

NSCP National Membership Meeting 2009

Morgan Lewis

Conflicts of Interest

(Large Firms)

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Overview

- Defining “Conflict of Interest” and the Regulatory Regime
- How to approach conflicts
 - Do I need a conflicts officer or a conflicts committee?
 - Conflicts Analysis
 - Outside Business Activities
- Regulators and Conflicts
 - Recent Enforcement Cases
- Disclosure

What is a Conflict?

- Broadly defined, a “conflict of interest” exists when two or more activities or relationships are incompatible to some extent.
- 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 (client/client conflict) as well as self-interest (client/adviser) conflict

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)

Client Expectations

- 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
- Complete "Conflict Evaluation"

How to Approach Conflicts

- Continually evaluate adviser's business for potential conflicts of interest
 - Identify any business practice that has the potential to sacrifice the interests one set of clients in favor of another (Divided Loyalty)
 - Identify any situations in which the adviser could place its employees, and its affiliates interests ahead of clients' interest (Self-Interest)
 - Follow the Money
 - Have key personnel complete conflict questionnaire on an annual basis and require updates for substantial changes.
 - Unidentified or unaddressed conflicts can negatively impact the adviser's business.
- Whenever possible an adviser should attempt to eliminate potential conflicts of interest. When a conflict is unavoidable, adviser should attempt to mitigate or manage the conflict and disclose it to clients.

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/marketing 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

Outside Business Activities

- Adviser's should have all employees complete outside business activities questionnaire on an annual basis.
- Employees should certify on an annual basis that they have reported all outside activity in a timely manner.

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

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 do you share with 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 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 Exhibit C or D.		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 concerns.		How is potential conflict otherwise managed? In your description below, where applicable, please cross-reference to discuss number of the applicable policies and procedures as identified on Exhibit C or D 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: <ul style="list-style-type: none"> - Material Compliance matter identified - Material Compliance matter identified - Compliance Appendix - Other Exception identified - Compliance Appendix 	Did Testing Result: Require Changes to Policies & Procedures for 2006? Complete Appendix I to Material Change:		
	Yes	No		Describe	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. Fail that firm or individual Portfolio Manager compensation structure may incentivize the firm or Portfolio Manager to place their interests ahead of fund shareholders' interests.	<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 the firm's policies regarding the management of, and control over, 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 matter identified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Consistency with investment style. Fail that Portfolio Manager engages in multiple drift in order to boost fund 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 pumping in order to boost fund 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 performance of fund holdings or to coverable drift.	<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/selling, picking and favors one account over other accounts.	<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 Model Data 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 an 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"/>

Do I need a Conflicts Officer or Conflicts Committee?

- A dedicated person or committee accountable for identifying conflicts will assist an adviser in managing conflicts firmwide.
 - *Confirm the controls surrounding all identified Conflicts of Interest are functional and adequate.*
 - *Identify any new or emerging Conflicts of Interest that may fall within the Compliance Committee's oversight realm. Any changes affecting existing identified Conflicts of Interest, related controls, or any newly or emergent Conflicts of Interest must be reported to the CCO promptly.*
 - *All conflicts identified will be included in the Conflicts of Interest Summary Report, which will be a dynamic report ("Report") and any related control failure or newly identified Conflict of Interest that is identified outside of the formal annual review process will be added to the Report and promptly reported to the CCO.*

Regulators & Conflicts

- Fiduciary Duty under Section 206 requires advisers to act in the best interests of clients.
- Compliance Rule requires advisers to develop policies and procedures to identify conflicts and develop policies and procedures to address them
- Regulators try to understand advisers business practices and relationships to identify potential conflicts of interest or undisclosed arrangements, which are then scrutinized more carefully.
- Regulator's goal is to make sure that clients are not being disadvantaged. Even if no clients were harmed as a result of a client, they will examine whether the potential conflict is material and clearly disclosed.

CAUTION

Unidentified and/or Undisclosed
Conflicts can result in
Regulatory Actions.



Recent Enforcement Actions

Undisclosed Side Arrangements

- Mutual Fund Adviser (“Adviser”) entered into an agreement with Mutual Fund Administrator (“Administrator”) in which the Administrator would rebate a portion of its administration fee to the Adviser in exchange for their promise to continue recommending the Administrator to the Fund’s Board of Trustees.
- Adviser, Administrator’s President (who also served as the Chairman of the Fund’s Trustees) and General Counsel settled the matter with the SEC.

Party	Disgorgement/ Fines/Penalties
Adviser	\$11,488,234.81
Administrator	\$22,402,816.66
Administrator's President	\$18,000
Administrator's General Counsel	\$35,569.22

Compliance Testing & Lessons Learned

Compliance testing that may have helped identify this issue

- *Review all contractual arrangements.*
- *Review all sources of income.*
- *Email surveillance*

Lessons learned from this case.

- *If you are aware of material facts or potential conflicts you have a duty to disclose.*
- *If outside counsel advises you to disclose certain facts – follow that advice.*
- *Culture of Compliance comes from the Top.*

Recent Enforcement Actions

Directed Brokerage based on receipt of Travel, Entertainment, Gifts or Personal Relationships

- Mutual Fund Adviser and several employees improperly accepted over \$1.6 million in travel, entertainment, and other gifts that were paid by brokers who were seeking trading business generated by its mutual fund clients.

Party	Disgorgement/ Fines/Penalties
Adviser	\$8,000,000
Senior Executive	\$51,317
Senior Executive	\$267,475
Trustee	\$20,133
Trader #1	\$13,093
Trader #2	\$208,768
Trader #3	\$90,987
Trader #4	\$82,420
Trader #5	\$82,549
Trader #6	\$114,679
Trader #7	\$89,596
Trader #8	\$106,197

Compliance Testing & Lessons Learned

- **Compliance testing that may have helped identify this issue**
- *Email surveillance*
- *Annual certification by all employees that they have reported all gift and entertainment received during the period.*
- **Lessons learned from this case.**
- *Independent reviewer (not just up the management chain) of Gifts & Entertainment*

Recent Enforcement Actions

Undisclosed Receipt of Commissions for Recommending Money Managers

- Dually registered adviser/broker dealer (“Adviser”) did not inform clients that they recommended other money managers who gave them incentives to make those recommendations.
- The Adviser and its representative received a portion of the \$3.3 million in brokerage commission generated by the other money managers.
- The SEC found that the Adviser violated Section 206(2) of the Advisers Act. In addition, the SEC found that the Adviser did not reasonably supervise the representative within the meaning of Section 203(e)(6) of the Advisers Act.

Party	Disgorgement/ Fines/Penalties
Adviser	\$500,000
Representative	Case pending

Recent Enforcement Actions

Undisclosed Directed Brokerage & Fee Sharing Arrangements

- Adviser did not disclose to its pension consulting services advisory program clients a conflict of interest in the adviser recommending that clients use directed brokerage to pay consulting fees.
- The Adviser and its representatives received more revenues through directed brokerage commissions than they would have received if clients paid the Adviser's annual consulting fee with hard-dollars and paid brokerage commissions for trade execution elsewhere.
- In addition, the Adviser did not disclose that its representatives had a direct financial incentive to recommend that clients use the Adviser's affiliate for transition management services.

Party	Disgorgement/ Fines/Penalties
Adviser	\$1,000,000
Representative	\$0
Representative	\$20,000

Compliance Testing & Lessons Learned

- **Compliance testing that may have helped identify this issue**
- *Thorough branch office examinations*
- *Email Surveillance*
- *Review of representatives previous client complaints*
- *Compliance Review of Marketing Materials and RFPs*
- **Lessons learned from this case**
- *Recognize the conflicts associated with the dual nature of broker/advisory business and develop adequate compliance and supervisory procedures to manage the conflicts.*
- *Ensure there is a clear understanding by all employees and all groups who is responsible for supervising compliance with the Adviser's policies and procedures.*

Recent Enforcement Actions

Undisclosed Potential Conflict of Interest with use of 3rd Party Proxy Voting Service

- Adviser did not adequately disclose a potential conflict of interest that its selection of a 3rd party proxy voting service to vote clients' proxies based on the AFL-CIO proxy voting guidelines may be helpful in gaining and retaining union-affiliated clients.
- Adviser's Chief Operating Officer ("COO") was responsible for drafting the Adviser's Proxy Voting Policy and Procedures. The COO recognized the potential benefits to the Adviser and also acknowledged that different types of clients may have chosen a different proxy voting guideline, if offered.

Party	Disgorgement/ Fines/Penalties
Adviser	\$300,000
Chief Operating Officer	\$50,000

Compliance Testing & Lessons Learned

Compliance testing that may have helped identify this issue

- *Review of types of clients and potential impact of 3rd party proxy voting guidelines.*

Lessons learned from this case.

- *If you recognize or acknowledge there may be potential benefit to the Adviser disclose it.*
- *Consider offering clients a choice among the 3rd party proxy voting service guidelines.*
- *Avoid statements that you don't expect conflicts to arise if you are aware of any potential conflicts.*

Recent Enforcement Actions

Undisclosed Compensation

- Adviser took for its own benefit warrants from hedge funds it advised without disclosing that they were being paid for by its clients.
- The net value of the warrants was approximately \$18.9 million.

Party	Disgorgement/ Fines/Penalties
Adviser	\$100,000
President	\$50,000

Compliance Testing & Lessons Learned

Compliance testing that may have helped identify this issue

- *Review all sources of income.*

Lessons learned from this case.

- *Partial disclosure of a conflict of interest is not sufficient*

Recent Enforcement Actions

Undisclosed Conflict of Interest Arising from Payments to Placement Agents

- Adviser made undisclosed payments to placement agent for state pension fund investments. The payments allegedly ensured that the adviser would win mandates to manage assets for the state pension fund. The payments were derived from management fees paid to the adviser by the state pension fund.
- Part of wide-sweeping investigation by various government agencies of “pay to play” practices in the management of government funds.

Party	Disgorgement/ Fines/Penalties
Adviser	In litigation as of August 17, 2009
Principal of adviser	In litigation as of August 17, 2009

Compliance Testing & Lessons Learned

Compliance testing that may have helped identify this issue

- *Review all contractual arrangements.*
- *Third party due diligence*
- *Email surveillance*

Lessons learned from this case.

- *Give extra scrutiny to government mandates – regulators do!*
- *Educate business generators on proper/improper payments regarding all entities, but especially government entities*
- *Insist on compliance involvement in RFP process*

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

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

Q & A