Conflict Management: Thy Name is Governance

In a market economy, conflict of interest is inherent and often unavoidable in any professional or organisational setting, as individuals and entities juggle multiple roles and responsibilities, often with competing interests. The challenge arises when someone in a position of trust or public responsibility allows his private interests to influence fiduciary decisions. The key is not the existence or avoidance of conflicts, but managing them effectively to ensure they do not compromise the integrity of such decisions. Conflict management is the core of governance, especially in fund management, where trust, transparency, and accountability are paramount. This piece suggests a framework for conflict management for pension fund managers.

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INTRODUCTION

Pension fund management involves the professional oversight and investment of funds that individuals and employers contribute to ensure long-term financial security in retirement. It requires a careful balance between risk and return, with investments strategically diversified across asset classes to achieve sustainable growth while safeguarding the principal. Effective management ensures that sufficient assets are available to meet future liabilities, thereby protecting the financial well-being of retirees.

Conflict management, as an integral part of fund management, ensures that fund managers make decisions solely in the best interest of beneficiaries, free from personal or external interests/biases. By addressing and mitigating potential conflicts, fund managers uphold the integrity of their fiduciary duties, foster trust in the pension system, and contribute to the long-term stability and sustainability of retirement income for participants.

Drawing primarily from the experiences of the securities market and insolvency processes, where conflicts of interest are particularly pronounced, this article explores: (a) the inherent nature of conflicts in fund management, (b) the evolution of conflict management frameworks in financial markets in India, (c) key conflicts encountered by fund managers, (d) common examples of conflicts for directors of fund management companies, and (e) strategies to mitigate some such conflicts effectively.

INHERENT CONFLICTS IN FUND MANAGEMENT

Consider an early and typical case of conflict in fund management in the Indian market.[1] Between 2007 and 2009, a portfolio manager of a Foreign Institutional Investor leaked sensitive information about upcoming orders to a relative. Acting on this tip-off, the relative traded ahead of the orders, swiftly squaring off his positions once the large orders moved the markets, thereby making substantial profits. The Securities and Exchange Board of India (SEBI) detected the synchronised trading and ruled that both engaged in front-running - trading ahead of a large order for personal gain. At the time, under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations 2003 (FUTP Regulations), only intermediaries were liable for front running. The Securities Appellate Tribunal (SAT) overturned SEBI's ruling in 2012, as neither party involved was an intermediary. In 2017, on appeal, the Supreme Court upheld SEBI's stance, ruling that their actions violated the code of business integrity and constituted fraudulent and unfair practices. This landmark case led to a 2019 amendment to the FUTP Regulations, broadening the definition of front running to encompass all persons, not just intermediaries. Since then, SEBI has been actively cracking down on front running, particularly by mutual fund dealers profiting at the expense of fund unitholders.

A fund manager often faces multiple conflicts of interest, which can undermine both the decision-making process and the interests of beneficiaries. These conflicts arise due to the presence of diverse parties and objectives. Below are a few key sources of conflicts and their implications:

- **Multiple Interests:** A fund manager typically pursues two interests: private interests encompassing salary, fee, and potential benefit that may accrue to its employees or relatives, and the fiduciary or public interest serving the interests of beneficiaries. The challenge arises when investment choices prioritise the manager's private gains over the beneficiaries' returns, leading to suboptimal outcomes. For example, a fund manager may engage in excessive trading to

1. *Shri Dipak Patel v. The Adjudicating Officer, SEBI (Appeal No. 216 of 2011, SAT decision dated 09.11.2012) and SEBI v. Shri Kanaiyalal Baldevbhai Patel (CA No. 2595 of 2013, Supreme Court judgment dated 20th September 2017).*

generate higher fees for himself, at the expense of the beneficiaries' returns due to increased transaction costs. While it may seem tempting to exclude individuals or entities with potential conflicts, doing so could unintentionally exclude many competent professionals from fiduciary roles, resulting in a loss of expertise. Instituting incentive structures that align fund managers' compensation with long-term portfolio performance can mitigate this risk.

- **Multiple Stakeholders:** Entities or individuals responsible for safeguarding the interests of diverse stakeholders often grapple with conflicting priorities. A fund manager, for instance, must balance the interests of multiple investors, investees, funds, markets, products, and even regulators. A decision to adopt a particular strategy may be perceived as favouring one set of stakeholders at the expense of another. While avoiding this complexity might seem appealing, it would come at the cost of sacrificing economies of scale and portfolio diversification, the very foundation of effective fund management. Regular stakeholder engagement, transparent disclosures, and independent oversight can help reconcile the interests of divergent stakeholders.

- **Multiple Objectives:** The most pervasive conflict for fund managers is the conflict between risk and return. If high returns could be achieved without risk, every other conflict would fade into insignificance. While investors seek high returns with zero/minimal risk, fund managers often have the temptation to chase riskier strategies to meet investor expectations. Extreme approaches such as investing solely in low-risk, low-return instruments or high-return, high-risk assets are impractical, as they fall outside market realities. This conflict is compounded by the mismatch between increasing investible funds and the limited availability of permissible, high-quality investment opportunities. As assets under management grow, fund managers face pressure to deploy funds effectively. This scarcity of viable options can lead to suboptimal or riskier investments, compromising portfolio quality and long-term performance. Establishing robust risk management frameworks and scenario-based stress testing can aid fund managers in maintaining balanced investment strategies.

> For a company to withstand the relentless pressures of competition and innovation, it must adopt strategies of resilience, adaptability, research and development, risk management, visionary leadership, and sustainable business practices.

In a world where competing interests are the norm, governance does not aim to eliminate conflicts of interest, but rather to identify, mitigate, and manage them effectively so that professional decisions remain unclouded and equitable, and competing interests and objectives are balanced transparently, prioritising professional considerations over personal gain.

EVOLUTION OF CONFLICT MANAGEMENT FRAMEWORK

In the early 1990s, a SEBI Chairperson faced ridicule for having "never *seen a share certificate*", casting doubts on his ability to regulate the securities markets. Reportedly, he retorted: '*Having shares is not a qualification prescribed for the position of Chairperson of SEBI, it could sometimes be a disqualification*'. Fast forward to today, the narrative has flipped, as another chairperson has drawn attention for having *"seen share certificates"*. What was once considered a qualification is now perceived as a potential liability, bringing conflicts of interest to the forefront of governance. In between, a different chairperson with modest holdings chose to divest them before assuming office, reinforcing the need for regulators to, like Caesar's wife, remain beyond reproach, free not only from actual conflicts but even the appearance of one.

- **Historical Context:** Initially, conflicts were most evident in the securities market, India's first sector to be liberalised. The conflict management mechanisms developed for securities markets were subsequently adapted, with modifications, across other sectors.

  Historically, the government played a dual role; running businesses through entities like BSNL and MTNL in telecom or GIC and LIC in insurance, while making rules to regulate these sectors. This dual role created a perception that the Government, being both a player and a regulator, would favour its own enterprises. Businesses were wary of a system where their competitor also set the rules, issued licences, conducted investigations, and imposed penalties.

  To address this inherent conflict of interest, independent regulators, such as the Central Electricity Regulatory Commission for electricity, the Petroleum and Natural Gas Regulatory Board for fossil fuels, and the SEBI for securities markets, were established to regulate businesses. The withdrawal of government nominees from the governing boards of self-regulatory organisations like stock exchanges further mitigated the conflict.

- **Conflict Management in SEBI:** In the securities markets, this shifted the conflict, along with the responsibility, to SEBI. Initially, the SEBI Act, 1992 prohibited directors of companies from serving on its Board, with the rules mandating members to avoid financial or other interests that could prejudice their functions. However, in 1995, the SEBI Act was amended to allow company directors on the Board, accompanied by mechanisms to manage potential conflicts while benefiting from their expertise. In 2008, SEBI voluntarily implemented the *Code on Conflict of Interest for Board Members*, establishing a framework for identifying, managing, and mitigating conflicts.

- **Conflict Management in Stock Exchanges:** Historically, stock exchanges regulated brokers and markets. However, brokers owned, governed, and traded on the exchanges, creating significant conflicts of interest that often led to misconduct, as brokers' private interests sometimes overshadowed public interests. To address this, stock exchanges were demutualised and corporatised in 2005, limiting brokers' influence. Subsequent regulations further tightened governance: brokers can no longer sit on the governing board and may hold up to 50 percent of shares, while the managing director is prohibited from holding any shares in a broking entity.

  Demutualisation, however, introduced new conflicts between the commercial aspirations and regulatory responsibilities of stock exchanges. SEBI addressed these by regulating securities transactions by directors, requiring the majority of the governing board to be public interest directors, and creating separate verticals for regulatory and commercial functions.

- **Conflict Management in Markets:** SEBI extended its conflict management framework to enhance governance across markets, asset management, product distribution, and corporate structures. The framework today prohibits insiders from using confidential information for personal gain and prevents intermediaries from front-running trades for their own benefit. It mandates key executives in asset management companies to invest a minimum amount in the schemes they manage or oversee, aligning their interests with those of investors, and restricts employees from trading in securities of investee companies. Investment Advisers and Research Analysts must avoid promoting financial products where they have a personal interest, with mandatory disclosure of conflicts. Related parties are barred from voting on related-party transactions, while independent directors are denied stock options to ensure impartial decision making.

  The conflict management framework has undergone significant evolution, progressing from outright denial to a reactive, piecemeal approach, and ultimately to a structured and comprehensive system. By adopting mechanisms such as segregation, prohibition, and management, the framework ensures that fiduciary and regulatory decisions remain unclouded by personal or organisational interests.

KEY CONFLICTS OF FUND MANAGERS

With pension funds increasingly expected to allocate greater investments toward equities and debt in the coming years, the governance of the investee companies becomes a critical concern. The concern stems from the increasing risks to the lives of companies. Humanity invented companies in the pursuit of creating entities that could outlast individuals, a quest for immortality. Historically, companies lived long lives - the longest-living company, Kongo Gumi, survived 1,429 years before succumbing to debt in 2006. In stark contrast, modern trends reveal a concerning decline in corporate longevity. The average lifespan of an S&P 500 company has declined sharply from 90 years in 1935 to just 18 years by 2016. Recent studies suggest that the average lifespan of a publicly traded company, considering mergers, acquisitions, and bankruptcies, is now approximately 10 years. This steep decline underscores an alarming reality: companies today are more vulnerable than ever.

This vulnerability presents significant challenges for fund managers, particularly those making long-term investments. Poor governance practices can amplify these risks, undermining investor value, eroding returns, and diminishing trust in the investment process. Therefore, fund managers must remain vigilant, prioritising investments in companies that demonstrate strong governance practices to safeguard their portfolios and their investors' interests. Below are three key conflicts that fund managers must navigate to address this challenge effectively:

- **Conflict among Stakeholders**: A company is a complex amalgamation of diverse stakeholders, each with unique objectives, rights, interests, and levels of engagement, often leading to inherent conflicts. Consider the conflict between the limited liability of the shareholders and the unlimited liability of the company. Shareholders, driven by the desire to maximise their returns while enjoying limited liability, can inadvertently or deliberately expose the company to significant risks, sometimes with catastrophic consequences. The Bhopal gas tragedy and the Satyam scandal serve as stark reminders of how misalignment of interests can lead to disastrous outcomes.

  Another common conflict arises between those in control of the company and those who are not. Individuals in positions of power may siphon off or transfer value to themselves through avoidance transactions like preferential, undervalued, fraudulent, and extortionate transactions, draining the company of its resources. The scale of such practices is staggering: companies admitted to insolvency proceedings in India are estimated to have lost about three trillion rupees through such transactions. If these values had not been alienated, many companies may have avoided the insolvency process altogether.

  A third type of conflict exists between short-term and long-term investors. In today's fast-paced financial markets, some shareholders hold shares for mere fractions of a second, prioritising short-term profits over the company's long-term health and sustainability. This short-termism is at odds with the goals of long-term investors, who depend on the sustained growth and governance of the company to preserve value. These conflicts prevent fund managers from being passive investors, whether in equity or debt. They cannot afford to sit back and watch as a company's value erodes or, worse, the company itself disappears. Instead, fund managers must actively engage to mitigate these conflicts to safeguard their investments.

To address these challenges, the State has instituted robust corporate governance norms designed to align stakeholder priorities with the overarching interests of the company. These norms include provisions such as appointing independent directors, defining roles for key managerial personnel, regulating related-party transactions, protecting minority interests, conducting financial and secretarial audits, and ensuring timely and accurate disclosures about material matters. Fund managers play a pivotal role in upholding these norms. By prioritising investments in companies that adhere to or exceed these governance standards, they not only protect investor value but also contribute to building a more resilient and sustainable corporate ecosystem.

- **Conflict between Present and Future:** If a company lives too much in the present, it may jeopardise its future. It may lose its life when its business becomes unviable for reasons such as innovation, change in policy, change in social taste, exhaustion of natural resources, or even black swan events like COVID-19. If it focuses too much on the future, it may compromise the present. It may lose its life when it fails to compete with its peers in the industry for reasons such as poor organisation, inefficient management, and malfeasance, among others. If it focuses too much outside the business, it may compromise both the present and the future. Striking the right balance between present needs and future aspirations is critical for a company's longevity.

  For a company to withstand the relentless pressures of competition and innovation, it must adopt strategies of resilience, adaptability, research and development, risk management, visionary leadership, and sustainable business practices. Additionally, companies must be prepared for "unknown unknowns" and unpredictable challenges that could threaten their survival. Fund managers, as providers of equity and debt, have a critical role in strengthening the resilience of the companies they invest in. They must help build the capacity of companies to withstand competitive pressures and embrace innovation, ensuring they do not prematurely fail. Ideally, a company should live out its full economic life, provided it has a viable business model. If a viable company faces stress, it must be rescued and supported. Conversely, a company that has reached the end of its economic life and is no longer viable should be allowed to exit promptly.

  Fund managers bear the responsibility of discerning between viable and unviable companies, investing in the former and withdrawing from the latter, regardless of short-term returns. They must act decisively to ensure that viable companies do not die prematurely and that unviable ones do not linger on, depleting the funds that could be better deployed elsewhere.

  This conflict between present and future extends beyond individual companies to broader ecological and societal sustainability. Companies that prioritise short-term gains without regard for long-term consequences risk compromising not only their own future but also the future of the environment and society at large. For fund managers, this underscores the importance of integrating sustainability considerations into investment decisions, ensuring that both companies and the ecosystems in which they operate can thrive for generations to come.

- **Conflict between Debtors and Creditors**: A real sector company typically funds its operations through equity and debt. Ideally, shareholders and creditors should safeguard their stakes associated with equity and debt, respectively. This was, however, not the case till recently. The shareholders retained control over the company even after exhausting the equity fully. Failure to repay debt did not have any consequence, incentivising excessive leverage. The Insolvency and Bankruptcy Code, 2016 (IBC) has rebalanced the rights of stakeholders. Considering that whatever is left after equity is exhausted belongs to creditors, it allows them to decide the fate of the debt-laden company and consequently their own fate.

  As creditors of the company undergoing insolvency proceedings, fund managers need to be aware of their entitlement and authority to guide them to exercise their rights appropriately and in time to protect their interests.

  a. ***Entitlement of Creditors:*** A company uses contracts to borrow to take advantage of leverage. It enters a series of incomplete bilateral contracts that allow every creditor foreclosure rights over the company's assets. The company meets its commitment towards each creditor in the normal course and life goes on. However, when the company is stressed, creditors may rush to recover their claims before others do, triggering a run on the company's assets. They recover on a first come, first served basis till the assets of the company are exhausted, bleeding the company to death. This is a negative-sum game.

     The IBC endeavours to resolve such stress while discharging obligations towards creditors to the extent realistically possible under the circumstances. For this purpose, it overwrites the pre-insolvency rights and entitlements of parties. It prioritises the claims of stakeholders in a hierarchical order (priority rule). Further, this priority rule overrides every other law. Overwriting rights and overriding other laws are essential features of insolvency frameworks worldwide. It, however, does not ignore pre-insolvency rights altogether. It does not, for example, put unsecured creditors above secured creditors or put secured and unsecured creditors at par.

  b. ***Authority of Creditors:*** The IBC places financial creditors in the driving seat. It confers extra-ordinary powers on them to rescue a company through a compressive resolution plan: (a) they may seek the best resolution plan from the global market, in a significant departure from previous mechanisms that confined resolutions from existing promoters; (b) they may take and/or cause a haircut of any amount to any or all stakeholders as may be required for rescuing the company; and (c) the resolution plan may entail any measure(s) - a change of management, technology, or product portfolio; acquisition or disposal of assets, businesses, or undertakings; restructuring of organisation, business model, ownership, or balance sheet; strategies of turn-around, buy-out, merger, amalgamation, acquisition, or takeover; etc. Yet some companies may be beyond repair and must be closed.

A fund manager is not just a claimant in an insolvency proceeding. As a financial creditor, it has the right to initiate an insolvency proceeding of a defaulting investee company and drive the resolution process. It can optimise its interests if it understands its rights and obligations in an insolvency proceeding of the investee company and has the commercial wisdom to adopt the right strategies along the way.

CONFLICTS FOR DIRECTORS OF FUND MANAGEMENT COMPANIES

Directors of fund management companies navigate a complex web of conflicts involving personal interests, governance practices, investment objectives, and broader market dynamics. By implementing robust policies, fostering transparency, and adhering to fiduciary principles, these conflicts can be managed effectively, ensuring sustainable and equitable outcomes for all stakeholders. Below are key examples illustrating conflicts scenarios and effective strategies for resolution:

- **Personal Investment Conflicts**

  Examples are:

  a. A Director holds shares in a company that the fund is considering investing in, or the director is considering investing in a company the fund has already invested in. This creates a potential conflict between personal financial gain and the interests of the fund. This warrants robust disclosure policies and recusal mechanisms for managing conflicts of interest and maintaining trust.

  b. A fund management company holds shares in a company where one of its Directors serves on the Board. When voting on corporate governance matters, there may be a conflict between maintaining a good relationship with that company and acting in the best interests of the fund's investors. Implementing independent proxy voting guidelines can help ensure impartiality.

- **Conflicts in relation to objectives:**

  Examples are:

  a. *Balancing Risk and Return for Long-Term Liabilities:* A pension fund manager faces pressure to achieve higher returns by increasing equity allocation, but the trustees and beneficiaries have a low risk tolerance due to the fund's obligation to provide guaranteed payouts. The conflict arises when the manager must balance the need for better returns against the fiduciary duty to maintain low-risk investments. Transparent communication with stakeholders and clear investment policies aligned with the fund's objectives are essential to resolving this conflict.

  b. *Pressure to Follow Industry Trends:* Industry peers are increasing their equity allocations during market upswings, but the pension fund's mandate emphasises stability. Directors may feel conflicted between following industry trends to avoid criticism and adhering to their fund's conservative investment policy. Maintaining discipline by prioritising the fund's risk-return mandate over short-term market sentiment helps uphold fiduciary responsibility.

  c. Conflicts Between Short-Term Performance Metrics and Long-Term Security: Directors might face pressure to deliver quarterly or annual returns that look competitive, potentially pushing for riskier investments. However, pension funds are designed to meet long-term obligations spanning decades. Emphasising long-term investment horizons and establishing performance benchmarks that reflect long-term goals can mitigate this conflict.

  d. *Conflicts in Asset Allocation:* A pension fund's internal or affiliated asset managers may have incentives tied to specific asset classes (e.g., bonds or fixed-income instruments), creating a bias against equity investments even when it might benefit the fund's long-term portfolio diversification. Regular third-party reviews and clear conflict-of-interest policies can ensure allocation decisions are impartial and aligned with beneficiaries' interests.

- **Conflicts with Group Companies**: Group companies providing financial services (e.g., advisory, brokerage, or management) may earn fees or remuneration in the form of arranger fees, distribution fees, referral fees, advisory fees, management fees, trustee fees, commission, brokerage, transaction charges, underwriting charges, and other fees, raising concerns about conflicts in service quality or costs. Transactions with group companies must adhere to arm's length principles, complying with requirements/restrictions under the regulations.

- **Conflicts of Interest with Employees**: An employee may make a financial gain, or avoid a financial loss at the expense of an investor, has an interest in the outcome of a transaction carried out on behalf of an investor, or has financial or other incentives to favour the interest of an investor or group of investors over the interest of other investors. Clear policies outlining acceptable practices, regular training, and enforcement mechanisms ensure employee conduct aligns with fiduciary responsibilities.

- **Conflicts between Investor Interests and Company Profitability**

  The Examples are:

  a. *Short-Term Returns vs. Long-Term Investor Interests:* A fund management company is faced with the decision of whether to sell a poorly performing asset that could harm short-term returns but benefit long-term investor interests. The conflict arises when directors must balance short-term performance metrics (which may affect bonuses or client retention) with the fiduciary duty to serve long-term investor objectives. Upholding fiduciary duty requires transparent decision-making that prioritises investor interests over short-term gains.

  b. *Allocation of Investment Opportunities:* In multi-fund companies, conflicts can arise when deciding how to allocate a lucrative investment opportunity among different funds. For instance, prioritising a higher-fee fund over a retail-focused fund might maximise profits for the company but disadvantage smaller investors. Clear, pre-determined allocation policies help mitigate conflicts and ensure fairness.

  c. *Performance Reporting and Transparency:* Pressure to report consistent returns may tempt some fund managers to manipulate the timing of asset valuations or defer recognition of losses. Directors overseeing reporting processes must navigate conflicts between presenting favourable results and maintaining transparency. Strong governance frameworks and independent audits are essential for transparency and ethical conduct.

- **ESG Investments vs. Fiduciary Duty:** Pension fund managers may be pressured to invest in ESG-compliant equities due to public or political expectations. However, if these investments conflict with the fund's risk profile or fiduciary duty to maximise returns, a conflict arises. Developing a transparent ESG policy that balances ethical considerations with fiduciary duty can help to resolve such conflicts.

CONFLICT MANAGEMENT

Not every conflict warrants action. Action is required only when it is substantial and substantiated. In *SC AOR Association & Ors. Vs. Union of India* (2016), the Supreme Court clarified that only a genuine risk of bias necessitates recusal, emphasising that judges should deliver justice impartially despite any prior connections with lawyers or litigants. The Court stressed that recusal should be based on a reasonable apprehension or real danger of bias to prevent manipulative litigants from evading specific judges. Similarly, in *Vishal Tiwari Vs. Union of India* (2023), the Court dismissed unsubstantiated allegations against three members of an Expert Committee, underscoring the need for credible evidence to substantiate conflicts.

It is important to acknowledge that a conflict is rarely a straightforward, black-and-white issue. It often demands a thorough contextual analysis, considering factors such as the timing and duration of the individual's interest, the potential gains or losses involved, and the nature of the interest. It is crucial to assess whether the interest is substantial enough to influence fiduciary decisions. Even with such careful examination, it is not always possible either to reach a definitive conclusion or to eliminate conflicts. Therefore, the goal should be to establish a dynamic institutional mechanism that combines principles and rules to mitigate conflicts while recognising that some level of conflict may be inevitable.

Fortunately, there are several standard measures to address conflicts. On an individual level, these include (a) disclosing the conflict to relevant parties, (b) recusing from decision-making processes, and (c) divesting any conflicting investments. On an institutional level, measures include (a) segregating key functions, (b) aligning fund managers' interests with that of investors, (c) prohibiting certain actions, (d) establishing independent third-party reviews, (d) empowering parties to raise concerns about conflicts, and (f) sensitising individuals to recognise and appropriately manage potential conflicts.

Conflict management must not be taken to a ridiculous level. An anecdote captures the plight of a fund manager:

"A fund manager trudges into a bar, shoulders slumped, eyes weary. The bartender, trying to lighten the mood, asks, "*Why the long face*?"

The fund manager groans, "*I'm trapped in a web of conflicts of interest.*"

The bartender raises an eyebrow. "*What happened?*"

The manager sighs, "*I want a cup of coffee. But I can't, I've invested heavily in coffee companies.*"

The bartender chuckles. "*Alright! Have a can of cola.*"

The manager shakes his head. "*Can't. I've invested in cola brands too.*"

The bartender grabs a bottle of water. "*Here, water's always safe.*"

The fund manager leans in, eyes wide with exasperation. "*Nope, I have got shares in bottled water companies.*"

The bartender throws up his hands. "*Then what are you going to do*?"

The manager mutters. "*I guess… I'll just stay thirsty.*"

CONCLUSION

To conclude, in a world where competing interests are the norm, governance is not eliminating conflicts of interest, it is rather identifying, mitigating, and managing them effectively so that professional decisions remain unclouded and equitable, and competing interests and objectives are balanced transparently. By implementing robust conflict management frameworks, leveraging technology for regulatory compliance, and fostering a culture of transparency, fund managers can ensure decisions remain equitable, transparent, and aligned with the best interests of investors.

Note:

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