Identifying and managing conflicts of interest

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Ensuring that regulated firms identify and manage conflicts of interest ("**CoI**") appropriately is a matter of constant focus for regulators, which makes sense given its central importance to the fair treatment of clients and as it speaks to the firm's integrity. Indeed, in its 'Dear Chief Executive' letter to TCBs dated 22 October 2010[1] the JFSC stated that "*management of conflicts will become a routine topic that we will examine during our on-site examination programme*". This commitment has since been borne out by our clients' experience.

Nonetheless, firms would be forgiven for thinking that, beyond that Dear CEO letter, they have limited guidance as to what is expected of them when identifying and managing CoIs. However, this issue has received greater attention in the UK: in the enforcement case of *FCA v Arch Financial Products LLP & Ors*[2] the Upper Tribunal gave detailed guidance on what is expected of firms under the FSA's pre-November 2007 rules relating to CoIs. The similarities between the approach in those FSA rules and the requirements of the JFSC Codes of Practice ("**Codes**") mean the *Arch* decision offers JFSC-regulated firms helpful guidance on how they should manage CoIs.

Identifying and managing CoIs

At a high level, firms will need to consider their approach to: identifying and understanding a CoI; managing the CoI; and record-keeping.

Identifying and understanding the CoI

The starting point is that one size does not fit all: differences in conflicts, clients and firms means that the appropriate approach depends on the context.

- A firm must therefore identify what the particular conflict consists of and why it amounts to a conflict. At a high level, the Tribunal classified CoIs as follows:
  - Direct conflicts of interest between the firm and its client, where the firm is incentivised by self-interest to act contrary to the interests of its client.
  - Indirect conflicts of interest and duty between the firm and its client, where some more or less remote incentive presents the risk that the firm might be encouraged to act contrary to the interests of its clients.

- Direct conflicts of interest between clients, where although the firm's own interests are not affected the firm is involved in acting for clients whose interests conflict.
- A combination of the above.

Firms might argue there is an alignment of interests between them and their client that means there is no CoI (e.g. where the firm is co-investing with the client). However, caution must be taken before relying on this argument – how realistic is it to say that, viewed in the round, interests are fully aligned?

- Another important matter is whether there is a risk that a client will be disadvantaged if the transaction proceeds and, if so, the extent of the damage that will result.
- The seriousness of the conflict must be taken into account, including how direct the conflict is and its duration. In contrast, the value of the transaction will have limited, if any, relevance to whether there is a CoI.

Managing the CoI

It is important for firms to remember that they cannot 'contract out' of their regulatory obligations. Firms will therefore need to satisfy themselves that each CoI is being managed appropriately – relevant matters will include:

- Whether the transaction can be justified on a defensible objective basis.
- The quality of the internal review and assessment: the higher the degree of independence or insulation of the decision-maker the better.
- If there is (independent) external review and assessment, this may help ensure the CoI is managed properly – however, external review will often not be practicable.
- Continuing review: where there is an ongoing conflict the matter should be kept under review, for example to adjust in light of changing circumstances.

One option open to a firm under the Codes to manage a CoI is disclosure. However, from experience there is a real risk that firms place too much reliance on disclosure that proves to be insufficient. The Tribunal gave the following helpful guidance on when disclosure can help with managing a CoI:

- Generalised disclosure and consent: this has limited value from a regulatory perspective - " *the fact that a client knows that a conflict may arise from time to time does not dilute the need to deal with it fairly according to the standards laid down in the rules*". Indeed, this approach to general disclosure is reflected in the standards to which the JFSC holds its own Commissioners. [3]
- Specific disclosure and consent: " *its value depends on the experience, competence and position of the persons to whom the disclosure is made and whether they have been given sufficient information to give an informed consent so that they are in a position to assess the fairness of the transaction concerned*". For disclosure to be effective, it must be made in a timely manner and provide the client with the information they reasonably require to give informed consent.

- After-the-event disclosure: this will be insufficient in itself (the risk has already arisen), but if the client retrospectively agrees to the transaction that may have some value – however, there remains a risk the regulator would say the firm nonetheless acted inappropriately in running the risk in the first place.

Record-keeping

Record-keeping is often viewed by firms as a second-order obligation, less important than compliance with more 'substantive' rules (e.g. on fair treatment of clients). This is a mistake. As the Tribunal noted in the context of CoI management, adequate record-keeping establishes an audit trail (which is necessary if the regulator decides to conduct an on-site examination) and can give "corporate memory".

Firms should also bear in mind the Tribunal's warning that the value of records "*will be much diminished if they are not easily accessible, coherent and comprehensible and made soon after the event*". This is because the later they are made the less likely they are to be accurate.

Each firm must therefore ensure that it has appropriate arrangements in place to both make and maintain[4] adequate records in relation to CoIs. These arrangements will, of course, vary between firms. However, all firms can help their staff maintain adequate records by (for example) designing their template forms to prompt staff to record the required information – albeit firms must ensure the fact-sensitive nature of CoIs is respected (e.g. by avoiding prescriptive 'drop down' lists).

The Tribunal set out its view on "*sensible*" issues to record in relation to identification and management of CoIs. Whilst given in the context of an investment management firm, those comments nonetheless underscore the high expectations on record-keeping:

- the basic facts about the transaction, setting out the parties to the transaction and its terms
- the commercial rationale for the transaction, including how it was valued, priced and why was it thought to be in the best interests of the client
- the decision-making process for the transaction, stating who participated in the decision-making process, who carried out the analysis and on the basis of what material
- any specific analysis of the conflict that was carried out by the decision-makers (or by those who supervised them) concerning the nature of the conflict and its management, how significant the risks associated with the conflict were thought to be and the key mitigating factors
- any relevant independent advice received
- if disclosure was made to the client or a representative of the client, what disclosure was made, to whom and when
- any subsequent review

At a minimum, it is clear record-keeping is not a 'tick box' or 'technical' matter.

Systems and controls

In order to ensure that they are identifying and managing CoIs appropriately, firms will need to ensure they put in place appropriate and robust systems and controls. A key aspect of these will be the overarching CoI Policy. As the Tribunal noted "*It is difficult to reconcile the overarching requirement to manage conflicts fairly … without having established a conflicts of interest policy that identifies the type of conflict that the firm is likely to come across in its business and the measures that it has in place to manage those conflicts of interest*".

Firms will also need to ensure have appropriate governance around the management of CoIs. Each CoI should be considered at a suitably senior level by those who have the appropriate degree of independence.

Firms will need to be clear as to when a CoI should be escalated to the Board (whether for its information or decision). A necessary (but not sufficient) part of this will be the CoI Register. Boards should use this register as a tool to help them understand and manage the CoIs in their business, which means they must be satisfied that the register contains sufficient and up-to-date information and that it is tabled and discussed as a matter of routine.

Conclusion

Ultimately the guiding principle for managing CoIs is clear: firms must ensure they are acting with integrity and in the interests of their clients. It is clear that regulated firms are (quite rightly) held to a high standard in relation to CoIs, and so the Board and senior management must ensure that this is an area to which they apply close and constant scrutiny.

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[1] https://www.jerseyfsc.org/news-and-events/dear-ceo-conflicts-of-interest/

[2] https://assets.publishing.service.gov.uk/media/5753de9c40f0b64325000030/Arch_Financial_Products_LLP-v-FCA.pdf

[3] See paragraph 5.4 of the Commissioners' Code of Conduct regarding CoIs at https://www.jerseyfsc.org/industry/guidance-and-policy/commissioners-code-of-conduct-for-conflicts-of-interest/

[4] Both to ensure that on an ongoing basis it is taking decisions by reference to current information, and also to ensure compliance with GDPR obligations to keep personal data up-to-date.

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Key Contacts

Niamh Lalor

Partner

Jersey

E: niamh.lalor@ogier.com

T: +44 1534 514210

Matthew Shaxson

Group Partner, Ogier Legal L.P.

Jersey

E: matthew.shaxson@ogier.com

T: +44 1534 514064

Nick Williams

Partner

Jersey

E: nick.williams@ogier.com

T: +44 1534 514318

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