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## **Conflicts of Interest (Small Firms)**

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# Topics To Be Covered

- Types of Conflicts of Interest
- Target Areas of Current Scrutiny
  - *Trading Ahead of Research Reports*
  - *Supervision of Information Barriers*
  - *Circulation of Rumors*
- Case Study
- Identifying and Managing Conflicts of Interest

# Types of Conflicts of Interest

- Insider Trading
- Research
- “Directed brokerage”
- Compensation from third parties
- Circulation of Rumors
- Recommendations to Customers - Suitability
- Best Execution
- Trading ahead of customer limit orders
- Front-running
- Trading ahead of research reports
- Fairness Opinions
- Outside Business Activities
- Private Securities Transactions
- Gifts
- Communications with the Public – Marketing Disclosure
- Sharing in Accounts
- IPO Allocations
- Differential Compensation
- Fee differentials for Proprietary and Nonproprietary Products
- Public Offerings

# Target Areas of Current Scrutiny

- Rule 5280. Trading Ahead of Research Reports — Codifies and amends former NASD IM-2110-4
  - *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.*
  - *Eliminate the option to establish internal controls to manage the flow of information between research and trading.*
  - *Include all securities and their derivatives, including debt securities, irrespective of whether the security is exchange-traded.*
  - *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.*

# Trading Ahead of Research Reports

- Rule 5280 prohibits a FINRA member from:
  - *Adjusting an inventory position in a security or a derivative of such security*
  - *based on non-public advance knowledge of the content or timing of a research report in that security*
- Requires a member to
  - *establish, maintain and enforce policies and procedures reasonably designed to*
  - *restrict or limit the information flow between*
  - *research department personnel*
  - *or other persons with knowledge of the content or timing of a research report and*
  - *trading department personnel.*

# Supervision of Information Barriers

- Supervision of Information Barriers
  - *eliminate physical proximity, if practicable*
  - *separate reporting lines*
  - *restrict access to information on “need-to-know” basis*
  - *establish and monitor “need-to-know” exceptions*
    - *legal/compliance*
    - *advisors (tax, outside counsel, experts)*
    - *research analysts “over the wall”*
    - *internal/external vendors and service providers*
  - *safeguard of non-public information from intentional or inadvertent dissemination (password protected sites, encryption of information downloaded)*

# Supervision of Information Barriers

- Supervision of Information Barriers (cont'd)
  - separate compensation structure
  - describe internal surveillance systems and practices designed to review compliance with information barrier, including a listing and overview of all exception reports reviewed
  - watch lists
  - restricted lists
  - periodic attestation of compliance
  - review personal trading
  - adopt, develop and document training policies and programs

# Circulation of Rumors

- Rule 6140(e) – Origination and Circulation of Rumors

*“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.”*

# Circulation of Rumors

- Rule Re-Proposed as Rule 2030 prohibits a FINRA member from:
  - *originating or circulating in any manner*
  - *a rumor*
  - *concerning any security*
  - *that the member knows or has reasonable grounds for believing*
  - *is false or misleading; **and***
  - *is likely to influence the market price of such security.*
- NSCP Comment Letter
  - *<http://www.nscp.org/media/commentletters/comment-07-14-09.pdf>*

# Circulation of Rumors

- What is a “rumor”?
  - A “rumor” is a false or misleading statement or a statement without a reasonable basis.
- *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.

# Circulation of Rumors

- Proposed rule would require a member to
  1. *Report promptly*
    - *any rumor to FINRA*
    - *that a member has learned and*
    - *that the member knows or has reasonable grounds for believing*
    - *was originated or circulated for the purpose of*
    - *improperly influencing the market price of a security.*
  2. *Create WSPs to identify and address circulation of rumors*

# Circulation of Rumors

- Permissible Communications
  - *Discussions of a rumor*
    - *That is published by widely circulated public media, and source and unsubstantiated nature are disclosed;*
    - *Among market participants when necessary to explain market or trading conditions provided*
      - » no member or associated person intends to influence price movement
      - » comments and personal views as to the validity of the information must be presented in a “responsible way”
      - » providing the source of the information, if possible
      - » not embellishing the information
      - » presenting the information in a neutral and balanced way as practicable under the circumstances

# Circulation of Rumors

- Permissible Communications (cont'd)
  - *Discussions of a rumor*
    - *solely for the purpose of verifying or inquiring into the truthfulness or accuracy of the rumor*
      - the discussion may occur between associated persons of the same member
      - the member or the associated person must disclose
        - » the unsubstantiated nature of the information
        - » the source, wherever possible

# Case Study

BD publishes research reports regarding ABC equity security. ABC Company has also issued debt convertible into ABC equities and is negotiating with the Underwriting Department of BD a further underwriting assignment of corporate debt and a smaller private offering.

# Case Study

- The research analysts who prepare research reports are registered as Series 86/87 and Series 7 registered persons.
- The Research Department has relationships with various service providers who are involved in various aspects of the publication and distribution of research reports.
- The Research Department is located on the same floor, but on the opposite extreme of the Proprietary Trading Desk.
- The Proprietary Trading Desk and Syndication Desk are on separate floors of the building.
- Both the Research Department and the Trading Desk share certain administrative, unregistered, staff that performs clerical and ministerial tasks (*i.e.*, administrative personnel assigned to the floor). Certain unregistered persons service and are common to all BD departments (IT staff, mail room, among others).

# Multi-Tasking

- *A Research Analyst and a trader who works on the Proprietary Trading Desk are required to participate in a mandatory training workshop by the BD's human resources department. Expecting a long boring lecture, the Research Analyst brought a draft of the research report she is working on to continue editing the document. During a break, the trader caught a glimpse at the headline of the research report (without reading the content of the report) as relating to ABC securities. Later that day the BD's Proprietary Desk established a position in ABC securities.*

# Don't Take Your Work Home

- *The Research Analyst was working on a tight production deadline for the ABC securities research report and had not been able to catch up on her workload regarding the companies in her industry group. For this reason, she decided to download the draft reports on her thumb drive and work from home. Her supervisory principal who is anxiously awaiting her work product on ABC securities, asked her to e-mail it to him as soon as she had completed the document. As luck would have it, the firm's e-mail system was down, so she e-mailed the document to her supervisor's hotmail account, which he shares with his spouse.*

# The Next Day

- *Back at her desk early the next day, the Research Analyst decided she needed to clean out the mounds of paper that had accumulated on her work station. She asked a member of the cleaning staff to bring her a trash dumpster and threw away old drafts of research reports (in various stages of editing) and their back up documentation. When she was done, the dumpster was returned to the small coffee and snack station that was located between the Trading Department and Research Department.*

# One Person's Trash...

- *Two traders met in the coffee and snack station just before the beginning of the trading day, and discussed their weekend plans. “Hey, what’s your address again?” said Trader 1. “Here,” said Trader 2, as he grabbed a piece of from the large mound of paper in the dumpster and wrote his address. “I’ll be there at 6 sharp.” Trader 1 glanced at the address and flipped the paper over to review its contents. The address had been written on an early draft of the ABC report. Trader 1 returned to the Trading Department, quickly conferred with his supervisor, and spent the day liquidating BD’s newly acquired position in ABC securities.*

# TMI

- *After she was done with the clean-up of her work station, the Research Analyst quickly called a co-worker who worked in the BD's Finance Department to see if he wanted to grab a quick bite for lunch. "I've had the worst week," she sighed, "I've been knee deep in that ABC piece. It's total junk; my time could be better spent than on following companies on the brink of disaster." Her co-worker returned to his desk after lunch and shot an e-mail to his college buddy who published the online blog "Bear Raider" with the re line "Call me ASAP re ABC." The co-worker then purchased put options on ABC stock in his wife's brokerage account.*

# Who Hasn't Seen This Report??

- *The Research Analyst then got a call from a colleague in the Marketing Department. The Marketing Department was working on an overhaul of the formatting and design of all firm communications with the public and needed a sample research report for that effort. Seeing no harm in providing a research report to a firm staffer that was not in the Trading Department, the Research Analyst sent her a copy of the draft ABC securities research report. The colleague in the Marketing Department sent a copy of the draft research report to the Marketing Department working group members who were working on the marketing overhaul and to the PR firm that was assisting in the design of the templates for the BD's written communications.*

# What Isn't Wrong With This Picture??

- *Meanwhile, due to the blogger Bear Raider's reporting of the imminent collapse of ABC stock, a Senior Vice President of the BD was contacted by a member of the press. The SVP was a member of the Commitment Committee of the BD's Underwriting Department and was aware of the imminent assignment of ABC's debt underwriting to the BD. As a member of the Commitment Committee, the SVP had access to ABC Company's financial information and knew of the precarious situation of ABC Company. He assured the reporter ("off the record") that the financial health of ABC Company was not in jeopardy. After the call with the reporter, the SVP posted a few favorable comments regarding ABC Company under various screen names in the Bear Raider blog from his work computer.*

# Identifying and Managing Conflicts

- Systematic Approach to Assess Conflicts
- Working Definition of a Conflict
  - *“Follow the Money”*
- Assessment Process
- Develop a Checklist
- Collect, Analyze and Memorialize Assessment
- Make Needed Changes
- Assess Disclosure Requirements
- Monitor Conflicts
- Develop Action Plan Upon Discovering Conflicts

# Questions

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