The need to disclose conflicts of interest

When these are not disclosed or handled through a thorough and transparent process, they may result in sub-par outcomes

Why it comes to buying a piece of real estate, many in Singapore engage an agent to help them source for potential properties and negotiate the price. Having an agent definitely saves time, a precious commodity in the fast-paced city-state. Furthermore, a property agent is a licensed professional and is expected to have the necessary skills and knowledge to benefit clients fairly.

The problem arises when a few bad apples turn up in the industry, as was the case with real estate agent James Ng who was recently suspended for 12 months and fined S$30,000 for behaving unethically in a 2017 property transaction.

Ng had failed, among other things, to declare in writing to his client his conflict of interest in getting a co-broked commission from the seller. This was the commission paid by the seller to be split between the seller’s agent and Ng. In this instance, both agents would benefit from a higher selling price (which means a larger slice of commission for them): but paying a higher price would be detrimental to Ng’s client’s interest. Indeed, Ng acted against his client’s interest by hiking up the offer price without informing his client, while demanding that the seller’s agent give him a larger share of the seller’s commission.

In another unrelated incident involving conflict of interest, a researcher in Singapore was sentenced to jail in January 2019 for secretly setting up a business on the side to supply laboratory products to her employer at substantially inflated prices. Liang Juan did not declare to her employer that she was the sole shareholder of the contracted supplier or that she had any personal financial interests in the procurement process; nor did she abstain from the procurement process (which she was required to do).

When conflicts of interest are not disclosed or handled through a thorough and transparent process, they may result in sub-par outcomes. In the above examples, Ng’s misconduct led his client to lose over S$20,000 while Liang caused her employer to overpay more than S$15,000 for the lab products.

Disclosure of conflicts

Conflicts of interest often arise in the investment profession. Conflicts can occur between the interests of clients, employers, and members or candidate’s personal interests.

Common sources for conflict are compensation structures, especially incentive and bonus structures that provide immediate returns for members and candidates with little or no consideration of long-term value creation. The best practice is to avoid actual conflicts or even the mere appearance of conflicts of interest when possible.

Identifying and managing these conflicts is a critical part of working in the investment industry and can take many forms. When conflicts cannot be reasonably avoided, clear and complete disclosure of their existence is necessary.

Case study: Investment adviser affiliations

As a guide to today’s case, the desired ethical behaviour required is based on the CFA Institute Code of Ethics and Standards of Professional Conduct – https://www.cfainstitute.org/en/ethics/codes/std-of-practice-guidance/stds-of-practice-VI-A

Vincent is a 50 per cent owner and managing partner of Paragon Capital, an investment adviser firm, and VP Capital, a broker/dealer. Paragon’s only active advisory clients are three registered investment companies (mutual funds), which have their own boards, trustees, officers, and compliance staff separate from Paragon.

An investment committee at Paragon that includes Vincent and other Paragon staff recommends and approves all investments made by the mutual funds. Over time, the committee approves multiple investments and reinvestments in promissory notes issued by Aquarius Capital Management based on trade receivables. The mutual funds invest approximately 15 per cent of their net assets in the Aquarius securities.

Vincent and Aquarius both hold ownership stakes in Willow Grove Equity Solutions, a holding company established to invest in other investment adviser firms. Aquarius grants Willow Grove a S$10 million line of credit, which Willow Grove regularly accesses. Aquarius also pays VP Capital, the broker/dealer, fees for referring investors, other than Paragon clients, to invest in the securities issued by Aquarius. These referral fees amount to approximately S$1 million per year.

Paragon’s regulatory filings and marketing brochures describe Paragon’s and Vincent’s affiliations with VP Capital and Willow Grove. Paragon provides these documents to the mutual funds’ compliance staff each year when they conduct their annual due diligence visits to Paragon’s offices.

Vincent’s actions are:

A: acceptable because the referral fees paid by Aquarius to VP Capital exclude Paragon clients.
B: unacceptable because Vincent violates his duty of loyalty to Paragon by investing in other investment adviser firms through Willow Grove.
C: acceptable because Paragon provides disclosure to the mutual funds’ compliance personnel about the affiliations with VP Capital and Willow Grove when they conduct due diligence.

Analysis

This case relates to the disclosure of conflicts of interest, which requires investment management professionals to make full and fair disclosures of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their duties to clients.

In this case, Vincent’s financial interests are aligned with those of Aquarius through his common ownership stakes in Willow Grove. Vincent and Paragon advise their mutual fund clients to invest their money in Aquarius, while Aquarius is paying fees and providing credit to firms partly owned by Vincent.

In addition, Aquarius is paying referral fees to a brokerage firm partly owned by Vincent. These circumstances give Vincent a material financial interest in supporting Aquarius by having Paragon’s mutual fund clients invest in Aquarius. Vincent thus has a conflict of interest related to Paragon’s clients’ investments in Aquarius’ promissory notes.

Vincent and Paragon did not provide the advisory clients with sufficient information about the financial ties to Aquarius so the clients could understand those conflicts. Although Vincent and Paragon provide disclosures related to the affiliation with VP Capital and Willow Grove, the disclosures do not cover the nature, magnitude, or extent of the financial ties between Aquarius, Willow Grove, VP Capital, Paragon, and Vincent.

Failure to disclose the conflicts renders the due diligence of the mutual funds’ compliance staff ineffective. Excluding the mutual funds from the referral fee arrangement does not effectively address the conflicts of interest. The fact that Vincent has ownership interest in multiple investment adviser firms through Paragon and Willow Grove may give rise to loyalty concerns, but there are no facts presented supporting any potential unethical conduct relating to conflicts among the advisory firms.

Answer D is the best choice.

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The writers are CFA charterholders who volunteer with the Singapore society on advocacy issues with a view towards promoting financial literacy among retail investors and improving overall standards and integrity in the industry. Should you have comments and feedback, do write to the CFA Society Singapore Advocacy Committee: advocacy@cfasingapore.org.