS 11.3: http://fsahandbook.info/FSA/html/handbook/COBS/11/3.

independent external manager. Many firms follow US-style policies and require that where any employee wishes to engage in PA dealing, the specific written consent of the firm's compliance officer must be obtained prior to the dealing taking place (so that the firm can ensure that the dealing does not create a conflict of interest). It should also be noted that, even if an employee is dealing in a security that the hedge fund manager's customers do not hold or trade, the individual concerned could still have a conflict in terms of the time and attention he spends on his or her PA dealing (e.g., if he or she should, in fact, be spending that time managing the assets of customers).

The Report highlighted examples of what the FSA considers good practice in this area. This guidance was fairly straightforward, and any FSA-authorised hedge fund managers that allow PA dealing by employees should consider using the following list of best practices in creating a framework for a revised PA dealing policy:

- Establishing a requirement to educate and train employees on the conflicts of interest that can be created by PA dealing;
- Drafting written policies that set out clear PA dealing procedures;
- Enforcing policies and procedures that impose significant PA restrictions (the FSA cited as examples a "long-term investor"/minimum holding period requirement and an upper limit on trading frequency);
- Monitoring PA dealing activity, and performing targeted reviews on the PAs of staff engaged in extensive personal trading or who are judged to be in particularly sensitive roles; and
- Empowering a governance committee to oversee PA dealing activity and periodically to review other aspects of the policy to help ensure it remains appropriate.

Trade Errors. While the Report conceded that most reviewed investment managers had considered trade errors in some detail and were aware of the potential for conflicts of interest in the allocation of resulting losses, the FSA was particularly focused on the reliance by some firms — "mostly hedge fund managers" — on gross negligence clauses to reduce their liabilities for the costs of trade errors and omissions. While the FSA did not state that "gross negligence" — which is a standard that many UK hedge fund managers employ — is not appropriate in this area, it did indicate that it has some concerns about reliance on these clauses to justify not reporting trade errors to customers or not collecting error-related information. The FSA commented that it felt that the firms in its review that utilised this standard had not considered whether repeatedly making the same or similar errors might in itself amount to gross negligence.

Irrespective of the issuance of the Report, hedge fund managers should continue to assess each error irrespective of liability and act to resolve each such error pursuant to the applicable regulatory rules and their customer agreements; however, the Report impliedly encourages investment managers to require that all trade errors be reported internally to a centralised recording and analysis system, with a subsequent review and disclosure to customers. The FSA also endorses a policy that clearly allocates losses (to the investment manager) and gains (to the customer) from trade errors, with certain exceptions, but this position remains an FSA preference and not a requirement. While it is wise for all hedge fund managers to review their policies and procedures on identifying, defining, disclosing and resolving trading errors in light of this guidance, we would also suggest that new policies in this area, which can be quite tricky in today's global markets, only be adopted with the benefit of the advice of outside counsel.

Specific Concerns for UK Affiliates of Offshore Managers
The Report also highlighted concerns that the FSA has with authorised managers that are part of a larger global organisation. The FSA stated that they "saw evidence" that affiliated UK managers "had governance arrangements that did not meet our requirements regarding conflicts management."

The issues cited in this area related to governance and organisation (and the Report did not state that there was any correlation between these governance issues and the level of overall conflicts of interest management). The Report specifically noted that in some cases:

- The UK board did not exercise sole or "meaningful control" over the authorised manager's conflicts management and other compliance responsibilities and

- Individuals based overseas at the parent entity were making decisions on the investment manager's core practices.

In other words, no approved person in the UK effectively took actual responsibility for compliance with the FSA's rules.

It is important to note that these concerns were not idiosyncratic issues of a single manager; the specific language of the Report makes clear that several of the entities reviewed by the FSA were affiliates or subsidiaries of non-UK managers and different weaknesses were highlighted for different managers. Therefore, all entities that control a UK hedge fund manager should carefully review the Report's guidance in this area.

Next Steps

Compliance Review. In the Report, the FSA states that it expects its conflicts of interest principles and rules to be embedded in investment managers' businesses and to be taken into account when considering new products, processes or business models. The FSA further expects the boards of investment managers to regularly review their practices to ensure compliance with the FSA's requirements.

Attestation of Compliance Required by 28 February 2013. However, the FSA has — for the first time ever — requested (i.e., required) that those firms that receive a hard copy of the Report from the FSA in the form of a "Dear CEO" letter[9] should also take the following steps:

- The board of the relevant investment manager should discuss the Report at a board meeting during the next three months; and
- The chief executive officer of the investment manager should complete, sign, and return the "attestation" below to the FSA by 28 February 2013.

> 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.

Given the FSA's comments on the seriousness of the issues identified in the Report and the fact that the FSA has already taken enforcement action, all FSA-authorised hedge fund managers should give the issues set forth in the Report a high degree of prominence and must ensure that they review their procedures in connection with conflicts of interest (and must ensure that they return their signed attestation to the FSA before 28 February 2013).

AIFM Directive — Conflicts Policies after July 2013. The Alternative Investment Fund Managers Directive ("AIFM Directive") comes into force across the EU on 22 July 2013. Those FSA-authorised hedge fund managers that will be defined as alternative investment fund managers under the AIFM Directive will need to comply with slightly different[10] conflict of interest rules after they re-register with the FSA as AIFMs[11] —

[9] *See* Footnotes 2 and 3.

[10] The FSA's current conflicts of interest rules in the FSA Systems and Controls Sourcebook (see Footnote 4) are derived from the Markets in Financial Instruments Directive ("MiFID"). However, an AIFM under the AIFM Directive is not subject to MiFID. The AIFM Directive contains its own provisions relating to conflicts of interest, the details of which will be published in the AIFM Directive's "Level 2" rules, which are expected to be published in late November or early December 2012.

[11] FSA-authorised investment managers that are currently MiFID investment firms will need to apply to the FSA for a variation of permission to become AIFMs before 22 July 2014. (*See* Paragraph 2.41 of http://www.fsa.gov.uk/static/pubs/cp/cp12-32.pdf.)

meaning that such firms will need to: (i) conduct an initial conflicts of interest review now, (ii) return the attestation to the FSA (if required of that firm by the FSA) and (iii) conduct a further review of compliance policies and procedures in 2013 and make any changes necessary to comply with the specific requirements imposed on them under the AIFM Directive.

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