

INSIGHTS FROM CFA SOCIETY SINGAPORE

By CFA Society Singapore Advocacy Team

# Are you getting the best deal from your investment manager?

There is potential conflict in interest if he makes a recommendation for which he may receive some benefit, monetary or otherwise



The CFA Institute, under its Referral Fees Standard, requires that investment professionals inform their employer, clients, and prospective clients of any benefit received for referrals of customers and clients.

**Y**OU just signed on the dotted line to purchase a dream home. And your spouse relates to the property sales agent that the plan is to have a Bali-themed concept renovation. The property agent whips out a business card to recommend a renovator.

Most clients will have questions at the back of their mind: Is the recommended renovator a dependable and trustworthy company? Did the agent recommend the renovator as there is a side arrangement between him or her and the renovator? These questions arise as there is potential conflict in interest which is not uncommon in many sectors, including the financial services sector.

In the above hypothetical scenario, the buyers' interest is securing the best renovator, which could be down to several criteria such as track record, price of quotation, execution and warranty. This can differ from the property agent's interest should there be a referral fee involved. The agent may be out to secure an additional income stream and therefore securing referral fees is definitely on the table. As the interests of the buyer and the agent differ, the outcome may not be optimal for the buyer.

## The need to disclose referral fees

The CFA Institute, under its Referral Fees Standard, requires that investment professionals inform their employer, clients, and prospective clients of any benefit received for referrals of customers and clients. Such disclosures allow clients or employers to evaluate (1) any partiality shown in any recommendation of services and (2) the full cost of the services.

Appropriate disclosure means that the client must be advised, before entering into any formal

agreement for services, of any benefit given or received for the recommendation of any services provided. In addition, the nature of the consideration or benefit must be disclosed – for example, flat fee or percentage basis, one-time or continuing benefit, based on performance, benefit in the form of provision of research or other noncash benefit – together with the estimated dollar value. Consideration includes all fees, whether paid in cash, in soft dollars, or in kind.

Some firms may completely restrict such fees. If the firm does not prohibit such fees, there should be clear procedures for requesting approval and declaring compensation received, and clients should be notified of approved referral fee programmes.

## Case study: Disclosure of referral arrangements and informing the firm

Katherine Lai is a portfolio manager at Katama Investments, an advisory firm specialising in managing assets for high-net-worth individuals. Katama's trading desk uses a variety of brokerage houses to execute trades on behalf of its clients.

Lai asks the trading desk to direct a large portion of its commissions to Naushon Pte Ltd, a small broker/dealer run by one of Lai's business school classmates in Singapore Management University. Katama's traders have found that Naushon is not very competitive on pricing, and although Naushon generates some research for its trading clients, Katama's other analysts have found most of Naushon's research to be not especially useful.

Nevertheless, the traders do as Lai asks, and in return for receiving a large portion of Katama's business, Naushon recommends the investment ser-

vices of Lai and Katama to its wealthiest clients. This arrangement is not disclosed to either Katama or the clients referred by Naushon.

Who is in violation of the Code and Standards?

- A. Katherine Lai
- B. The referrers at Naushon
- C. Katherine Lai and the referrers at Naushon
- D. None of the above

## Analysis

The high-net-worth individuals at Katama Investments would want the best brokerage house when trades are executed on their behalf. Low fees, useful and relevant reports are several considerations to go with a particular broker.

Katherine Lai on the other hand will benefit from a bigger client base. She is likely remunerated in some way or the other with number of clients, asset under management and performance of the portfolio.

Therein lies the potential conflict of interest. Katherine Lai in selecting Naushon as the brokerage house passes business to Naushon who may or may not be the best brokerage house for the high-net-worth clients.

In the case study, Naushon is unlikely to be the best brokerage as the pricing is not competitive and the research output from Naushon falling short. Clients of Katama could be better off with another brokerage house.

But because Katherine Lai benefits from Naushon with regard to wealthy clients being recommended to her, she benefits from this undisclosed relationship.

The referrers in Naushon, on the other hand, are also happy to continue with this undisclosed relationship. Naushon continues to benefit as Katama's trades are routed through Naushon. And in return, the referrers in Naushon recommend Katama who again may not be the best advisory firm to Naushon's unsuspecting clients.

Therefore, Katherine Lai has violated the Referral Fees Standard by failing to inform her employer of the referral arrangement although the benefit was not in fees but came in another form. The same can be said for the referrers at Naushon. Both parties should have disclosed this arrangement to their respective firms for approval of this mutually beneficial referral practice. Should the practice be allowed, disclosure should also be made to Katama's and Naushon's clients. Hence, the suggested answer is Choice C.

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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](mailto:advocacy@cfasingapore.org)