

NSCP National Membership Meeting 2008

Morgan Lewis

Conflicts of Interest

(Large Firms)



Joseph McGill
UBS Global Asset Management
(Americas), Inc.

Ivan P. Harris
Morgan, Lewis & Bockius LLP

www.morganlewis.com

Overview

- Defining “Conflict of Interest” and the Regulatory Regime
- Identifying Conflicts of Interest
- Disclosure and Monitoring Conflicts
- Current Regulatory and Enforcement Issues

What is a Conflict?

- Any activity or relationship in which an adviser's interests compete with the interests of its clients
 - Concern is that the conflict of interest provides an incentive for the investment adviser to provide advice that is not disinterested, or to take actions that benefit the adviser at the expense of the client
 - Conflicts are sometime described as the problem of “wearing two hats”
 - Self interest is always one of the elements in a conflict, and self interest may clash with fiduciary or legal obligations
 - Conflicts may involve divided loyalty as well as self-dealing

The SEC's View

“Section 206 of the Advisers Act establishes a fiduciary duty for [investment advisers] to act for the benefit of their clients, requiring advisers to exercise the **utmost good faith** in dealing with clients, to **disclose all material facts**, and to employ reasonable care to avoid misleading clients . . . **Potential conflicts of interest are always material.**” In the Matter of Warrant Lammert, et al., AP File No. 3-12386 (April 28, 2008)

Conflicts Among Clients – Divided Loyalty

- Agency cross and cross trades (§ 206, Rule 206(3)-2 and ERISA limits)
- Allocation of investment and trading opportunities
 - **Investment allocation**
 - Late trade allocation – allocating among clients after execution
 - “Armed with the knowledge of where the security traded between the time of execution and time of allocation, this practice enables a firm to allocate to its most lucrative customers the most beneficial trades that occurred during the day.” Stephen Cutler, SEC Enforcement Director, NRS Speech (September 9, 2003).
 - **Batching client trades**
 - **Sequence of client trades**

Conflicts Between Adviser and Clients – Examples of Self Interest

- Allocation of investment opportunities (e.g., IPOs), including to proprietary accounts
- Breakpoints
- **Directorships in companies**
- Double dipping
- Fee differentials for proprietary and nonproprietary products
- Interests in securities (both as to investment and proxy voting)
 - [Affiliate stock](#)
 - [Client stock](#)
 - [Managed mutual fund](#)
 - [Underwritings by an affiliate](#)
- Interests in market makers or trading marketplaces
- Market timing issues
- Parallel trading and front running
- **Performance based fees**
- Principal trading (§ 206(3))
- **Portfolio pumping/marking the close**
- **Possession of confidential information**
- **Proprietary & personal securities trading, including in own mutual funds & 401(k) accounts**
- Receipt of trade-based compensation
- Scalping
- Selective dissemination of holdings
- **Side-by-side management of hedge funds and other accounts**
- Soft dollars, including mixed use products & commitment to pay deficit
- Solicitation arrangements
- “Sticky” deals/waivers of transfer limits, redemption fees or trading windows
- Trade errors
- Brokerage for referrals/fund sales
- **Valuation issues**

Portfolio Management

- Firm and Individual PM Compensation Structure
 - Risk that firm or individual PM compensation structure may incent the firm or PM to place their interests ahead of fund shareholders
- Consistency with investment style
 - Risk that PM engages in style drift to boost fund performance
- Portfolio pumping
 - Risk that PM engages in portfolio pumping to boost performance
- Window dressing
 - Risk that PM engages in window dressing to boost perceptions of fund holdings or to cover style drift
- Prevention of dumping/ cherry picking
 - Risk that PM engages in dumping/cherry picking and favors one account

Conflicts – Source of Obligation

- Compliance Procedures Rules
 - “Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks.”
- SEC’s Portfolio Manager Disclosure Requirements
 - Disclosure of Portfolio Manager compensation and fund ownership
 - Disclosure of any side by side management arrangements
 - Disclosure of Potential “Material” Conflicts
 - Material conflicts between the investment strategy of the fund and the investment strategy of other managed accounts
 - Material conflicts in allocation of investment opportunities between the fund and other managed accounts

New DOL Rules for Cross-Trading

- On October 7, 2008, DOL issued Final Rule for Cross-Trading of Securities between a plan and any other account managed by the same investment manager
 - Requires adviser to adopt, and effect cross-trades in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program. Describe, among other things:
 - Criteria for determining that cross trade will be beneficial to both parties to the transaction;
 - How independent current market price will be determined in accordance with Rule 17a-7;
 - How conflicts are mitigated.
 - Managers must appoint a compliance officer who will review periodically compliance with the policy (sampling) and provide an annual report to the plan fiduciary

New DOL Rules for Cross-Trading

- Final rule changed disclosure of “potentially conflicting loyalties” to “conflicting loyalties.”
 - “The Department believes that there is an inherent conflict of interest when there is a common investment manager for both sides of a transaction.”
- SEC/DOL Memorandum of Understanding (July 29, 2008)
 - Establishes a process for the department's Employee Benefits Security Administration and SEC staffs to share information and meet regularly to discuss matters of mutual interest. These include examination findings and trends, enforcement cases and regulatory requirements that impact the missions of both agencies.

Client Demands

- Describe your firm's overall philosophy regarding conflicts and how they are managed (e.g., oversight committee, new product committee, governance committee)
- Describe your firm's process for identifying and evaluating conflicts
- Describe how your compliance program is designed to identify, monitor and address those conflicts
- Please complete "Conflict Evaluation"

The “Ultimate” Client Demand



Conflicts of Interest. Identify any **real or potential conflicts of interest** you would have in managing a securities portfolio as described in this notice, **and explain how you would avoid, mitigate, or neutralize any such conflicts. Include the interests of your corporate parents, subsidiaries, and affiliates in your answer.** Also, describe your philosophy in fulfilling your duty to the Treasury and the U.S. taxpayer in light of **your proprietary interests and those of other clients.**

- U.S. Department Of The Treasury Notice To Financial Institutions Interested In Providing Securities Asset Management Services For A Portfolio Of Troubled Mortgage-related Assets

Conflict Assessment

- Define the mandate and scope of the assessment
 - Should this best be done on a top-down, business-unit basis or other basis?
 - Should the assessment focus on all business units or just ones believed to pose significant conflict issues?
 - How frequently should such an assessment should recur
 - Should you employ outside consultants or counsel to assist?
- Develop conflicts checklists
- Perform interviews
- Collect, analyze and memorialize findings
- Make any needed changes designed to eliminate, mitigate or address conflicts

Checklists – Where to Start?

- Organizational chart – by entities and personnel
- Affiliates – Affiliated transactions
- Products and services
- Clients and fee relationships (with portfolio manager)
- Clients and investment objectives (with portfolio manager)
- Distribution practices

Checklists – Where to Start?

- Where do you make its money?
 - “Follow the money”
 - Fee differentials
 - Performance fees
 - Compensation to affiliates
 - Compensation from third parties
- Processes
 - Analytical/Portfolio management
 - Trading
 - Operations/account administration
 - Marketing
- For each item, make a list of areas that need to be addressed for possible conflicts

Memorializing & Reporting

- Written report v. No written report
 - What level of detail?
- What telling Boards and Clients?
- Confidentiality/ Privilege Issues
 - What information is privileged?
 - Protecting the privilege

Addressing Conflicts

- Make any needed changes designed to eliminate, mitigate or address conflicts
 - Limit Conflicts
 - Assess Disclosure Requirements
 - Assess Consent Requirements
 - Monitor Conflicts
 - Consider How You Should Institutionalize the Conflicts Assessment Process

Limiting Conflicts?

- Define your relationship around the conflict
- Separate internal groups having conflicting interests
 - Have separate portfolio managers for competing products
 - Separate trading and portfolio management
- Structure compensation to smooth out conflicts
 - Consider how compensation practices complicate or compliment your efforts on conflicts

How do We Decide on Disclosure?

- How to Disclose
 - In writing
 - In Plain English
- What level of detail?
 - Only material conflicts?
 - Just what ADV asks?
 - Existence of conflict
 - Manner addressed
- Where?
 - Form ADV
 - Advisory agreements
 - Fund offering documents
 - Client mailing
 - Actual delivery
- When to disclose
 - In advance
 - Situational disclosure
- Limits of Disclosure
 - Will disclosure cure a conflict that is ultimately unfair?
 - More required with retirement accounts
 - Disclosure generally cannot cure breach of duty of care

Form ADV Disclosure of Conflicts

- Part IA
 - Item 7 - Financial Industry Affiliations
 - Item 8 - Participation or Interest in Client Transactions
- Part II
 - Item 7 - Other Business Activities
 - Item 8 - Other Financial Industry Activities and Affiliations
 - Item 9 - Participation or Interest in Client Transactions
 - Including new requirement to describe a firm's code of ethics and offer clients a copy on request
 - Item 12 - Investment or Brokerage Discretion
 - Item 13 - Additional Compensation
- Schedule H
- Proposed Form ADV Part 2

Proposed ADV Part II

- Item 5 – Fees and Compensation
 - Disclose receipt of compensation attributable to the sale of securities or other investment products, including mutual fund distribution and service fees
 - Explain that this practice creates an incentive to base investment recommendations on the amount of compensation received
- Item 6 – Performance Fees and Side-By-Side Management
 - Explain conflicts associated with side-by-side management, including incentive to favor accounts that pay performance fees

Proposed ADV Part II

- Item 10 – Other Financial Industry Activities and Affiliations
 - Disclose relationship or arrangements with related persons that are material to your advisory business or to clients
 - Disclose the receipt of direct or indirect compensation or business relationships with other investment advisers you may recommend or select for your clients
- Item 12 – Brokerage Practices
 - Research and other soft dollar benefits
 - Brokerage for client referrals
 - Directed brokerage
 - Trade aggregation and bunching practices

Proposed ADV Part II

- Appendix 1 – Wrap Fee Brochure
 - Disclose whether any your related persons act as portfolio managers
 - Disclose whether related person portfolio managers are subject to the same selection and review as the other portfolio managers that participate in the program
 - If they are not, describe how you select and review related person portfolio managers

Involving Clients and Situational Disclosure

- Where seek consent?
 - Principal trades
 - Agency & cross trades
 - Cash referral arrangements
- When?
 - Advance
 - Generally best
 - Sometimes not practical or allowed
 - Situational
- Practical limits
 - Client unavailability
 - Disinterested or independent approval

How Should We Monitor Conflicts?

- Consider exception reporting
- Focus on
 - Key relationships or interests
 - New products and services

Conflict Evaluation

Potential Conflict of Interest Description	Do you have Written Policies and Procedures addressing this conflict? Please provide cross-reference to Ethics Code.		If No, describe why the potential for conflict does not exist. Please use summary bullet points.	Is the potential conflict disclosed? Please identify other disclosure locations.		How is potential conflict otherwise managed? In your description below, where applicable, please provide cross-reference to discussion number of the appropriate policy and procedure(s) identified as Ethics Code in your Compliance Manual. Please use summary bullet points.		Were the controls tested as part of the annual assessment?		Result of Testing Use pull-down menu to select one of the items listed below: - Material Compliance matter identified - Material Compliance matter identified - Compliance Appendix I - Other Disclosure identified - Compliance Appendix I	Did Testing Reveal: Require Changes to Policies & Procedures for 2006? Complete Appendix I to Material Change:		
	Yes	No		ADY	Other Identify	Preventative Controls Describe	Detective Control Describe	Yes	No		Material Change	Administrative Change	No Change
I. Portfolio Management													
(a) Firm and Individual Portfolio Manager Compensation Structure. Fail that firm or individual Portfolio Manager compensation structure may incentivize the firm or Portfolio Manager to place the interests ahead of final shareholder interest.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	Material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Proprietary account policies. Fail that no sufficient policies controls allow the interests of client over proprietary account to be placed over the interests of final shareholder.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Consistency with investment style. Fail that Portfolio Manager engages for multiple drift in order to boost final performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d) Portfolio pumping. Fail that Portfolio Manager engages in portfolio pump and dump in order to boost final performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e) Window dressing. Fail that Portfolio Manager engages in window dressing in order to boost perceptions of final holding or to avert the shift.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(f) Prevention of dumping/ cherry picking. Fail that Portfolio Manager engages in dumping/ cherry picking and favors one account over other account.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(g) Portfolio holdings disclosure. Fail that Portfolio Manager makes non public Leverage Ratio (LR) Portfolio holdings information available to one or more before it is made available to all investors.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
II. Trading													
(a) Use of affiliated brokers. Fail that Investment Advisor routes trades to affiliated Broker Dealer for reasons other than Best Execution.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Best execution and brokerage allocation. Fail that Investment Advisor routes trades to a particular Broker Dealer for reasons other than Best Execution.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Current Scrutiny

- Financial crisis issues
 - Adherence to investment guidelines in a falling market
 - Communications with clients
 - Valuation
- Personal trading
- Gifts and entertainment
- Use of sensitive information
- Proxy voting

Recent Enforcement Actions

- Banc of America Investment Services, Inc. and Columbia Management Advisors, LLC – selection of mutual funds in a wrap fee program used a methodology that was contrary to disclosures to clients and that favored affiliated funds
 - Watch for adequate disclosure of selection of affiliates for other programs, e.g. cash sweeps
- AmSouth Bank, N.A. and AmSouth Asset Management, Inc. (Part I) – follow-up to BISYS Fund Services case. Without disclosure, Advisers accepted undisclosed rebate of administrative fee from BISYS so that Advisers would continue to recommend BISYS as administrator for the funds.

Recent Enforcement Actions

- AmSouth Bank, N.A. (Part II) – part of administrative fee was used to subsidize marketing and other expenses that otherwise would have been incurred by the Adviser, including the country club membership of an officer of the Adviser.
- Gifts and entertainment, continued – SEC settlements expected soon in Fidelity gift case, in which traders accepted more than \$1.6 million in gifts and entertainment from brokers seeking Fidelity trading business.
- SEC v. WealthWise – Adviser who recommended clients invest in a hedge fund failed to disclose that it received a kickback from the hedge fund adviser of the adviser's performance fee

Lessons from the Past

- Valuation - Heartland Advisors Inc. (SEC AP File No. 3-12936, Jan, 25, 2008)
 - Adviser and fund directors knew or should have known that several municipal bonds in fund portfolio were valued incorrectly
 - Adviser worked with independent pricing service gradually to bring down the prices on the bonds, thereby spreading the NAV impact over time
 - Adviser and employees fined over \$4 million
 - Adviser personnel received associational suspensions and fund director a cease-and-desist order

Q & A