# Money Management: Conflicts of Interest*

KELLY S. RODGERS[1]
*Chartered Financial Analyst and Investment Consultant, Toronto*

Frequently boards find themselves depending on outside professionals and volunteers to provide them with the information they require if they are to discharge their responsibilities to their not-for-profit organizations effectively. Boards should remember there are questions they need to ask of their money managers and their consultants, and most importantly, of themselves.

This article will concentrate on an area that receives far less attention than it should—conflicts of interest. It is a subject that many boards and most financial advisors in the field don't like to discuss for a variety of reasons.

The first reason many give is "because it isn't polite", as if by addressing the subject we are somehow insulting the person concerned. This can be a particularly sensitive issue with volunteer board members.

Another reason some people don't want to discuss conflicts of interest is because they have them and they don't want to draw attention to the fact. Much creative and often convoluted reasoning is used to minimize or justify even serious conflicts.

The third reason is put forward by people in the money management business who say they don't talk about conflicts because they don't have any of their own and don't want to be accused of bad-mouthing the competition.

Not talking about conflicts won't solve the problem and certainly won't give anyone an incentive to eliminate conflicts which can cause real harm to an organization. Often it's only when conflicts begin to cost money in terms of lost clients or accounts not won that advisors have an incentive to eliminate them. For their part, boards must face the fact that only by avoiding or dealing with conflicts can they ensure that they fulfil their fiduciary responsibilities and avoid negative repercussions for their organizations.

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Many not-for-profit organizations hire investment managers to look after their long-term investment portfolios, often with the assistance of consultants and ideally with written investment policy statements to guide the relationship. Nevertheless, even when such policies are pursued, there are three main areas in which conflicts of interest can occur to the detriment of the organization.

The first is when individual members of the board or finance committee are in a conflict position. The second is when the investment manager is in a conflict position and the third is when the consultant is in a conflict position. In each instance the board must fully assess both the potential for conflict and the full ramifications of that conflict.

The most obvious conflict for a volunteer board member arises when his or her firm is the investment manager for the organization's investment portfolio. Often the reasoning behind this appointment is that a volunteer or a volunteer's firm will be more aware of the organization's goals, more knowledgable about the inner workings of the organization, and therefore more committed to the organization's success than someone in a purely business arrangement. Historically, many people in the investment business served on boards for reasons of both prestige and profit: standard practice in the "old boys' network". Standards have changed over the last few years but not all not-for-profits have changed with them.

Seeking or allowing this sort of relationship can be detrimental to an organization in a number of ways. Perhaps the most obvious is the difficulty a board will have in critically evaluating the investment performance of the manager when the manager is a board member. It is extremely difficult to ensure full and open discussion of less than stellar investment performance when the manager may be providing other valuable volunteer service such as fund raising to the organization. Human nature being what it is, it is unreasonable to expect the investment manager to recommend that his or her firm be fired if the firm's performance is inadequate.

This type of conflict can cost an organization in ways that many boards have never considered. When a volunteer's firm manages the investment portfolio there may be a bias against soliciting or using other volunteers from the investment management business. If the current manager gained the business in part because of a volunteer position, he or she will have an incentive to prevent employees or partners of competitors from coming to the attention of the board during volunteer recruitment. It is surprising how many boards fail to consider this sort of hidden cost when they are assessing the possible consequence of a conflict of interest.

The Girl Guides of Canada National Council has dealt with this potential conflict in a very simple and effective manner. When I was invited to serve on the portfolio review subcommittee, I was informed that while I was a volunteer neither I nor any firm with which I was associated could be hired as the investment manager. It is simple and straightforward and leaves me with no reason not to recruit my competitors when they can be of value.

Some not-for-profits think they will avoid conflicts by asking their volunteers to donate their money management services. This can become a dangerous trap for the organization if the manager fails to perform to industry standards. The board may congratulate itself on saving one per cent in fees without considering that returns are two or three per cent below industry norms. Nor do they consider the old saying that "you get what you pay for' and the best service and advice will always go to the paying customers.

Brokers who serve on not-for-profit boards are often very committed to the aims and goals of the organization but they can also gain significant benefits. Volunteer service enhances the professional profile of broker board members and can lead to valuable new business. When selecting broker investment managers, whether for separately managed pooled funds, wrap accounts or mutual funds, boards should fully investigate what benefits, both direct and indirect, the broker might receive, including service or trailer fees, marketing support and other trading business.

The second area for potential conflicts of interest lies with money managers themselves. When hiring an investment manager it is important that an investment policy statement be developed that properly reflects the objectives of the organization and that an evaluation procedure be put in place. Once this has been done, the selection committee can search out investment managers who can meet the objectives. In evaluating prospective managers the selection committee and the board should be aware of the potential for conflicts. The responsibility for identifying conflicts is theirs—few candidates for the business will be likely to point them out.

The most basic of all conflicts arises in the area of commissions and fees. Commissions are paid every time a trade is executed for the investment portfolio. Commissions are the transaction costs and they vary from a third of one per cent at the low end of institutional rates up to two per cent at the high end for small retail accounts.

Management fees are just what the name implies: fees charged to compensate a professional for providing a management service.

Management fees are charged by investment professionals who have been hired by clients to make decisions on a day to day basis. Commissions are charged by sales professionals who execute the decisions the manager has made at the commission rate the manager deems appropriate.

These are clearly two different functions. Each has its place, and the system generally works pretty well. Most importantly, it usually works in the client's favour.

A conflict of interest arises when the same person or firm decides to wear two hats and fill both roles, i.e., acts as both investment professional and sales professional. In the investment professional role a decision is made as to when, how often and at what commission rates trades are done. The sales professional executes the trades. Quite simply, when these two functions are merged one person is now in the position of deciding how often and how much he or she will get paid.

Practitioners who do take on both roles seldom suggest that they have no conflict of interest but insist that they are able to "manage" the conflict by always acting "objectively". They will also assure you that their clients never complain. A wise board will want to consider whether this silence is based on satisfaction, fear of losing volunteer support and service or simple ignorance.

As part of their sales pitch, one firm that earns revenue from both commissions and fees always let prospective clients know that all trades are executed at rates discounted by 25 per cent. It certainly makes new clients feel good to know that their portfolio manager is really looking out for their best interests and getting them such a good deal. The only problem is that the discount is on retail commissions of two per cent. Clients paying fees for management of their portfolios should have their trades executed at institutional rates which are one half of one per cent rather than at 75 per cent of the retail two per cent rate. It probably is not a surprise that the portfolio managers at this particular firm have remuneration packages that are based on the total revenue generated—fees plus commissions.

It would seem obvious that compensation that includes commissions and fees could at least potentially bias a portfolio manager toward a trading strategy that's as active as possible, whether or not the result is maximum revenue for the client.

Another firm that operates in this manner states for the public record that none of its accounts has a turnover rate of more than 50 per cent. Typically the turnover rate for not-for-profit accounts is in the range of 20 to 40 per cent, so 50 per cent doesn't seem to be too far out of line. Unfortunately in the last two months I've seen two portfolios from this firm where the turnover ratio has been well in excess of the stated 50 per cent with no obvious explanation for this deviation. In one $4,000,000 portfolio the turnover rate was 75 per cent in

1993, with commission rates of one and a half to two per cent. In another $2,000,000 portfolio the turnover has been almost one hundred per cent in the first 10 months of 1994. Both of these portfolios have been shown to me by the clients' accountants and the clients are in different cities with different portfolio managers within the same firm.

Another area that can give rise to conflicts of interest is board memberships of publicly traded companies. This is an area that receives very little attention and when it does, managers usually present it as a positive. After all, they reason, they will now have additional insights which can be used on behalf of the board. On the surface this seems like a good thing but if we look closely we see that it can create some significant problems.

The most obvious, of course, is the potential use of insider information. No manager is going to use insider information to earn additional returns for clients. It is illegal and it is not worth jeopardizing the firm's registration and ability to do business for the sake of any person or organization. In fact it is more likely that a board member manager will err on the side of caution. This could prevent him or her from trading in certain securities at all, however advantageous such trades might be for the organization.

At the other extreme, the most common potential risk to clients when their managers sit on the boards of publicly traded companies is a natural tendency for such managers to be biased in favour of these companies. Human nature is such that once we become closely involved in an organization, either charitable or corporate, we tend to become "believers". We want to see the positives and believe that we can make a positive difference. Usually the insiders are the last to recognize that the problems might be insurmountable or at least require dramatic changes. Typically we will also be generous in our assessment of our own capabilities. In any case, insider status has real potential for adversely affecting judgment and analysis.

For these reasons it is extremely unusual for investment counsellors to accept board positions with publicly traded companies. In the few cases where I have observed such potential conflicts, all too often I have seen the volunteer organization left holding the bag—in the form of securities issued by the counsellor's companies even when, normally, such securities would not meet the quality standard set out in the investment policy statement.

One situation that has come to my attention recently concerns a brokerage firm that only manages accounts on a discretionary basis. On behalf of their clients, they own 18 per cent of the common stock of one company. This makes them insiders. This company is in trouble financially. Last summer this investment firm led a shareholders' group that ousted management. Now they have boxed themselves and their clients into a corner. With the company in financial trouble they can't be seen to be selling because it would have a very negative impact on the stock price, if they could find a buyer. So their clients are left holding the bag and have to hope that the situation turns around.

In this particular situation there is an added wrinkle. After ousting the management team and just before a warning by a major credit rating agency of a probable bankruptcy the investment manager purchased subordinated debentures of the company for at least one client. At the time of purchase these debentures were rated below investment grade and the client is in his early sixties. It is difficult to think of any way this investment could be construed as appropriate. The end result was that the client's accountant called the portfolio manager and insisted that the trade be set aside and that the investment firm assume any losses and costs, which they agreed to.

We will never know whether this is a case of poor analysis, overconfidence in an ability to get the firm turned around, use of client money to try to shore up the financials or simply use of client money to strengthen the investment firm's position in the shareholder-creditor negotiations. What we do know for certain is that the purchase was not in the best interests of the client and even the most inexperienced investment advisor would question the appropriateness of the whole transaction.

The third area where conflicts can occur is between consultants and investment managers. The consultant's role is to advise the client who the money manager should be. Being much closer to the investment industry than most board members, consultants can often provide valuable assistance and additional insights to not-for-profit boards when this decision is being made.

Potential conflicts arise when consultant's fees are paid in "soft" dollars or directed commissions and some are paid a finder's fee by the manager instead of by direct fees. The straightforward fee for service is quite simple and allows board members to determine easily if the organization is receiving value for its money.

The second method of payment, "soft dollars" or directed commissions, involves an arrangement whereby the client retains the consultant and agrees to a set fee. The investment manager who wins the account agrees to direct the commissions from the client's account to a particular brokerage firm with whom the consultant has an arrangement. The brokerage firm then agrees to pay the invoice from the consultant with a proportion of commissions. Typically such an arrangement might be that for every dollar of invoice amount the broker needs one dollar and twenty-five cents of commission business from the investment manager.

Another conflict occurs when the investment manager who wins the business agrees to pay a finder's fee to the consultant. These arrangements are usually fairly straightforward and work on a percentage of the assets or on a percentage of the fee the manager charges. In some cases it will extend to annual fees for as long as the client stays with the manager, like the trailer fees paid by mutual funds.

Fee arrangements of this kind are often presented to clients as being "free". Well, nothing is ever free. The potential for conflict arises because not all investment managers will pay directed commissions or finder's fees for accounts. Such arrangements often depend on the size of the account. You need to know how the consultant is being paid because this will affect his or her ability to make an objective choice of manager.

The other area that should be investigated when consultants are involved in the choice of the manager is what other business relationships they have with the managers they are recommending. Most consultants work in the industry in addition to conducting manager searches, typically in such areas as strategic planning or human resource consulting. You need to be aware of any other business relationships between prospective investment managers and your consultants and how each is being paid. Even though the manager searches are based on direct fees-for-service there may be other transactions between the two involving potentially dangerous directed commissions.

The issue of conflicts of interest will not go away. It has always been with us and it always will. In my experience it is a limited number of individuals and firms that engage in the types of practice I've outlined. The vast majority of individuals and companies in the investment industry work very hard to do a good job for their clients and to avoid even the appearance of conflict. Like other volunteers most donate their time and talents because of deep personal commitment to a particular cause.

With due diligence on the part of both the volunteer member of the investment industry and the boards they serve, negative repercussions need never occur.

**FOOTNOTES**

1. Kelly Rodgers is the author of *The Insider's Guide to Selecting the Best Money Manager*. Her firm provides investment consulting services to not-for-profit organizations and individuals. She is also a member of the finance committee and portfolio review sub-committee of the Girl Guides of Canada.