

CONFLICTS OF INTEREST (SMALL FIRMS)

PANELISTS

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1. Overview¹

Although conflicts of interest are unavoidable, if they are not properly managed, they may harm the business or reputation of the broker-dealer. In fact, even the appearance of a conflict may have regulatory or reputational implications for a broker-dealer. The federal securities laws, rules and regulations as well as SRO rules² and guidance address various broker-dealer conflicts. In some instances conflict may be mitigated by informational barriers or disclosure, in others, the conduct is prohibited entirely.

2. Types of Conflicts

- a. Insider Trading (SEC Rule 10b-5)
- b. Research Analysis (Rule 2711)
- c. “Directed brokerage”
- d. Compensation from third parties
 - i. Special Cash Compensation Payments (Rule 2830)
 - ii. Non-Cash Compensation Payments (Rule 2830)
- e. Circulation of Rumors (Rule 6140(e))
- f. Recommendations to Customers - Suitability (Rule 2310)
- g. Best Execution (Rule 2320)
- h. Trading ahead of customer limit orders (IM-2110-2)
- i. Front-running (NASD IM-2110-3)
- j. Trading ahead of research reports (NASD IM-2110-4)
- k. Churning (NASD IM-2310-2)
- l. Fairness Opinions (Rule 5150)
- m. Outside Business Activities (Rule 3030)
- n. Private Securities Transactions (Rule 3040)
- o. Gifts (Rule 3220)
- p. Communications with the Public – Marketing Disclosure (Rule 2210)
- q. Sharing in Accounts (Rule 2330)
- r. IPO Allocations (Rule 5130)
- s. Discretionary Accounts (Rule 2510)
- t. Differential Compensation
- u. Fee differentials for Proprietary and Nonproprietary Products
- v. Public Offerings(Rule 2720)

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² For these purposes, unless specifically stated, a “Rule” number may refer to either a FINRA rule or an NASD rule that has not, or is in the process of being consolidated into FINRA’s rulebook.

3. Target Areas of Current Scrutiny

a. Information Barriers

- i. Rule 5280. Trading Ahead of Research Reports — Codifies and amends former NASD IM-2110-4.

- (1) Amendments to NASD IM-2110-4

- i. Seek to prevent trading department personnel from utilizing non-public advance knowledge of the issuance or content of a research report for the benefit of the member or any other person by creating an affirmative informational barrier.
- ii. Eliminate the option to establish internal controls to *manage* the flow of information between research and trading.
- iii. Include all securities and their derivatives, including debt securities, irrespective of whether the security is exchange-traded.
- iv. Apply only where a firm establishes or adjusts its inventory position based on non-public advance knowledge of the content or timing of a research report in the security.

- (2) Prohibits a FINRA member from

- i. adjusting, including:
 - 1) establishing
 - 2) increasing
 - 3) decreasing or
 - 4) liquidating
- ii. an inventory position
 - 1) in a security or
 - 2) a derivative of such security
- iii. based on non-public advance knowledge of
 - 1) the content or
 - 2) timing
- iv. of a research report in that security

- (3) Requires a member to

- i. establish, maintain and enforce policies and procedures reasonably designed to
- ii. restrict or limit the information flow between
 - 1) research department personnel
 - 2) or other persons with knowledge of the content or timing of a research report *and*

3) trading department personnel.³

- ii. Supervision of Informational Barriers⁴
- (1) eliminate physical proximity, if practicable
 - (2) separate reporting lines clearly and distinctly, including indirect supervision
 - (3) restrict access to documents or information on a “need-to-know” basis
 - (4) establish and monitor “need-to-know” exceptions
 - i. legal/compliance
 - ii. advisors (tax, outside counsel, experts)
 - iii. research analysts “over the wall”
 - iv. internal/external vendors and service providers (*e.g.*, IT, mailroom)
 - (5) safeguard of non-public information from intentional or inadvertent dissemination (password protected sites, encryption of information downloaded)
 - (6) separate compensation structure
 - (7) describe internal surveillance systems and practices designed to review compliance with information barrier , including a listing and overview of all exception reports reviewed
 - (8) watch lists
 - (9) restricted lists
 - (10) periodic attestation of compliance
 - (11) review personal trading
 - (12) adopt, develop and document training policies and programs

b. Circulation of Rumors

i. Re-proposed Rule 2030. Origination and Circulation of Rumors⁵

- (1) Rule 6140(e): “No member shall make any statement or circulate and disseminate any information concerning any designated security which such member knows or has reasonable grounds for believing is false or misleading or would improperly influence the market price of such security.”⁶

³ See Regulatory Notice 09-11 (Feb. 2009) available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=7433.

⁴ See Targeted Examination Request (Jan. 2008) available at <http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P038022>.

⁵ See Regulatory Notice 09-29 (Jun. 2009) available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8467.

⁶ See Rule 6143(e) available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4322.

- ii. Proposed rule prohibits a FINRA member from:
 - (1) originating or circulating in any manner
 - (2) a rumor
 - (3) concerning any security
 - (4) that the member knows or has reasonable grounds for believing
 - (5) is false or misleading; and
 - (6) is likely to influence the market price of such security.

- iii. Proposed rule would require a member to
 - (1) report
 - i. promptly
 - ii. any rumor to FINRA
 - iii. that a member has learned and
 - iv. that the member knows or has reasonable grounds for believing
 - v. was originated or circulated for the purpose of
 - vi. improperly influencing the market price of a security
 - (2) create WSPs to identify and address the circulation of rumors, considering the following suggestions ⁷
 - i. monitor electronic communications, including external and internal emails, vendor terminals, instant messages, message boards, internet chat rooms and PINs
 - ii. deploy software that monitors for false or misleading rumors that permits the firm to search for specific subjects, topics, and names
 - iii. block websites that promote the sharing of false or misleading rumors and or other information which could affect market conditions or which otherwise could be considered manipulative
 - iv. address how external email vendors, personal cell phones and blackberries will be monitored for false or misleading rumors, if used at the firm
 - v. address how sales and trading personnel should handle inquiries or comments pertaining to rumors from clients and internal or external members of the broker-dealer community, including whether such personnel are permitted to comment at all on such rumors
 - vi. require sales and trading personnel to report to a designated person any instances involving a client or internal or external member of the broker-dealer community who is engaging in circulating rumors

⁷ See FINRA Targeted Examination Request (July 2008) available at <http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P038929>.

- (3) clearly identify person responsible for
 - i. issuing guidance when responding to rumors, including escalation procedures and
 - ii. reporting obligations
 - (4) adopt, develop and document training policies and programs
 - iv. Proposed Definition of Rumor
 - (1) a false or misleading statement or
 - (2) a statement without a reasonable basis
 - v. Proposed Permissible Communications
 - (1) exception to definition of “Rumor” - a statement will not be considered a "rumor" if it is clearly an expression of an individual's or firm's opinion, such as an analyst's view of the prospects of a company
 - (2) discussion of a rumor that is
 - i. published by widely circulated public media and
 - ii. source and unsubstantiated nature are disclosed
 - (3) discussion of rumors among market participants when necessary to explain market or trading conditions provided
 - i. no member or associated person intends to influence price movement by discussing the information
 - ii. comments and personal views as to the validity of the information must be presented in a “responsible way”
 - 1) providing the source of the information, if possible
 - 2) not embellishing the information
 - 3) presenting the information in a neutral and balanced way as practicable under the circumstances
 - b. discussing the information solely for the purpose of verifying or inquiring into the truthfulness or accuracy of the rumor
 - i. the discussion may occur between associated persons of the same member
 - ii. the member or the associated person must disclose
 - 1) the unsubstantiated nature of the information
 - 2) the source, wherever possible
- c. Preferential Treatment
 - i. Clients
 - ii. Class of clients

4. Identifying and Managing Conflicts

a. Conflicts Factor into Written Supervisory Procedures

Broker-dealers, in designing their 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.

b. Systematic Approach to Assess Conflicts

- i. Framework to identify, assess, monitor and control conflicts
- ii. Limits of piecemeal approaches
- iii. Alternatives:
 - (1) Top-down, organization-wide, theme-based assessment
 - (2) To complement regular and *ad hoc* assessments

c. Working Definition of a Conflict

- i. Any activity or relationship in which a broker-dealer's interests compete with the interests of its clients
- ii. Conflicts are sometime described as the problem of "wearing two hats"
- iii. Self interest is always one of the elements in a conflict, and self interest may clash with fiduciary or legal obligations
- iv. Conflicts may involve divided loyalty as well as self-dealing
- v. Suggestion: "Follow the Money"

d. Assessment Process

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

e. Developing a Checklist

- i. Develop a comprehensive checklist making a list of areas that need to be addressed for possible conflicts. For this analysis include:
 - (1) Organizational chart – by entities and personnel

- (2) Affiliates – Affiliated transactions
 - (3) Products and services
 - (4) Clients and fee relationships
 - (5) Distribution practices
 - (6) Where does the broker-dealer make its money? -- “Follow the money”
- f. Collect, Analyze and Memorialize Assessment
- i. Written report
 - (1) Advantages
 - (2) Disadvantages
 - ii. Confidentiality/ Privilege Issues
 - (1) What information is privileged?
 - (2) Protecting the privilege
- g. Make Needed Changes
- i. Make any needed changes designed to eliminate, mitigate or address conflicts
 - (1) Limit Conflicts
 - (2) Assess Disclosure Requirements
 - (3) Monitor Conflicts
 - (4) Consider How You Should Institutionalize the Conflicts Assessment Process
 - ii. Limit Conflicts
 - (1) Separate internal groups having conflicting interests
 - (2) Structure compensation to smooth out conflicts
 - (3) Consider how compensation practices complicate or compliment your efforts on conflicts
- h. Assess Disclosure Requirements
- i. How to Disclose
 - (1) In writing?
 - (2) What level of detail?
 - ii. Where?
 - (1) Client agreements
 - (2) Fund offering documents
 - (3) Client mailing
 - (4) Actual delivery
 - (5) Maintain evidence of delivery
 - iii. When to disclose
 - (1) In advance
 - (2) Situational disclosure – Point of Sale

- iv. Limits of Disclosure
 - (1) Will disclosure cure a conflict that is ultimately unfair?
 - (2) More required with sales to seniors
 - (3) Disclosure generally cannot cure breach of duty

- i. Monitor Conflicts
 - i. Consider exception reporting
 - ii. Focus on
 - (1) Key relationships or interests
 - (2) New products and services
 - (3) Proprietary Trading
 - (4) Informational Barriers
 - (5) Differential Compensation

- j. Consider How to Institutionalize the Conflict Assessment Process •Conflicts policy?
 - i. Standing conflicts officer or committee?
 - ii. Rotating assessment of business units and services?

- k. Discovery of Conflicts
 - i. If you discover violations during the course of your assessment
 - (1) Immediately seek the advice of your counsel and address the matter promptly
 - (2) Take prompt corrective action
 - (3) Review with management
 - (4) Review with department managers
 - (5) Set timeline to correct deficiencies
 - (6) Revise policies and procedures, if necessary
 - (7) Take prompt action (30 – 60 days)
 - (8) Follow-up report to management
 - (9) Review periodic follow-up reports
 - ii. Should you “blow the whistle” on yourself?