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MITIGATING CONFLICTS OF INTEREST – FUND MANAGERS

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INTRODUCTION

The Monetary Authority of Singapore ("**MAS**") revised its Guidelines on the Licensing and Conduct of Business for Fund Management Companies (the "**Guidelines**") to include examples of potential conflicts and best practices for fund managers. This regulatory update discusses those non-exhaustive and non-prescriptive examples where conflicts can arise and the best practices Fund Management Companies ("**FMCs**") can adopt.

AREAS OF CONFLICTS OF INTEREST

Are all fees clearly disclosed?

All fees should be disclosed to customers in relevant agreements (or the supporting documents, such as an 'Information Memorandum'). Conflicts arise when the customer has no prior knowledge of the charges because of insufficient documentation, such as those in the fund's offering documents or any other communications from the fund manager. This can become a conflict when the customer is unaware of the potential impact of these fees on their investment returns and the manager is trying to allocate costs. Fund establishment documents should contain provisions specifying the types of costs and expenses that a fund manager may be reimbursed for from the fund. The Guidelines allude to the potential risk of conflicts that may arise from the lack of disclosure on these points.

Are related party transactions conducted in the best interests of customers?

Fund managers often acquire services from related entities in which its CEO, directors, or representatives hold significant interests. The decision to attain these services can be influenced more by personal or business interests of the leadership rather than the best interests of the customers. Fund managers may prioritize internal relationships over the needs of its customers, compromising the objectivity and fairness of the services provided. Fund establishment documents must contain and make clear the internal procedures put in place in connection with the handling of such situations and to ensure that related-party transactions are always entered into at arm's length. The Guidelines have alluded to the inclusion of an approval process, so as to mitigate the potential conflicts that may arise from fund managers dealing with related parties.

Are co-investment practices fair and transparent for all stakeholders?

FMC and its related parties or corporations may participate in co-investments in portfolio companies. The related entities could be given preferential terms or benefits, which put the FMC's customers at a disadvantage.

Fund managers should formalize and disclose co-investment policies to customers, obtain approval with clear documentation, and ensure transparent communication to stakeholders, addressing any potential conflicts of interest. These disclosures must be clearly set out in the relevant fund establishment documents.

Are all investments allocation conflicts managed?

Fund managers may manage several funds or mandates with similar or overlapping investment strategies, which could lead to clashes when allocating investments between them. For example, potential conflicts may arise where FMCs use one fund to make a follow-on investment in, or to provide rescue financing for, a portfolio company, for the benefit of another fund. To mitigate against such scenarios, fund establishment documents ought to clearly state the extent of the investment mandate given to FMCs (e.g., types of investments allowed) and clearly set out approval mechanisms in connection with investments to mitigate risks of such conflicts.

Could investment decisions in portfolio companies harm customer interest?

Conflicts may arise when the portfolio company is either be wholly or partially owned or controlled by the FMC, its affiliates, or its employees, directors, or shareholders. Investments in the portfolio company may deviate from the fund's investment mandate or fail to prioritize the best interests of the FMC's customers. Where such situations are anticipated, FMCs should clearly state in the relevant fund establishment documents intent to make such investments. Where such conflicts are not anticipated from the outset, proper approval processes ought to be clearly set out in the relevant fund establishment documents to mitigate such conflicts should they arise.

Do fund term extension and interest exchange prioritise customer interest?

As a fund approaches the end of its term, the FMC may extend its duration or provide customers with the option to swap their interests for those in another fund managed by the FMC or its affiliates and may not prioritize the customers' best interests. As such, the discretion to extend the initial term of the fund life be formalised into the fund establishment documents.

Are committees effectively independent?

The committees responsible for reviewing and approving conflict situations may not be sufficiently independent, underqualified, or fail to represent customers. FMCs ought to clearly set out its policies on the formation of these committees in the relevant fund establishment documents.

MITIGATING CONFLICTS OF INTEREST

In order to mitigate conflicts of interest, FMCs should:

- customize conflict management strategies to suit their specific business models and create innovative approaches to effectively manage conflicts of interest beyond the provided examples;
- document and disclose all fees, including agent fees, marketing expenses, and third-party payments, with detailed breakdowns. Unexpected or additional fees must be approved by customers or relevant committees (e.g., a limited partner advisory committee), with documentation of the rationale;
- ensure the related-party transactions are negotiated at arm’s length aftermarket options are assessed, with proper approvals and clear documentation of the rationale;
- formalize and disclose co-investment policies to customers, obtain approval with clear documentation, and ensure transparent communication to stakeholders, addressing any potential conflicts of interest;
- establish a clear, well-documented investment allocation policy to ensure transparency, obtain proper approvals with documented reasoning, disclose potential conflicts of interest to customers, and outline mitigation measures. This should also ensure the investment pricing is fair and independently determined, either internally or by a third party;
- ensure that the investment decisions in the portfolio company must be consistent with the fund's mandate and place customer interests first, supported by clear and well-documented justification. Stakeholders should be informed if the portfolio company is controlled by the FMC or its affiliates, through appropriate disclosures. Conflicts of interest policies should ensure independent oversight and provide customers with examples of potential conflicts and their resolutions;
- ensure clearly outline provisions for fund term extensions in contractual agreements and disclose them upfront to customers for approval. When offering exchanges for interests in other funds, FMCs should ensure transparency, fairness, and independent valuation of the new fund, along with disclosures about business relationships; and
- ensure that the committees responsible for conflict management is independent from the FMC and include members who represent all customers' interests. The committee’s responsibilities should be clearly defined and documented and should be outlined in key documents such as a private placement memorandum.

CONCLUSION

The latest additions to the Guidelines suggest that a high level of disclosure in the fund establishment documents is warranted so as to ensure proper conflict management, which MAS considers to be good practice amongst FMCs.

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