

# Case Study

## Addressing Potential Conflicts of Interest between Parallel Funds

### Executive Summary

This memo sets out a case study about potential conflicts of interest that can arise between parallel funds and highlights how the Alternative Investment Standards address these issues. The memo also provides examples for **additional measures managers can take to strengthen their approach** and provides an **overview of areas investors should assess as part of their due diligence** on how a manager addresses potential conflicts of interest. Appendix C includes an overview of regulatory expectations and references the specific regulatory documents.

### Case study

#### Situation

- A manager has multiple funds which have identical investment strategies, but for various reasons cannot be managed completely in parallel / on a pari passu basis (with mechanistic pro rata allocation of trades), e.g.:
- Funds are at different stages of their investment life cycle
- Different ancillary restrictions (e.g., one is fully invested, other one not yet)
- Underlying opportunities are illiquid, or cannot be shared across multiple funds (e.g., property/real asset strategies)

#### Issues

- This can give rise to concerns about fair treatment of investors in the different funds (e.g., perception of giving preference to one fund over the other in terms of allocations, etc.)
- Conflict of interest can be aggravated by some funds paying performance fees, others not, or investment manager co-investment in some (but not all) funds
- In some cases, new investment opportunities with the same issuer, but in different parts of the capital structure, can emerge over time, with the result that parallel funds can have adverse positions if the issuer becomes distressed
- Not all fund regimes have “fund governing body/board of directors” to explicitly
- Review these conflicts

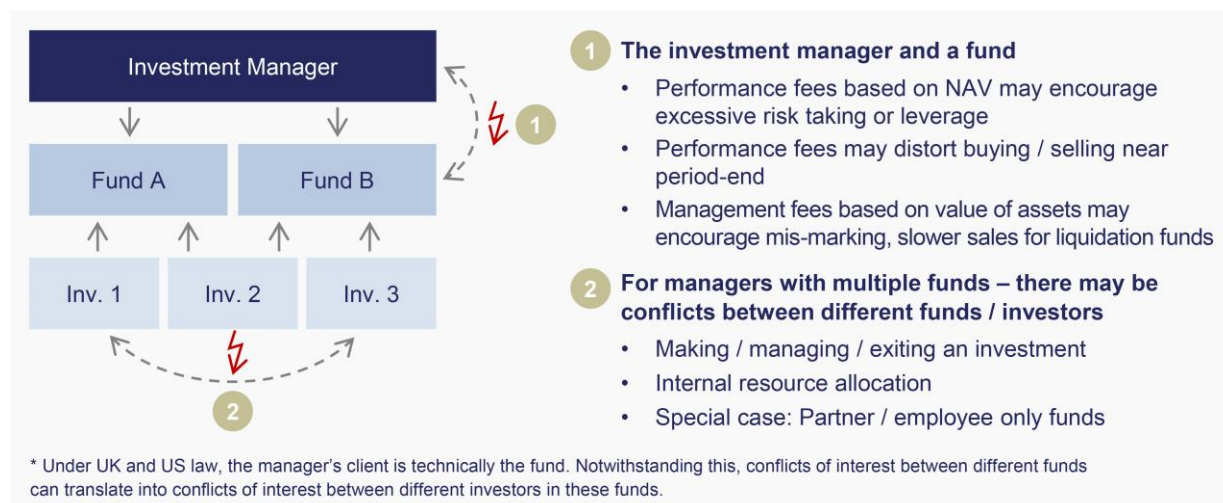
### How the Alternative Investment Standards address conflicts of interest

While asset managers must act in their clients’ best interests and treat them fairly, the relationship between managers and their clients can give rise to conflicts of interest between a manager and its clients and between different clients (see Exhibit 1).

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The SBAI Toolbox is an additional aid to complement the SBAI’s standard-setting activities. While alternative investment fund managers sign up to the Alternative Investment Standards on a comply-or-explain basis, the SBAI Toolbox materials serve as a guide only and are not formally part of the Standards or a prescriptive template.

## Exhibit 1: Overview of types of conflicts of interest



The Alternative Investment Standards provide a comprehensive framework for addressing such conflicts of interest, including in areas such as risk management, valuation, commercial terms and governance (see Appendix A for overview). In addition, the SBAI published the Standardised Board Agenda<sup>1</sup> which highlights the areas where fund directors play an important role in assessing and mitigating conflicts of interest.

**In 2015/16, SBAI consulted on the topic of conflicts of interest in similar funds (Consultation Paper CP4)<sup>2</sup>.** Specifically, the SBAI looked into conflicts that can arise between parallel funds, as well between external funds and partner/employee only funds, and in each case the funds pursue similar (but not necessarily identical) investment strategies. Investors highlighted specific concerns about priority of transactions/opportunities (where funds compete with respect to individual investments that have limited capacity), manager resource allocation to different funds/accounts/vehicles and alignment of interests between the investment manager and the investors.

The consultation CP4 led to the enhancement of the Alternative Investment Standards in the following areas (see Appendix B for detailed overview):

1. Disclosure of similar funds, accounts or vehicles, including partner/employee funds (to facilitate due diligence/well informed investment decisions)
2. Disclosure of trade allocation policy to investors
3. Internal arrangements to mitigate conflicts of interest (e.g., documented compliance policies and procedures (e.g., conflicts of interest policy), recording of conflicts of interest and reporting to senior management, where applicable, reporting to Fund Governing Body)

<sup>1</sup> See <https://www.sbai.org/wp-content/uploads/2016/04/Standardised-Board-Agenda-Nov-2019.pdf>

<sup>2</sup> <https://www.sbai.org/standards/consultations/>

## Additional specific measures to address conflicts of interest

Managers can take additional measures to specifically address potential conflicts of interest between parallel funds:

Additions to allocation policy <sup>3</sup>	<ul style="list-style-type: none"><li>• Include section dealing with situations where allocations can differ (i.e., setting out the reasons why differences can occur)</li></ul>
Trading/compliance reporting system	<ul style="list-style-type: none"><li>• Require explanation and rationale for allocation decisions when trades are entered (where allocations differ from the methodology as defined in the allocation policy)<sup>4</sup></li></ul>
Audit of allocations by CCO or conflicts of interest committee <sup>5</sup>	<ul style="list-style-type: none"><li>• Review of gross performance differential and tracking error between funds</li><li>• Specific review of trades that contributed most to performance differential</li><li>• Review of explanations provided in trade reporting system</li></ul>
Review by independent third party	<ul style="list-style-type: none"><li>• Engage a compliance consultant to conduct an annual audit or as part of a recurring mock audit review</li></ul>
Reporting to Fund Governing Body	<ul style="list-style-type: none"><li>• Review of gross performance differential between funds</li><li>• Requesting log of explanations provided in the trade reporting system</li><li>• Review of output of audit of allocations (internal or third party)</li></ul>

It is important to highlight that some of the analyses suggested above (performance review, tracking error, etc.) are easier to undertake in situations where funds are very similar, but become more difficult for carve out strategies, where only a subset of a given fund has overlap with (an) other fund(s). Other more complex examples include strategies where allocations are based, for example, on risk-based calculations (e.g., on a daily basis). In these situations, a more thorough review of the trade allocation policy will be required.

## Investor due diligence

The list below includes areas for further assessment by investors as part of their due diligence:

- Compare aggregate AUM in strategy to fund AUM (to identify other similar accounts/funds)
- Review manager's disclosure of any material adverse effects of parallel funds
- Review trade allocation policy to ensure it is sufficiently explicit on how transactions are allocated between funds
- Review manager's arrangements to manage and mitigate conflicts of interest
- Potential drill downs:
  - For single investor fund (from single investor perspective: request report from manager comparing positions and performance of funds (i.e., review of tracking errors))
  - Review sample of notes/commentary in trade reporting system (if available)
- Request evidence of reviews completed by CCO
- Request evidence of reviews conducted by independent third parties

<sup>3</sup> Also see Standard 17i.1/17i.2

<sup>4</sup> Note: this might not be possible in higher volume trading

<sup>5</sup> Larger fund complexes tend to have a Conflicts of Interest Committee; often more ad hoc approach for smaller firms (e.g., as part of Compliance Committee)

## Appendix A

### Examples for conflicts of interest addressed by the Alternative Investment Standards

Conflicts of interest	Mitigation (examples)
Management fees based on value of assets might encourage over-valuation	<ul style="list-style-type: none"><li>• Independent valuation / segregation of functions</li><li>• Governance framework for valuing hard-to-value assets Valuation Policy</li><li>• Investor disclosure</li><li>• Review by fund directors</li></ul> <i>(Standards 5-9, 21)</i>
Performance fees based on NAV might encourage excessive risk taking or leverage by the manager ('roll the dice')	<ul style="list-style-type: none"><li>• Upfront risk disclosure (including use of leverage)</li><li>• Risk management framework</li><li>• Ongoing risk reporting to investors</li><li>• Independent fund governance arrangements / review of adherence to investment policy</li></ul> <i>(Standards 1, 9-16, 21-22)</i>
Hidden fees charged to the fund	<ul style="list-style-type: none"><li>• Detailed upfront commercial terms disclosure</li><li>• Comparability of fee methodology in offering document and financial statements</li><li>• Standards addressing adverse changes of commercial terms</li></ul> <i>(Standard 2)</i>
Conflicts of interest between different investors	<ul style="list-style-type: none"><li>• Handling of redemptions / fair treatment of investors</li><li>• Disclosure of existence of material side letters</li><li>• Disclosure of existence of funds/accounts using the same investment strategy (as the investor fund) and potential material adverse effects</li></ul> <i>(Standard 1, 2)</i>
Personal account dealing	<ul style="list-style-type: none"><li>• Personal account dealing policy (including disclosure to investors upon request)</li></ul> <i>(Standard 17h)</i>

## Appendix B

### Specific Standards addressing conflicts of interest between parallel funds

#### 1. Disclosure of similar funds, accounts or vehicles, including partner/employee funds

##### Amended Standard 2.4

###### Upon request, a fund manager should disclose

- a) Existence of funds, accounts or vehicles managed by it using the same or similar<sup>18</sup> investment strategy,<sup>19</sup>
- b) any material adverse effects which the existence of such other funds, accounts or vehicles may have on investors in the fund,
- c) the aggregate value of asset managed by the manager using the same or similar<sup>18</sup> investment strategy,
- d) the aggregate size of employee or partner interests in the investment strategy,<sup>20</sup>
- e) the existence of any other funds or accounts managed by it which follow the same or similar<sup>18</sup> investment strategy to the fund and which are available for investment only by partners or employees (or their connected persons) of the fund manager,<sup>19, 21</sup> and
- f) in the case of (e) above, the size of such funds and accounts.

Please see below an example of non-binding guidance to determine “similarity”

18 Similar strategies should be interpreted to include funds, accounts or vehicles managed by an investment management team or individual within the fund manager and which trade substantially in parallel, in whole or in part with the fund. Substantially similar trading patterns over time, rather than overlapping positions by themselves, can be an indicator (i.e., overlapping positions by themselves do not define similarity).

19 For the avoidance of doubt, the Standard requires fund managers to disclose that they manage other funds, accounts or vehicles, but does not require disclosure of specific details of such funds, accounts or vehicles.

20 For the avoidance of doubt, the Standard requires disclosure of aggregate partner/employee investment in the respective strategy, not a person-by-person break-down.

21 For the avoidance of doubt, a feeder fund, accessible only to partners or employees (or their connected persons) which only invests into a master fund accessible to external investors through a different feeder does not fall under this disclosure.

###### Definition of “similar”

One of the challenges of the consultation CP4 was to define what constitutes a “similar” strategy. On the one hand, it is not intended to capture funds/accounts/vehicles which have some identical underlying positions, but which do not trade in parallel – it would be very difficult for managers to monitor this situation. On the other hand, it could be important to capture, for example, a multi-strategy set-up where a fund is similar in relation to a sub-strategy of such a multi-strategy fund, particularly in situations where trades may have scarce capacity.

## Example of one non-binding approach to determine “similarity”

1. The Portfolio Manager or investment team, the investment mandate (i.e., equity, fixed income, macro) and the strategy or style (i.e., market neutral, relative value, trend following) will all need to be the same.
2. Additionally, the “similar” fund or separately managed account will have to have an 80%<sup>6</sup> overlap in the following 4 areas (an example follows each item):
  - a) Asset classes traded (i.e., mortgages, equity, credit, FX) - If the fund is 100% equities, then other funds/sleeves must have at least 80% in equities to be classified as similar.
  - b) Target risk and return - Funds must have similar risk-return targets (measured by Sharpe or Information Ratio) to be classified as similar. Thus, if the fund targets a Sharpe ratio of 1, then “similar” funds must target a Sharpe between 0.8 and 1.2 (+/-20% band).
  - c) Time horizon of positions - If the average holding period for the fund is 3 months, then the holding period for the similar fund needs to be between 2.4 to 3.6 months (+/- 20% band).
  - d) Average liquidity of positions - If the average liquidity profile of the fund is 10 days, then the similar fund needs to have an average liquidity profile between 8 to 12 days to be classified as similar (+/- 20% band).
3. A multi-strategy fund would have to have 80% overlap of allocations among sub-strategies, and the sub-strategies would have to be substantially similar (80%), as in item 2 above.

## 2. Disclosure of trade allocation policy to investors

### New Standards 17i.1 and 17i.2 [Operational risk]

- 17i.1 A manager should put in place a trade allocation policy.
- 17i.2 Upon request, a manager should disclose the trade allocation policy to investors on a confidential basis.

## 3. Internal arrangements to mitigate conflicts of interest

### New Standard 17k.1 [Operational risk]

A manager should ensure that it has internal arrangements to manage and mitigate conflicts of interest, and this should include documented compliance policies and procedures (e.g., conflicts of interest policy). Conflicts of interest should be recorded and reported to senior management on a periodic basis (e.g., monthly or quarterly) or, in the case of conflicts requiring the approval of senior management, escalated as soon as reasonably practical. Where applicable, conflicts of interest should be reported to the fund governing body.

Examples of conflicts of interest may include, but are not limited to:

- a) Cross trades
- b) Fair allocation of trades / opportunities across different funds or accounts
- c) Employee/partners funds
- d) Funds that in turn invest in other internal/external funds with incremental fees
- e) Internal resource allocation across different funds/client accounts
- f) Personal Account dealing policies
- g) Allocation of expenses

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<sup>6</sup> 80% is used as an indicative example here, but there is no particular “magic” to the 80% number. Firms could choose to use another number.

- h) Use of affiliated service providers
- i) Lack of independent valuation
- j) Differential terms or fees
- k) Use of soft dollars/dealing commissions
- l) Other business interests of investment manager employees
- m) Gifts and entertainment
- n) Suspension and/or gating of redemptions

## Appendix C

### Regulatory focus on conflicts of interest

Financial regulators are well aware of conflicts of interest that can arise in investment management. Accordingly, a large body of regulation exists to address conflicts. Regulatory approaches vary from jurisdiction to jurisdiction, but the overarching objective is to ensure fair treatment of investors by either managing/mitigating conflicts of interest or disclosing such conflicts, where applicable. This appendix provides an overview of the regulatory focus on conflicts of interest for different jurisdictions.

In addition, lately many regulators have been paying closer attention to identifying conflicts of interest between asset managers and their investors. For example, the regulatory compliance inspections by the SEC Office of Compliance Inspections and Examinations (OCIE) started assessing the handling of conflicts of interest by registered firms. The UK FCA published a dedicated review of conflicts of interest in asset managers in 2012.

*(Underlined words are hyper-linked to the relevant regulatory documents)*

US Securities and Exchange Commission (SEC): Form ADV <a href="#">(Instructions for Part 2)</a>	Disclosure obligation as a fiduciary: (...) As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. (...) provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest (...), and can give informed consent to such conflicts or practices or reject them.
US SEC <a href="#">Examination Priorities for 2014</a>	“Registrants [have engaged] in activity that puts their own interests ahead of their clients in contravention of their fiduciary duty and existing laws, rules and regulations.” (p.4)
European Securities and Markets Authority (ESMA): Alternative Investment Fund Managers Directive <a href="#">(AIFM-D)</a>	(80) ... to take all reasonable steps to avoid conflicts of interest and, where such conflicts cannot be avoided, to identify, manage and monitor, and where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated.
UK Financial Conduct Authority (FCA): <a href="#">Principles 6 &amp; 8</a>	A firm must pay due regard to the interests of its customers and treat them fairly. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
UK FCA: Handbook	<ul style="list-style-type: none"> <li>• <a href="#">Investment Funds Sourcebook</a> (e.g., FUND 3.2, 3.7, 3.9, 3.10, 3.11)</li> <li>• Other: Conduct of Business Sourcebook (<a href="#">COBS 11.3.1 (3)</a>), Senior Management Arrangements, Systems and Controls (<a href="#">SYSC 10.1</a>)</li> </ul>

UK FCA Report (2012)	<ul style="list-style-type: none"> <li>• <u>Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks</u></li> </ul>
Hong Kong Securities and Futures Commission (SFC)	<ul style="list-style-type: none"> <li>• <u>Code of Conduct</u>: GP6 (Conflicts of Interest) – avoid conflicts, treat clients fairly; paragraph 10.1 (Disclosure and Fair Treatment)</li> <li>• <u>Fund Manager Code of Conduct</u>: 2.1.1-2.1.4 Personal Account Dealing; 2.2. Receipt of Provisions of Benefits</li> </ul>
Monetary Authority of Singapore (MAS)	<ul style="list-style-type: none"> <li>• <u>Securities and Futures Regulation (SFR)</u>: Regulation 13B</li> <li>• <u>Securities and Futures Act</u>: Guidelines on Licencing, Registration and Conduct of Business for Fund Management Companies: Measures to mitigate conflicts of interest, disclosure (4.1.3)</li> </ul>
Australian Securities and Investment Commission (ASIC):	<ul style="list-style-type: none"> <li>• Registered Managed Investment Schemes: Guidance on conflicts of interest (guide 76), specific disclosure duties (s601FD, 601FE) of the <u>Corporations Act</u></li> <li>• Unregistered Schemes: no requirements specific to conflicts of interest, but general Australian Trust law is applicable, separate guidance about <u>corporate governance</u></li> </ul>
Canadian <u>National Instrument (31-103)</u>	<p>Identification of conflicts of interest (13.4), restrictions on managed account transactions (13.5), Disclosure of recommendation of related securities (13.6), relationship disclosure information (14.2), disclosure about fair allocation of investment opportunities (14.3); Companion Policy 31-103 CP 13.4-13.6, 14.2-14.4</p>
Switzerland	<p>Swiss Funds &amp; Asset Management Association: SFAMA <u>Code of Conduct</u>: (5., 10.) Avoidance / disclosure of conflicts of interest [The Swiss Financial Market and Supervisory Authority FINMA has recognised the SFAMA Code of Conduct as a minimum standard]</p>