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# Investment Adviser Regulation An A to Z Workshop

Managing Conflicts of Interest  
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# 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
- » Soft dollars
- » Personal trading
- » Use of sensitive information
- » Side letters

# 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

# 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.”

## » Fiduciary Duty

## » Regulatory Requirements (designed to regulate conflicts)

# 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”

# What is a Conflict?

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*“Actually, I wear two hats.”*

# Conflicts Among Clients

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

# Self-Dealing Conflicts

- » Allocation of investment opportunities, including to proprietary accounts
- » Directorships in companies
- » Double dipping
- » Fee differentials for proprietary and nonproprietary products
- » Interests in securities - both as to investment and proxy voting (e.g., 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
- » Receipt of trade-based compensation
- » 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

# Conflicts Management

- » Conflicts policy
- » Standing conflicts officer or committee (or heighten awareness of existing committees)
- » Rotating assessment of business units and services
- » Education
- » Tie into annual reporting requirements under compliance program

# Conflict Assessments

- » Define the mandate and scope of the assessment
  - Top-down, business-unit basis or other basis?
  - Focus on all business units or just ones believed to pose significant conflict issues?
  - Frequency of update?
  - Use of outside consultants or counsel to assist?
- » Develop conflicts checklists
- » Perform interviews
- » Collect, analyze and memorialize findings

# 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

# 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

# Limit 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

# Disclosure

- » “I know of only two ways in which advisers can handle their conflicts of interest and remain within an acceptable level of regulatory compliance:
  - Eliminate the arrangements or activities that create the conflict.
  - Disclose each conflict fully and fairly and then manage the adviser’s affairs so the impact of a conflict on clients and fund investors will be consistent with the disclosures made.”

# 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
- » 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

# 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
  - Situational
- » Practical limits
  - Client unavailability
  - Disinterested or independent approval

# Monitor Conflicts

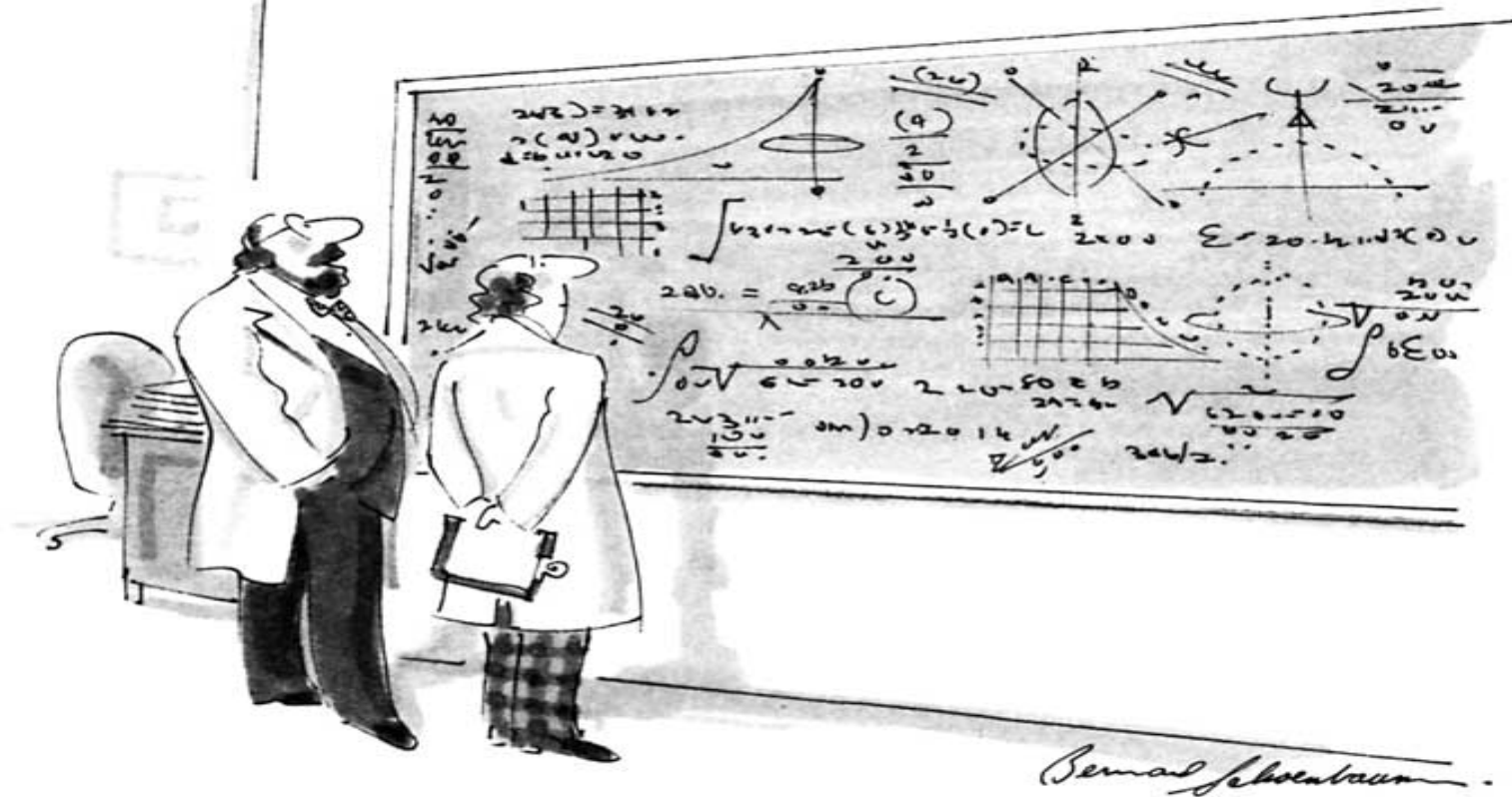
- » Consider exception reporting
- » Focus on
  - Key relationships or interests
  - New products and services
  - Affiliated relationships

# Institutionalize the Process

- » Do you have Written Policies and Procedures addressing this conflict?
  - Please identify
- » 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 the testing?
  - Did the testing results require changes to policies and procedures

# Managing Conflicts

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*“Oh, if only it were so simple.”*

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