

National Society of Compliance Professionals
National Membership Meeting
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C O U N S E L O R S A T L A W

Conflicts of Interest

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Conflicts of Interest

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 - Form ADV Disclosure of Conflicts
 - Do We Need Client Consent?
 - How Should We Monitor Conflicts?
 - Do We Need to Institutionalize the Assessment Process?

The Past – SEC “Mini Sweep” Inquiry

1. Has the firm conducted an assessment of conflicts in ... the last year?
2. If yes, describe the ... assessment, its mandate and scope, how it was performed, and the findings
3. Describe any changes made as a result ...
4. Describe any proposed actions ... taken or planned to address conflicts, whether as a result of the assessment or otherwise
5. If your firm has not conducted an assessment, describe whether an assessment is planned, or other ways the firm identifies and addresses conflicts

The Present – Current Scrutiny

- Pension consultants
- Political contributions and “Pay to play”
- Proxy voting
- Gifts and gratuities
- Directed brokerage and “Shelf Space” Payments
- Soft dollars
- Personal trading
- Use and disclosure of sensitive information

The Present – Client Inquiries

- 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”

Conflict Evaluation

Potential Conflict of Interest Description	Do you have Written Policies and Procedures addressing this conflict?		If No, describe why the potential for conflict does not exist. Please use summary bullet points.	Is the potential conflict disclosed?		How is potential conflict otherwise managed? In your description below, where applicable, you may cross-reference or discuss number of the applicable policies and procedures as identified in Exhibit C to your Compliance Manual. Disclose controls to be pursued.	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: <ul style="list-style-type: none"> - No Material Compliance matters identified - Material Compliance matters identified - Group has responded - Other Discrepancy identified - Group has responded 	Did Testing Results Require Changes to Policies & Procedures for 2006?			
	Yes	No		ADV	Other Identify		Preventative Controls Describe	Detective Control Describe		Yes	No	Test Results	Material Changes
I. Portfolio Management													
(a) Firm and Individual Portfolio Manager Compensation Structure. Eal that firm or individual Portfolio Manager compensation structure may induce the firm or Portfolio Manager to place the interests of fund shareholders in front of the interests of the fund.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	Material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Proprietary account policies. Eal that investment policies or controls allow the interests of related investment proprietary accounts to be placed over the interests of fund shareholders.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Consistency with investment style. Eal that Portfolio Manager investment style may be inconsistent with best fund performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d) Portfolio pumping. Eal that Portfolio Manager investment style may be inconsistent with best fund performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e) Window dressing. Eal that Portfolio Manager investment style may be inconsistent with best fund performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(f) Prevention of dumping/ cherry picking. Eal that Portfolio Manager investment style may be inconsistent with best fund performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(g) Portfolio holdings disclosure. Eal that Portfolio Manager investment style may be inconsistent with best fund performance.	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>			<input type="checkbox"/>	<input type="checkbox"/>	No material Compliance matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
II. Trading													
(a) Use of affiliated brokers. Eal that Investment Adviser seeks to use affiliated Broker Dealers 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 matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Best execution and brokerage allocation. Eal that Investment Adviser seeks to use 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 matters identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Close Full Screen

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
- Proprietary account policies
 - Risk that insufficient policies/controls allow the interests of subadviser proprietary accounts to be placed over the interest 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
- Portfolio holdings disclosure
 - Risk that PM makes nonpublic Portfolio holdings information available to one customer before it is made available to all

Trading

- Best execution and brokerage allocation
 - Risk that Adviser routes trades to a Broker-Dealer, including an affiliate, for reasons other than Best Execution
- Prohibition on directed brokerage
 - Risk that Adviser engages in the prohibited practice of Directed Brokerage
- Soft dollars
 - Risk that Adviser engages in soft dollar practices outside Section 28(e)
- Step out trades
 - Risk that Adviser chooses to step out trades other than for Best Execution
- Allocations of investment opportunities
 - Risk that Adviser favors one client over another in allocating opportunities
- Trade Aggregation and block trading
 - Risk that trade allocation / block trading favors one client over another
 - Trade error correction
 - Risk that Adviser experiences trade errors and does not escalate them for appropriate resolution

Code of Ethics

- Personal trading procedures, including trading in fund shares
 - Risk that access persons place their own interests ahead of shareholders interests
- Insider trading procedures, including procedures with respect to non-public information
 - Risk that Adviser personnel take advantage of non-public insider information
- Ethical wall (*i.e.*, screening) procedures
 - Risk that ethical walls are insufficient to manage conflicts of interest
- Procedures governing outside employment / directorships and other business activities
 - Risk that Adviser personnel may place their own interest (resulting from outside employment / directorships) ahead of the interest of Fund shareholders

Conflict Description – For each Area

- Do you have Written Policies and Procedures addressing this conflict?
 - Please identify
 - If No, describe why the potential for conflict does not exist
- Is the potential conflict disclosed (and where)?
- How is potential conflict otherwise managed?
- Were the controls tested as part of the annual assessment?
 - What were the Results of Testing?
 - Did Testing Results Require Changes to Policies & Procedures for 2006?

The Process – 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 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

What's a Conflict?

- Any activity or relationship in which an adviser's interests compete with the interests of its clients
 - 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
 - Suggestion: “Follow the Money”

Institutionalizing Conflicts Management

- Conflicts policy?
- Standing conflicts officer or committee?
 - Or heighten awareness of existing committees?
- Rotating assessment of business units and services?
- Education
- How does this Tie into Your Annual Reporting Requirements under the Final Compliance Rules?

Conflict Assessments – the Process

- 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 does the adviser 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

Checklist – Conflicts Among Clients

- Agency cross and cross trades (§ 206, Rule 206(3)-2 and ERISA limits)
- Allocation of investment and trading opportunities
 - Investment allocation
 - Late trade allocation
 - Batching client trades
 - Sequence of client trades

Checklist– Self-Dealing Conflicts

- 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

What Kind of Charts?

SAMPLE CONFLICTS INVENTORY

Conflict	Category	Cross Group	Risk	Current Approach and Comment	Disclosure	Additional Mitigants
1. Agency cross trades	C-C					
2. Cross trades	C-C					
3. Allocation of investment and trading opportunities	C-C, F-C					
• Allocation of investments						
• Late trade allocation	C-C					
• Batching client trades	C-C					
• Sequence of client trades	C-C					
4. Breakpoints	F-C					
5. Directorships in companies	F-C					
6. Double dipping	F-C					
7. Fee differentials for proprietary and nonproprietary products	F-C					
8. Interests in securities (both as to investment and proxy voting)	F-C					
• Affiliate stock	F-C					
• Client stock	F-C					
• Managed mutual fund	F-C					
• Underwritings by an affiliate	F-C					
9. Interests in market makers or trading marketplaces	F-C					
10. Market timing issues	F-C					
11. Parallel trading and front running	F-C					
12. Performance based fees	F-C					
13. Principal trading (§ 206(3))	F-C					
14. Portfolio pumping/marketing the close	F-C					
15. Possession of material, nonpublic information	F-C					
16. Proprietary and personal securities trading, including in own mutual funds & 401(k) accounts	F-C					

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
 - Maintain evidence of 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

Do We Need Client Consent?

- Where seek?
 - Principal trades under § 206(3)
 - Agency & cross trades under § 206(3), Rule 206(3)-2, 1940 Act Rule 17a-7 and PTCE 86-128
 - Cash referral arrangements under Rule 206(4)-3
- 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

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