

CONFLICT OF INTEREST – RESOLUTION THEREOF

Dr. V.R. Narasimhan*

A “conflict of interest” exists where there is a divergence between the individual interests of a person and interests that he/she is expected to take care of in his/her “official capacity”, such that an independent observer might reasonably question whether the actions or decisions of that person in his/her official capacity are influenced by his/her personal (own) interests. The expression “official capacity” would mean a fiduciary capacity whether discharged as a part of employment or in a social or political organization.

Conflict of interest shall be contrasted with complimentary interest. If individual interest (achievement of sales target, incentives/commissions for performance) is in divergence with the organizational interest (reputation, customer retention, etc), it results in conflict of interest. If individual interest converges with organizational interest, it results in complimentary interest.

The term conflict of interest is widely used in commercial and legal transactions and is acknowledged in the codes of ethics of various professional bodies, to identify behavior that is unacceptable. Despite international usage of the term, there is no universally accepted definition of conflicts of interest. To further accentuate the problem, the globalization of the world’s financial markets has led to different definitions and regulations of what constitutes a conflict in different jurisdictions. Conflicts of interest are normally attributed to imperfections in the financial markets and asymmetric information.¹

Conflict and complimentary interest were well demonstrated in the epic Mahabharata. Bheeshma and Dhritarashtra succumbed to the conflict of interest; former kept love for his oath above the responsibility of good governance by state and the later kept love and affection to his children above the responsibilities of good governance – both allowed perpetration of atrocity to woman and finally had to see the down fall of their kingdom. Interest of Krishna and Yudhishtira in vanquishing the wrong doers was complimentary to one another.

*Kotak Mahindra Bank Limited, Vinay Bhavya Complex, Kalina, Santacruz (East), Mumbai

¹ Guidelines for the Regulation of Conflict of Interest facing market intermediaries, 2010, IOSCO Emerging Market Committee Report.

*Views expressed in this article are views of the author and do not represent views of employer.

There are several examples in and around us which can be recalled to understand the adverse effect of conflict of interest on the self and the beneficiaries of the official position occupied by that self.

Conflict of interest surfaces in every public office where the person occupying the position is vested with the authority to sanction. Whether or not state of conflict of interest exists will be known only to those who are intimately involved in that state of affairs. It is the responsibility of those persons to handle the conflict of interest in the interest of the subjects of the office and therefore depends on the strength of character of the person in question.

Focus on “conflict of interest” is raging due to steep fall in individual character and preeminence of status symbols that can be procured with money over honesty. An individual occupying any position in a business, political or social organization has an access to resources that are expected to be put to use for the benefit of the relevant community impartially but can also be put to use in pursuance of individual interest. Not that every person in such an official capacity exploits the conflict of interest but the very potential to such a possibility needs a careful handling. In the context of deteriorating ethical value system, it is the perception of a conflict of interest that may be important, whether or not such conflict actually exists. Therefore, conflict of interest needs to be discovered and defused even before the impropriety arising out of such conflict is executed.

CONFLICT OF INTERESTS BUILT INTO STRUCTURES

Most of business structures have in-built conflict of interest. The policy maker’s struggle in choosing between economic development and environmental protection while granting license for an airport or mining license is a typical example of conflict of interest which is built in the government structure.

Businesses can be done more efficiently and resources can be used more optimally when the benefits of synergy are fully utilized. In the quest of synergies, it is possible that structures are built to bring in conflicts also. A bank may also run a stock broking firm and sell leveraged facilities to customers to trade on the stock exchange. While it is a convenience for the customer, it will have inherent conflict of interest. Most of the financial intermediary organizations have in-built conflict of interest since their commercial interest is in pushing the customer to do more number and more value of transactions; but every transaction (in financial market is ridden with risk) may not necessarily be in the interest of the customer. There remains a question behind every recommendation to the customer, whether it is for the

benefit of the organisation or in the benefit of the customer (which incidentally benefit the organisation too in the form higher volumes).

Self-dealing, for example, in which an official/director who controls an organization causes it to enter into a transaction with another person or another organization that benefits the official/director. The official is on both sides of the "deal." However, the transaction may not be detrimental to the organisation.

Incentive schemes to drive sales by and large have built in conflict of interests. Sales persons strive to sell whether or not the customer needs / capable of handling the item being sold. Examples are not difficult to imagine – in financial services, in insurance, in harmful consumption goods, etc. Trade commission related to volume sold drive traders to showcase and sell goods that offer better commissions than those actually needed by the customer.

Similar conflict of interest can be traced in the dealings of lawyers, doctors, and so on. There are several such examples which readers can imagine for themselves.

PRINCIPAL – AGENT RELATIONSHIP: A MAJOR SOURCE OF CONFLICT OF INTEREST

All professionals (doctors, lawyers, engineers etc..) play a dual role i.e., that of being the principal and an agent to their customers, while discharging their functions. This inherent dual capacity naturally gives rise to conflicts of interest in cases where the professional acting as an agent, prescribes actions which he knows are to his own benefit as principal, rather than to the customers. The professional has additional information or is in a position to generate additional information which the customer cannot access or generate. Imperfect information presents some individuals with the opportunity to act in ways that allow them to benefit at the expense of others, whom they are supposed to serve. Information asymmetry leads to the problems of adverse selection. Adverse selection is a situation where due to lack of proper information, some of the good proposals may get rejected, while the relatively not so good ones get accepted.

Jeremy Cooper, FAICD, Australian Securities and Investment Commission on presented a paper on “Managing conflict of interest in the Australian financial services industry⁴”. He dealt with the issues relating to conflict of interest extensively. He has quoted the results of certain survey on the quality of advice given to the clients by the advisors who were in the situation of conflict of interest to establish that conflict of interest is a real phenomenon about which regulators must be concerned.

The September 2008 Wall street melt down can be attributed, amongst other reasons, to this predominance of conflict of interest arising out of this Principal, agent dual role played by investment bankers who were principals being originators (issuers) of exotic derivative financial instruments and agents for hawking them to the customers through distribution channels and wealth management services.

For the financial industry, conflicts of interest may be defined as arising when a financial service provider, or an agent within such a service provider, has multiple interests which create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets. But behavior that exploits a conflict of interest will, once recognized, reduce the reputation of an institution. Consequently, the existence of a conflict does not imply it will be exploited if the institution places a high value on its reputation. The implication is that public policy remedies may not be required to control the exploitation of conflicts. When they are necessary, government intervention to reduce conflicts needs to be balanced against any reduction in the economies of scale.

RESOLUTION OF CONFLICTS OF INTEREST

Thankfully, conflict of interest is manageable. As is stated in the preceding paragraph, value placed on institutional reputation/personal reputation in itself acts as a buffer that prevents exploitation of conflict of interest.

Market discipline hits firms hard with pecuniary penalties and promotes the development of institutional structures that limit conflicts and signal the firm's intent to the public. Customers may choose the path avoiding an intermediary if they perceive that the intermediary/its employees succumb to conflict of interest and exploit the customer. The other path available to customers is to litigate. While litigation may be the appropriate response to discipline specific firms and individuals as part of an overall market solution, legal liabilities and penalties need to be appropriately designed to encourage genuine fight against conflict of interests. However litigation presupposes formal knowledge of exploitative conflict of interest. Further, litigation requires supportive legislative structures in the process of establishing conflict of interest and for bringing wrong doers to the book. The Right to Information Act precisely serves the purpose of formally establishing whether or not there was a conflict of interest in decisions taken by government and government bodies.

The market may not be effective if it is unable to obtain sufficient information to punish firms that are exploiting conflicts of interest. To address this failure, there are four classes of

interventions: (1) mandatory disclosure for increased transparency, (2) supervisory oversight, (3) separation by function, and (4) socialization of information.

Mandatory disclosure to increase transparency is the least intrusive remedy. Disclosure that reveals whether a conflict of interest exists may help investors/customers to judge how much weight to place on the information delivered by each firm. Yet, mandatory disclosure may be insufficient if the mandated disclosures are not well designed or the industry does not respect the mandate in letter and spirit. The fine prints and disclaimers generally used in all such disclosures is an illustration of inadequacy of “mandatory disclosures” as an instrument to handle conflict of interest. This problem suggests that a more intrusive approach i.e., supervisory oversight (State/regulatory oversight) may be required. Supervisors can observe proprietary information about conflicts of interest and can take actions to prevent financial firms from exploiting conflicts of interest.

If the market cannot get sufficient information from disclosure or supervisory oversight, one may contemplate a more extreme solution of enforcing the separation of institutions by function. Separation by function has the goal of ensuring that “agents” are not placed in the position of responding to multiple “principals” so that conflicts of interest are reduced. Moving from less stringent separation of functions (different in-house departments with firewalls between them) to more stringent separation, (different activities in separately capitalized affiliates or prohibition of the combination of activities in any organizational form), lessens conflicts of interest. However, stringent separation of functions may seriously reduce synergies of information collection, thereby preventing firms from taking advantage of economies of scale in information production.

The most radical response to conflicts of interest is to socialize the provision or the funding source of information. The argument for this approach is that information is a public good and so may need to be publicly supplied. Of course, the problem with this approach is that a government agency or publicly funded entity may not have the same strong incentives as private financial institutions to produce high quality information, thus reducing the flow of essential information to financial markets. SEBI, during the first few years of its inception when the issuer delinquency in resolving the investor complaint was very high, experimented the socialization of information concept by collecting and publishing the issuer wise investor grievance received and resolved. Several issuers worked hard to see that the name of their company does not rank in this list.

ADDRESSING CONFLICT OF INTEREST – INDIAN APPROACH

Indian regulatory system has adopted the first three methods of conflict of interest resolution viz., mandatory disclosure of information for transparency, regulatory oversight to check conflicts and separation of functions. Reserve Bank of India, Securities and Exchange Board of India, IRDA and several other consumer protection organizations require the respective regulated organizations to make disclosures on the occurrence of an event, at periodic intervals like end of quarter/half year/year, etc. All the regulators inspect the regulated entities and are equipped to issue “cease and desist orders” to prevent the organisation from perpetrating practices that are ridden with conflict of interest. Most of these regulations have clauses that require “Chinese walls” to be erected between functions to prevent conflict of interests that arise out of the structure of the organisation. The method of socialization of information production as a serious tool is yet to gain recognition though a good beginning is made in terms of disclosures under listing agreements, disclosures under various SEBI regulations, etc. Attempts to set up Self regulatory organizations, databases in public domain, etc are ideas at a distance. Until then, improved corporate governance standards should help handle conflicts of interests.
