Conflicts of Interest: Real Issues and Challenges

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The Indian financial sector has witnessed phenomenal growth over the last two decades with both the investor and issuer sentiments favoring a much deserved boost to the nation's economy. Investments by foreign institutional investors have grown from about Rs. 99,330 million in Fiscal 2000-01 to Rs. 16,83,670 million in the last Fiscal (*source: www.sebi.gov.in*) – an indicator of the financial performance of the domestic market. Given the avenues that our economy affords to investors, international and domestic alike, and the regulatory endeavor to ensure fair play in the market, 'conflicts of interest' has remained a concern yet to be addressed and resolved in its entirety.

'Conflicts of interest' is indeed hard to define. One may find its reference in many regulatory and legal literatures, though none of them seem to have aptly defined this concept. The traditional way of describing it - and as a legal dictionary would define it – conflict of interest relates to a real or *seeming incompatibility* between one's private interests and one's public or fiduciary duties[1] . From the perspective of corporate laws, one would typically associate this concept either with the management of a company, or the business partners of the corporate. However, the contours of the discussion would expand significantly if one were to analyze it from the viewpoint of specific sectors. For instance, conflict of interest issues in the banking sector would differ significantly from that in the infrastructure sector.

This article seeks to discuss the critical issues and challenges that conflicts of interest pose in the securities market in the country. Again, in order to streamline the discussion, we may restrict its scope to understanding the issue from two standpoints – one, from the standpoint of external advisors to a company issuing securities, and two, from the standpoint of the issuer company's management in the course of any fund-raising exercise.

External advisors to an issuer company

Any fund-raising exercise by a company, particularly from the securities market, would typically involve merchant banks, underwriting firms and analysts, besides legal and tax advisors. In case of a financial advisor, including a merchant bank, a classic conflict of interest exists between its 'promotional role' in raising capital for the issuer company in the securities market and its obligation to provide suitable investment avenues for retail clients. Given that the bulk of its fees comes from the capital-raising side, and the information asymmetry that exists on the two sides of spectrum, exploiting such conflicts could have significant negative consequences for retail investors.

The Securities and Exchange Board of India ("**SEBI**") has been aware of this concern since long which is reflected in the various SEBI regulations framed to govern the activities of market intermediaries. For instance, the recently introduced SEBI (Investment Advisers) Regulations, 2013[2] provides that an investment adviser "*shall ensure that in case of any conflict of interest of the investment advisory activities with other activities, such conflict of interest shall be disclosed to the client.*" Unfortunately, however, the regulations do not prescribe any objective criteria to determine the existence (or lack thereof) of a conflict of interest. In such cases, and even otherwise, one would assume that the determination of a real or potential conflict of interest rests on the subjective satisfaction of the regulator. Thus, quite understandably, the SEBI (Framework for Rejection of Draft Offer Documents) Order, 2012[3] categorically states that "*quantification of conflict of interest may not always be possible but it would largely depend upon [SEBI]'s assessment on whether such conflict of interest may affect the judgment and ability of the Merchant Banker in conducting due diligence activity of issuer*."

An underwriter would generally be confronted with the following three major conflicts of interest:

a) Advising issuer companies on whether to raise equity when, as an underwriter, it would earn substantial fees from such equity raising;
b) Advising issuer companies on the issue price of shares when, as an underwriter, it would benefit from higher discounts given that such discounted price will decrease the risk of low 'take-up'; and

c) Hedging its risk as an underwriter, guaranteeing the proceeds of the share issuance, when this may have an adverse impact on the share price. For instance, an underwriter unable to profitably place securities in a public offering would seek to limit its exposure to losses by allocating unwanted securities to accounts over which it has discretionary authority.

Again, while the SEBI (Underwriters) Regulations, 1993, requires an underwriter to '*avoid conflict of interest [and] make adequate disclosure of his interest*'[4] , much remains to be achieved given the lack of guidance on the definitive parameters of such interests. Quite similar to underwriters, even analysts may face serious conflicts of interest given the diverse products they study and report on, many of which portfolios being inherently incompatible with each other, particularly from the issuer company's perspective. Also, merchant bankers may often be interested in public offers by companies having availed of debt financing from their retail banking arms, given that the proceeds of the issue would be used to repay such debts. In fact, SEBI's Concept Paper on Regulation of Investment Advisors rightly acknowledges two major conflicts of interest in the financial product distribution space: (a) the dual role of intermediaries as agents of manufacturers of financial products (i.e. the issuer companies) as well as the investors in such products, and (b) the likelihood of biased distribution of products of the highest paying issuer companies as against other issuers.

Given the roles played by market intermediaries, one cannot also negate the conflicts of interest which legal and tax advisors may face in any securities offering. Attorneys hired to render legal services to issuer companies need to be cautious, particularly while also advising the underwriters. Drafting of agreements and negotiating legal and commercial agreements would be quite onerous particularly in cases where law firms happen to represent both sides of the negotiating table. While the Bar Council of India does require lawyers to disclose their real and potential conflicts of interest to clients at the outset, mere disclosures may not always address the adverse consequences which such conflicts would render.

Company's 'in-door' management

A listed company is mandatorily required to report *materially significant* related party transactions that may conflict with the interests of the company at large.[5] However, such reporting requirements may not always highlight conflicts which the promoters or directors of a company may have in any securities offering that the company may undertake. For instance, a nominee director of a private equity investor ("**PE Investor**") may be interested in the successful completion of a public offering of the company, such that the PE Investor may sell-out in case the securities trade at a price higher than the price at which it had invested in. Similarly, a promoter offering for sale his shares in a company by a public offer would definitely be interested in higher returns than the returns which a minority shareholder would receive had he invested in the company's primary offering.

While most corporate groups would endeavor to adhere to highest standards of corporate governance, one may appreciate the inherent difficulties in complying with these practices. As suggested by the Reserve Bank of India's ("**RBI**") 'Report of the Working Group on Conflicts of Interest in the Financial Sector', "*the closely held structures of Indian corporates – both in the public and private sectors, inhibits implementing robust corporate governance practices.*" Further, weak accountability chains and cross holdings in other entities are among the key factors which significantly contribute in the failure to meet disclosure requirements in this regard.

The regulatory concern on the potential adverse impact such conflicts of interest may cause in the securities and financial market has been well documented. The RBI's Master Circular on 'Prudential Norms for Classification, Valuation and Operation of Investment Portfolio of Banks' ensures that stockbrokers as directors of banks avoid '*any possible conflict of interest*' and restrain from involving themselves with the Investment Committee of banks or in the decision making process for investments in securities. Similarly, non-banking financial companies are restricted from giving loans or advances to their directors and any of their related concerns. Moreover, stock exchanges as distinct legal entities are required to maintain internal manuals and conduct internal training sessions on avoidance of conflicts of interest within the management.

The liability of independent directors as regards conflicts of interest has been an area of significant academic discussions in the past. The limited role, if at all, played by such directors in the day-to-day affairs of companies, has been a strong reason to contend that they should not be subjected to the same liability regime as that of executive directors. It is perhaps the endeavor to have a transparent securities market which has influenced the regulators and the judiciary to implicitly reject this contention.

Conflicts of interest need not always pertain to individual interests of directors and promoters of corporates. Media groups appointed to cover a company's proposed securities offering and other developments in the company's business may often be given equity by such company. Also, a nominee of such media group may be appointed on the board of the company. A serious conflict of interest may arise in such cases, given that the independence of press, besides investor sentiments, may get severely impacted. Given these concerns, media companies have now been directed to disclose all possible conflicts of interest they may have in various companies, including the equity stake and 'private treaties' that they may have entered into.

The Way Forward

Clearly, 'conflict of interests' is not an issue unanswered by our regulatory and legal regime. Our regulators, SEBI and RBI alike, have issued various circulars and directions endeavoring avoidance of conflicts of interest and fair disclosure of such conflicts in case they exist. However, what is perhaps lacking is a clear guideline on the ambit of concern and the liability for its breach.

A disclosure regime, as is currently the case in the Indian securities market, will no doubt ensure information symmetry across all segments of markets. Investors - financial institutions and retail investors alike - can make judicious decisions of investing in securities based on information of possible conflicts of interest which external advisors or companies may have had in any securities offering. However, the greatest challenge that regulators have before them is the lack of adequate measures that may be taken to compel adherence with such disclosures.

Many large corporate houses, law firms, financial advisors and accountants have internal policies to regulate and avoid situations of conflicts of interests. Internal *Chinese-Walls* are established such that different teams advising or involved in different aspects of the same transaction maintain complete anonymity. Further, a disclosure of such Chinese-Walls and the existence of internal conflicts, if any, are typically made known to clients (and regulators, where necessary).

Given these effective steps which are usually taken by self-motivated organizations, a formalized and regulated guideline by our policy-makers is the call of the hour. A structured and well defined law needs to be framed which mandates the following, at least for corporate houses and investment advisors:

a) ***Greater transparency:*** Particularly in case of investment advisors to a given securities offering, true and complete disclosures of *potential* conflicts of interest should be publicly disclosed, whether in the form of a conspicuous statement in offer documents or public announcements through the online media, such that investors may make conscious decisions while investing in securities. Advisors facing *real* conflict of interests should refrain from rendering financial advice to issuers.

b) ***Recuse from decision making process:*** Promoters and directors of corporate houses who become aware of circumstances that pose an *actual* or *potential* conflict of interest should recuse themselves from the decision-making process and take no part in the discussion or the vote.

c) ***'Conflict of Interest Policies' to be made publicly available*:** Internal policies on avoidance of conflicts of interest should be made publicly available, preferably by hosting on the websites of corporates (particularly, listed companies) and investment advisors. This will ensure that such policies are duly framed and not merely endeavored to be made.

d) ***Whistleblower protection:*** The law should protect whistleblowers who expose undisclosed conflicts of interest in any given securities transaction.

While one may have several other recommendations, the key to ensuring avoidance and regulation of conflicts of interest lies in a disciplined and effective liability regime. The law should clearly prescribe the consequences of failure to address conflicts of interest, though such consequences may be of varied degrees depending on facts of each case. Of course, our policy-makers should be equally cognizant of the need for economic stability in the country. Given the unpredictable and precarious pivot on which our securities market currently rests, a strict liability regime may have grave consequences in its overall financial growth. While serving the interests of investors, one should also be equally considerate to corporate issuers and bankers, as any policy prejudicial to their interests would result in a stunted development of our securities market, and in-turn, our financial prospects.

Disclaimer

The views expressed in the article above, are purely those of the author of the article and not of the Firm.

[1] Black's Law Dictionary, 7th ed., at 295
[2] Notified on January 21, 2013
[3] General Order No. 1 of 2012 issued on October 9, 2012
[4] 'Code of Conduct' specified in Schedule III to the SEBI (Underwriters) Regulations, 1993
[5] Clause 49, Equity Listing Agreement