

Alternative Credit

Conflicts of Interest

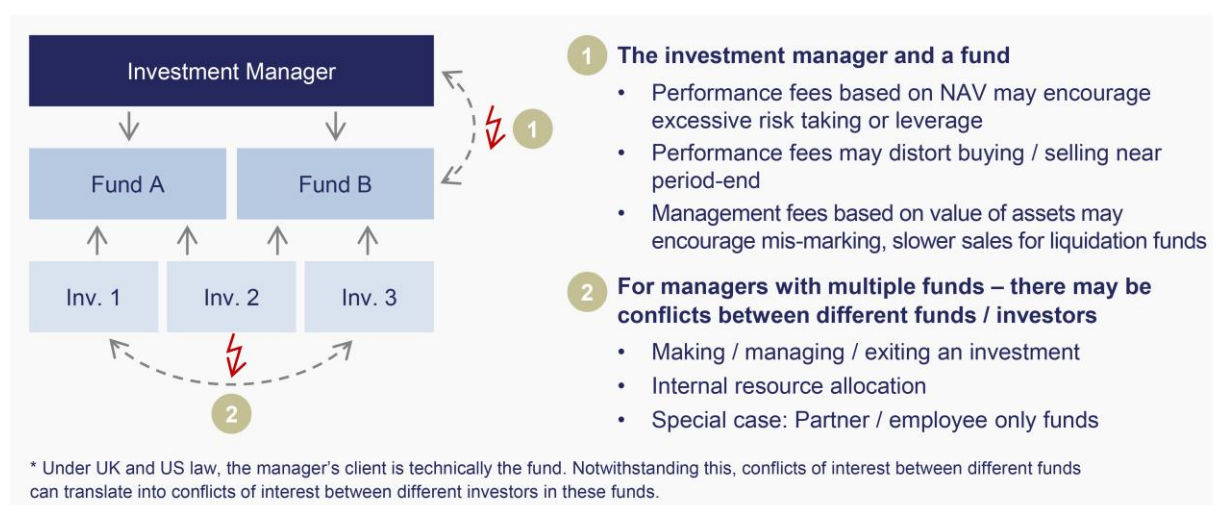
1. Introduction

This SBAI Toolbox Memo on Alternative Credit – Conflicts of Interest reaffirms the standards and guidance included in SBAI's Alternative Investment Standards (section 2), identifies specific conflicts of interest that can arise in the context of funds investing in (alternative) credit (section 3), and suggests questions that investors may wish to ask when assessing a manager.

2. What the Alternative Investment Standards Say

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).

Exhibit 1: Overview of types of conflicts of interest



Existing rules and regulations address these concerns (see Appendix A) by focusing on prioritising client interests and management/mitigation of any potential conflicts of interest. However, the existence of regulation alone may not be sufficient for investors to gain comfort. This means, in practice, that investors play a critical role in scrutinising managers and assessing any conflict of interest in their due diligence in order to be comfortable with how conflicts are addressed. Manager disclosure plays an important role in enabling this due diligence.

The Alternative Investment Standards provide a comprehensive framework for addressing conflicts of interest by putting in place arrangements to manage, mitigate and disclose potential conflicts of interest

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.

in areas such as valuations, portfolio risk management, handling of fees and expenses, etc. Exhibit 2 provides an overview of how different types of conflicts of interest are addressed throughout the Standards.

Exhibit 2: Examples of conflicts of interest addressed by the Alternative Investment Standards¹

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

In 2015/2016, the SBAI's Consultation Paper CP4² focused specifically on conflicts of interest that can arise between parallel funds (including parallel employee/partner funds). The new Standards published in 2016 strengthen the managers' arrangements to mitigate conflicts of interest and enhance the disclosure to investors in the following areas:

- Disclosure of similar funds, accounts or vehicles, including partner/employee funds
- Disclosure of trade allocation policy to investors

¹ Appendix A contains additional examples of how the Standards address different conflicts of interest.

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

- Internal arrangements to mitigate conflicts of interest

Exhibit 3: Internal arrangements to mitigate conflicts of interest (Alternative Investment Standard 17j)

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 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
- 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.

In addition to the Alternative Investment Standards, the SBAI published the [Standardised Board Agenda](#)³ which highlights the areas where fund directors play an important role in assessing and mitigating conflicts of interest.

3. Specific conflicts of interest in Alternative Credit

The management of alternative credit funds can give rise to more specific conflicts of interest. For example, fees generated by ancillary services provided by the manager (loan servicing, origination fees, affiliated CLO business), and the usually illiquid nature of assets (and resulting lack of robust public market price formation) may lead to conflicts. The following sections focus on specific examples of conflicts of interest that can arise between the manager and the fund, and between different funds managed by the same manager.

³ See <https://www.sbai.org/standards/>, a detailed overview of examples of specific concerns addressed by the Alternative Investment Standards is included in Appendix A

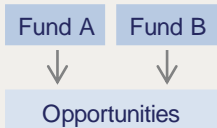
3.1 Manager vs. Fund

Area	Conflict/Issue	Considerations/Key questions for investors to ask
Affiliated CLO business	Firm (or related entity) earns a fee/ supports the proliferation of a new business by purchasing CLO equity /warehousing loans in the fund	<ul style="list-style-type: none"> • Does the manager invest in vehicles created by the affiliated CLO business? • Does the manager provide a clear policy on investing in the equity (or other tranches) of related CLOs? Related, does this include an upper limit on related CLO holdings it intends to own in the Fund? • Do the fund's investment objectives align with the manager's practices? • Are relevant fees received (if any) clearly disclosed (including applicable rebates)? • What governance arrangements are in place to mitigate conflicts between affiliated businesses (including roles of Fund Directors)?
Affiliated loan servicing	Related entity earns a fee for servicing a loan held in the Fund	<ul style="list-style-type: none"> • Are loan servicing fees prominently disclosed to fund investors? • Does the manager undertake a third party/governance review around the competitiveness of fees charged to the fund? • Does the manager own the loan servicer? If so, is the servicer owned by the GP or the Fund? (if owned by the GP, questions around cost/competitiveness; if owned by LP: what happens if the Fund closes (sale of servicer to third party, or follow-on fund?))
Loan origination fees	These are fees paid to the Manager when they originate a private loan to a third-party issuer	<ul style="list-style-type: none"> • Does the manager earn loan origination fees? • Does the manager clearly articulate the policy around earning origination fees? • Are the charges reviewed by Fund Directors? • Is a third-party assessment of fees charged to fund undertaken? • Alignment of interest between the GP and LPs: Do GP / co-investing partners / staff share the cost? • If the manager does engage in this practice, is the total amount prominently disclosed in the fund's financial statements, so the investor can assess the impact of the fees?
Conflicts of interest in private equity sponsor financing (sweeteners)	Prospect of major opportunity "down the road" creates incentive to provide funding for another project of the same PE sponsor (via a separate fund)	<ul style="list-style-type: none"> • Observation: This is both a conflict between the manager and the fund, as well as a conflict between different funds • See detail in section "Funds versus Funds/Investor versus Investor" below

Observation: The Alternative Investment Standards require disclosure of any special commercial terms which could result in potential conflicts of interest.⁴

3.2 Fund versus Fund / Investor versus Investor:

The table below summarizes a list of foreseeable conflicts that could arise between different funds managed by the same manager, or more directly between investors in each respective structure:

Area	Conflict/Issue	Considerations/Key questions for investors to ask
<p>Allocations of credit instruments across multiple funds with similar strategies.</p>  <p>(Observation: Conflicts can also arise when exiting investments.)</p>	<p>One fund may receive preferential treatment over another. This is particularly relevant around a fund's life cycle, relative size, proportion of internal capital, overall profitability to the manager (position relative to HWM), net outflows.</p>	<ul style="list-style-type: none"> Does the manager's allocation policy discuss specifics on how it allocates scarce credit investments? What oversight arrangements (e.g., compliance, conflicts of interest committee, Board of Directors - ...)⁵ are in place? How are disposals of illiquid instruments handled (e.g., one close-ended fund vs. other open-ended fund with redemptions pressure)? <p>The Standards require disclosure of the manager's allocation policy to investors upon request.⁶</p>
<p>Cross trades of illiquid investments</p>	<p>Risk of value transfer between investors in different funds if assets are mispriced (especially relevant if one fund is experiencing outflows)</p>	<p>Valuation:</p> <ul style="list-style-type: none"> Where available: are cross-trading platforms (mostly level 1 / 2 assets) or Bid Wanted in Competition (BWIC) used to determine a fair price? Is third-party valuation undertaken? (Especially where there is a meaningful deterioration of a loan.) <p>Oversight:</p> <ul style="list-style-type: none"> What internal/external oversight was involved in approving the cross trade? (e.g., compliance, valuation committee, conflicts of interest committee, Director or LP Advisory committee oversight and approval of all cross trades, etc.) Were investors consulted for approval prior to cross trade? <p>Disclosure:</p> <ul style="list-style-type: none"> Are relevant materials that were used to value investment made available to investors?⁷ Does the manager make third-party valuation agent's memo available for investors to ensure symmetrical understanding of the state of the loan?

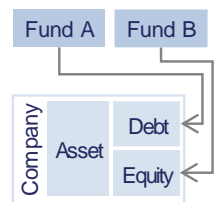
⁴ Alternative Investment Standard 20.3

⁵ Alternative Investment Standard 17j (Conflicts of interest), 17a.1, 17a.2

⁶ Alternative Investment Standard 17i (<https://www.sbai.org/standards/>)

⁷ Alternative Investment Standard: Disclosure of Valuation Policy Document to investors (on confidential basis) (Standard 6.1); Disclosure of fund manager involvement in valuation process (Standard 6.2); In-house valuation: Disclosure of any material issues to investors (Standard 8.4)

Area	Conflict/Issue	Considerations/Key questions for investors to ask
Please see separate SBAI Toolbox Memo: Alternative Credit Valuation.		
Later fund refinancing an earlier fund out of a private loan	<p>Earlier iterations of private debt funds could have artificially higher returns, as an “amend and extend” practice is employed.⁸</p> <ul style="list-style-type: none"> • Relevant if track record of earlier iteration of Fund is used to market subsequent iterations • Penalizes subsequent fund investors by putting an issuer that is subject to greater risks of deterioration on them 	If refinancing is done between funds, how is a “fair value” determined? <i>(also see questions above on Valuation, Oversight and Disclosure.)</i>
Investing at different levels of a given company’s capital structure through different funds/accounts	<p>Conflicts occur where two funds are invested in different parts of a given issuer’s capital structure as it becomes distressed. Given the generally “zero sum” nature of restructurings, one fund could profit at the expense of the other.</p>	<ul style="list-style-type: none"> • Does the manager allow different funds to become invested in different parts of a single capital structure? (If not, this represents the most straightforward mechanism to mitigate the conflicts of interest) • If an issuer becomes distressed, does the manager allow a misalignment to persist? Or if not, how is the misalignment cured?⁹ • If two funds become locked at odds with each other, what considerations are made to determine which interests the manager will advocate for? • What framework (including policies and documentation) and what surveillance by control functions (including board of directors) are in place (pre- and post-investment)? • What information barriers does the manager put in place in situations of misalignment? • How are conflicts disclosed to investors?
Broken deal expenses, deal-related legal costs (fund level vs deal level)	Fair allocation of expenses across all affected funds (including co-investments)	<ul style="list-style-type: none"> • What controls are in place? • What is the methodology? • Where are deal-related expenses accounted for (visible at fund level vs. non-disclosed at deal level)?



⁸ Essentially marking up positions in prior vintages to the benefit of early investors, while at the expense of investors in more recent vintages
⁹ e.g., selling down a position, or aligning funds by combining different liens into one single position held by both funds

Area	Conflict/Issue	Considerations/Key questions for investors to ask
Access to material non-public information	Instances where a manager erects an internal wall to protect material non-public information (e.g., involvement with creditor committees)	<ul style="list-style-type: none"> • What controls does the manager have in place to ensure that there are no improper wall crossings? • Is a third-party assessment of robustness of insider protection policies and practices undertaken?
	Where a manager does not have internal walls, receiving MNPI necessarily precludes trading in securities of the relevant issuer. For managers that pursue both public and private investment strategies, taking in MNPI to evaluate private investment opportunities comes at the expense of foreclosing investment opportunities in public securities, at least temporarily. This can create conflicts of interest between funds that primarily focus on private investments vs. funds that primarily focus on trading public securities.	<ul style="list-style-type: none"> • What controls does the manager have in place to evaluate and reconcile conflicts of interest between funds that arise from receiving MNPI to evaluate private investments? • What controls does the manager have in place to prevent the inadvertent receipt of MNPI that could restrict trading in existing public securities positions? • How often has the manager encountered situations where taking in MNPI to evaluate a private investment prevented it from selling or hedging an open position in another fund? • How often has the manager declined to evaluate private investment opportunities due to positions in public securities of the same issuer?
Co-investments	<ul style="list-style-type: none"> • Conflicts between different co-investors, and conflicts between the co-investors and the fund • Allocation of expenses • Allocation to third parties 	See separate SBAI Memo on Co-investments ¹⁰ .

¹⁰ <https://www.sbai.org/toolbox/co-investments/>

Area	Conflict/Issue	Considerations/Key questions for investors to ask
Conflicts of interest in private equity sponsor financing (sweeteners)	Prospect of major opportunity “down the road” creates incentive to provide funding for other projects of the same PE sponsor (via a separate fund), potentially at unfavourable rates? (volume motivated distortions)	<ul style="list-style-type: none"> Does the manager provide transparency of deal flow across different funds? What governance arrangements are in place to address potential conflicts of interest? (documentation of conflicts, approval processes, board of director oversight) Joint agreement (alongside other lenders) to ensure fair pricing?

Appendix A

Regulatory focus on conflicts of interest

(Underlined words are hyperlinked to the relevant regulatory documents)

US Securities and Exchange Commission (SEC): Form ADV (Instructions for Part 2)	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 Examination Priorities for 2014	<i>“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)</i>
European Securities and Markets Authority (ESMA): Alt. Investment Fund Managers Directive (AIFM-D)	<i>(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.</i>
UK Financial Conduct Authority (FCA): Principles 6 & 8	<ul style="list-style-type: none"> 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"> Investment Funds Sourcebook (e.g., FUND 3.2, 3.7, 3.9, 3.10, 3.11) Other: Conduct of Business Sourcebook (COBS 11.3.1 (3)), Senior Management Arrangements, Systems and Controls (SYSC 10.1)
UK FCA Report (2012)	<ul style="list-style-type: none"> Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks
Hong Kong Securities and Futures Commission (SFC)	<ul style="list-style-type: none"> Code of Conduct: GP6 (Conflicts of Interest) – avoid conflicts, treat clients fairly; paragraph 10.1 (Disclosure and Fair Treatment) Fund Manager Code of Conduct: 2.1.1-2.1.4 Personal Account Dealing; 2.2. Receipt of Provisions of Benefits
Monetary Authority of Singapore (MAS)	<ul style="list-style-type: none"> Securities and Futures Regulation (SFR): Regulation 13B

- [Securities and Futures Act: Guidelines on Licencing, Registration and Conduct of Business for Fund Management Companies: Measures to mitigate conflicts of interest, disclosure \(4.1.3\)](#)

Australian Securities and Investment Commission (ASIC)

- Registered Managed Investment Schemes: Guidance on conflicts of interest (guide 76), specific disclosure duties (s601FD, 601FE) of the Corporations Act
- Unregistered Schemes: no requirements specific to conflicts of interest, but general Australian Trust law is applicable, separate guidance about [corporate governance](#)

Canadian [National Instrument \(31-103\)](#)

- 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

Switzerland

- Swiss Funds & Asset Management Association: SFAMA [Code of Conduct](#): (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]

Appendix B

Examples of specific concerns addressed by the Alternative Investment Standards

Area	Standard	Approach
Total strategy AUM	1.1	Disclosure of aggregate value of assets managed by the manager using the same investment strategy (to address concerns about competing similar funds).
Changes to investment strategy	1.3	Either investor consent or ability to redeem before changes to investment strategy take effect.
Fees and expenses	2.1, 2.5	Disclosure of fees/expenses, other remuneration received by the manager, other fees payable by the fund, consistency between offering documents and audited financial statements.
Changes to fees and expenses	2.2	Either investor consent or ability to redeem before changes to fees that are materially adverse to investors take effect.
Side letters	2.3	Disclosure of existence of side letters to investors which contain material terms and the nature of such terms.
Conflicts between different funds	2.4	Disclosure of existence of other funds/accounts using the same strategy / any material adverse effects they have (upon request).
Handling of redemptions, exit terms	2.1	Disclosure of exit terms (including indication of circumstances in which normal redemption mechanics might not apply or may be suspended).
Valuation of assets	5, 6	Segregation of functions, valuation policy, governance arrangements, investor disclosure of manager involvement in valuation process.
Risk management	9 – 16	Risk framework, segregation of functions, investor disclosure.
Operational risk management	17-18	Segregation of functions (compliance, risk management, valuation), separate reporting lines, remuneration incentives, personal account dealing policy (including disclosure of summary upon request).

Fund governance	21	Review of manager adherence to investment policy, review/ approval of side letters, Disclosure of conflicts of interest of directors.
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