Compliance Corner

Side-by-Side Management: Identifying and Mitigating Potential Conflicts of Interest

*By John V. O'Hanlon and Maureen Magner**

When an adviser manages multiple accounts ("side-by-side management"), with many differing structures (*e.g.*, registered investment company ("registered fund"), hedge fund, institutional account), conflicts of interest arise that could cause an adviser to favor one account over another account. These potential conflicts, as described below, are inherent to the advisory business generally where many advisers strive to diversify their business through management of multiple accounts and to provide the best management talent, which may be represented by the same person or team, to all accounts. Recognition of these conflicts harkens back to at least 1939 when the U.S. Securities and Exchange Commission ("SEC") identified the concerns associated with side-by-side management in its study that led to the passage of the Investment Advisers Act of 1940 ("Advisers Act").

Pursuant to the Advisers Act, advisers have a fiduciary obligation to place client interests above their own, to treat all clients equitably and to disclose material facts, including conflicts of interests. To that end, many advisers rely on their compliance and risk management programs to monitor and mitigate the potential conflicts of interest associated with side-by-side management. Constructing, reviewing and modifying these programs continues to be an important endeavor for advisers, especially in an environment where many advisers serve multiple business lines. To assist in this effort, this article seeks to (i) describe the primary conflicts of interest that arise in side-by-side management, (ii) identify the varying structures that advisers may employ to mitigate and monitor such conflicts, and (iii) highlight certain matters for consideration by sub-advisers.

Conflicts of Interest

The SEC, Congress, industry associations and industry participants have all noted the conflicts associated with side-by-side management, which may manifest in varying practices that could cause an adviser to favor one account over another account. Certain of these practices and related conflicts are described below.

Differing Fee Structures. Advisers may employ varying fee arrangements for different accounts. For example, a U.S. registered fund may pay a management fee based on a fixed percentage of assets under management (with or without breakpoints), while a private fund may compensate its adviser based on performance. A conflict arises in that an adviser has an incentive to allocate better performing assets to the performance based fee account rather than the fixed fee account because the adviser stands to earn a larger fee.

Investment by Portfolio Manager in Accounts. A portfolio manager of a U.S. registered fund may, but is not required to, invest in the fund. In contrast, private/hedge funds often require a portfolio manager or adviser to invest in the fund. In each case, the investment in the fund has the effect of aligning the portfolio manager's financial interest with those of other investors. However, to the extent that an investment in a private/hedge fund is more substantial than an investment in a U.S. registered fund, the possibility of greater returns on a portfolio manager's or adviser's assets invested in a private/hedge fund may provide an incentive to favor that fund over the U.S. registered fund or other account in which the portfolio manager or adviser has no interest.

Trading Practices. Certain trading practices also present conflicts of interest when managing multiple accounts.

Short Selling. Where a portfolio manager intends, even for legitimate investment reasons (*e.g.*, differing account investment mandates), to sell short a security for one account and buy long the same security for another account, large trades may impact the market with short sales depressing the value of a security and long purchases inflating the value of a security. The possibility of depressing or inflating a security's value before the purchase or sale of that same security

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by another account may provide an incentive to sequence those transactions in such a way as to favor one account over another account.

Notably, some advisers do not consider short sales against the box, synthetic shorts or derivatives or similar strategies that create the same economic effect to be an inconsistent trading practice that creates a conflict of interest when entered into for legitimate hedging purposes. Other firms do not consider short sales in one account as creating a conflict of interest if another account that tracks an index is underweight in that security.

Sequencing Trades. Where a portfolio manager plans to place the same trade for a security for different accounts in sequence, a large trade may affect the price of the security. The possibility of depressing or inflating a security's value before the purchase or sale of that same security by another account may provide an incentive to sequence those transactions in such a way as to favor one account over another account.

Cross Trading. Where a portfolio manager plans to sell a security held in an account to another account, the trade can be done in such a way that the purchase and sale are effected without pricing-in information that would otherwise be reflected in the security's price if it were bought or sold "at arm's length." The possibility of buying or selling a security in an affiliated transaction that may not price-in all market information may provide an incentive to effect cross trades that favor one account over another account. Note, however, that cross trades involving U.S. registered funds are governed by rules under the Investment Company Act of 1940, as amended, that would restrict, but not necessarily eliminate, the ability of a portfolio manager or adviser to unfairly disadvantage a registered fund with a cross trade.

Aggregation and Allocation of Transactions. A portfolio manager may aggregate or "bunch," trades and allocate securities among different accounts before or after the trade. Aggregation and allocation may be beneficial to all accounts in that a larger trade may take advantage of economies of scale. However, the possibility of using aggregation to meet a purchase minimum for one account by causing another account to also make a purchase or to increase the possibility of future participation in offerings by an underwriter or issuer may provide an incentive for a portfolio manager to cause one account to participate in aggregated trades when the portfolio manager would not otherwise make such a decision.

Brokerage Commission Allocation. Soft dollar commissions earned through brokerage transactions for one account may, consistent with Section 28(e) of the Securities Exchange Act of 1934, be used to obtain research for another account. The possibility of obtaining research for one account earned at the expense of another account may provide an incentive to favor one account over another in allocating soft dollar "credits." The SEC noted in its recently released proposed guidance that "an adviser may seek to use fund brokerage commissions to obtain research that benefits the adviser's other clients, including clients that do not generate brokerage commissions (such as fixed-income funds), those that are not otherwise paying more than the lowest available commission rate in exchange for soft dollar products or services (*i.e.*, "paying up" in commission costs), or those from which the adviser receives the greatest amount of compensation for its advisory services."

Additional Information. For additional discussion on the types of conflicts presented by side-side-management, see the Investment Company Institute's paper on the matter: Side-by-Side Management of Registered Investment Companies and Investment Accounts (March 2004). Please also see the statement of Michael S. Miller before the U.S. Senate Banking Committee regarding joint management of mutual funds and other accounts (March 2004), located at http://banking.senate.gov/public/_files/Miller.pdf.

Managing and Mitigating Side-by-Side Management Conflicts of Interest

As with compliance programs generally, there is no single approach that must be utilized to mitigate side-by-side management conflicts. Below are possible approaches, some of which may or may not be appropriate for an adviser depending on its structure and operations.

Firm-Wide Approach. Firms adopting this approach may restrict the ability of firm personnel to take investment positions that may be inconsistent with investment positions taken in any other accounts, regardless of the relationship, or lack thereof, of the particular employee(s) to the other accounts. This approach restricts, however, a portfolio manager's freedom of action.

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Team/Portfolio Manager Approach. **Firms adopting this restrict the ability of relevant employees to take inconsistent investment positions with respect to accounts over which they have management responsibility. This approach, among other things, typically prohibits a team/portfolio manager from assuming a long position on behalf of one account while simultaneously selling short the same security in another account managed by the team/manager.**

Silo Approach. **Firms utilizing this approach, may create "silos" whereby management personnel for one account type are walled off from the management personnel of another type of product. Some silos include research staff, analysts and traders. In other cases, the silo extends only to personnel actively providing investment advice. Some firms that implement the silo approach may also institute some combination of the following policies and procedures: (i) prohibiting persons from serving on multiple investment committees; (ii) prohibiting an individual from discretion or oversight over both hedge funds and mutual funds; (iii) limiting cross-access to non-public information about the silo accounts; and (iv) limiting access to trading desks or traders and assigning particular desks/traders to each silo.**

Other Approaches. **Some firms do not adopt a formal approach as described above with respect to managing potential side-by-side management conflicts. However, such firms may address these conflicts in other ways, including implementing one or more of the methods below.**

General Policies and Procedures. **Some firms address side-by-side management conflicts generally in their overall compliance program, including within any aggregation and allocation policies and procedures, cross trading policies and procedures, insider trading policies, code of ethics, proxy voting policies and valuation procedures. For example, the trading procedures may require advisory personnel to submit written reports to the compliance department justifying (and/or obtaining pre-approval for) potentially inconsistent transactions (*e.g.*, selling short/buying long), sequencing issues or other exceptions from standard policies. Or, the procedures might require side-by-side managers to affirm periodically that all trading was in compliance with each account's investment strategies and that all clients were treated fairly and equitably.**

Oversight Group. **Some firms establish a dedicated side-by-side oversight group to provide specific oversight and guidance as to the identification and mitigation of relevant potential conflicts.**

Review Committee. **Other firms conduct regular meetings among advisory personnel and others (*e.g.*, legal and compliance personnel or investment personnel) to review, discuss and address, if warranted: (i) the performance of accounts and any relevant differences, including those that resulted from potentially inconsistent investment decisions; (ii) trading and management activities to assess the effect that transactions conducted for one account(s) may have had on the market price of securities and the performance of other accounts; and/or (iii) hedge/private fund and mutual fund trading to identify potentially conflicted activities by a portfolio manager/team.**

Automated Systems. Some firms utilize trading parameters within their automated systems to flag or prohibit transactions that may raise side-by-side management concerns.

Sub-Adviser Matters for Consideration

In addition to the issues described above, a sub-adviser may face other practical issues when managing side-by-side conflicts. For example, the primary adviser may not have specific side-by-side management policies and procedures or the primary adviser's general compliance program may not explicitly consider such conflicts throughout its program. This could occur for example, if the primary adviser is manager to only a few clients of the same type with the same fee structure. A sub-adviser, nonetheless, must consider its own business and identify and manage any potential side-by-side conflicts arising out of its own client base, including the sub-advised account. In the case of conflicting policies/procedures, the sub-adviser and primary adviser should seek to identify the differences and reach a resolution on the matter. For example, a sub-adviser may not treat synthetic shorts as an inconsistent trading practice that creates a conflict of interest with long accounts. The primary adviser may differ and have specific policies and procedures that the sub-advised account should follow.

A sub-adviser (as well as a primary adviser) may also manage multiple accounts domiciled in differing jurisdictions and subject to varying regulatory regimes. To that end, advisers should ensure that any side-by-side oversight encompasses

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Legal & Regulatory Update

Commissioner Aguilar Favors Registration of Hedge Fund Advisers and Fiduciary Duty for Broker/Dealers

On January 10, SEC Commissioner Luis A. Aguilar, speaking before the North America Securities Administrators Association (NASAA) Winter Enforcement Conference, stated that the regulation of hedge funds and their advisers should be a top priority for the SEC. He cited an increasing amount of assets invested in hedge funds, about which little is known. "Congress should not hesitate," Aguilar stated, "to amend the Investment Advisers Act to clearly provide the Commission with authority over hedge fund advisers. Aguilar also expressed his support for applying the fiduciary duty to broker-dealers who provide investment advice. He stated ". . . as broker-dealers increasingly provide advice to their clients, the higher standards and fiduciary duties of advisers should also be applied to these broker-dealers." As far as enforcement recommendations, he supports: eliminating the SEC's penalty pre-authorization pilot program; rebuilding and empowering its enforcement staff; and concentrating SEC resources on cases with greater reach into the market. *See Speech by SEC Commissioner: Empowering the Markets Watchdog to Effect Real Results,* SEC Commissioner, Luis A. Aguilar (Jan. 10, 2009), available at http://www.sec.gov/news/speech/2009/spch011009laa.htm.

SEC Recommends Improving, not Suspending, Fair Value Accounting Standards

On December 30, 2008, the SEC delivered a report to Congress mandated by the Emergency Economic Stabilization Act of 2008 that recommends against the suspension of fair value accounting standards. Rather, the SEC recommends improving current standards by developing additional guidance for determining fair value of illiquid investments, enhancing disclosure and presentation requirements, and increased education. The SEC cited the benefits of fair value accounting, including transparency and facilitating better investment decision-making, and concludes that it did not play a major role in the bank failures of 2008. In preparation for the report, the SEC gathered and analyzed information from a broad cross section of financial institutions and received input from market participants, including the IAA and others through opportunity for public comment and three public roundtables. The IAA had recommended against suspension of fair value accounting; see the IAA letter to the SEC, Nov. 13, 2008, on the IAA website. *See "Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Value Accounting Standards,"* available at http://www.sec.gov/news/press/2008/2008-307.htm. The report is available at http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.

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such non-U.S. accounts. Moreover, care should be taken in applying any U.S. policy and procedure to the non-U.S. accounts (and *vice versa*) to ensure that the approach is acceptable under the applicable regulatory regime(s).

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As noted, there is no single "right" approach to addressing the oversight and mitigation of side-by-side management conflicts of interest. The above discussion is but a sample of the approach(es) that firms have considered to identify and manage the conflicts. Ultimately, the adviser must consider which approach, or modifications thereto, works best for its corporate structure and client base.

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