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C O U N S E L O R S   A T   L A W

# Assessing Risk and Managing Conflicts of Interest

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W. John McGuire  
Partner

Morgan, Lewis & Bockius LLP

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# Overview

- Evaluation of Conflicts of Interest
- Recent Enforcement Cases
- Conflicts and Risk Assessment
- Managing and Eliminating Conflicts
- Reporting of Conflicts

# Overview:

## Methods to Address Conflicts of Interest

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1. Prevention (*i.e.*, ethical walls)

2. Disclosure

3. Management

# Working Definition of “Conflict of Interest”

- **Any activity or relationship in which an adviser’s or broker’s interest compete with the interest of its clients**
  - Conflicts are sometimes 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”

# Regulatory Requirements

**Disclose Conflicts:** Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers to disclose conflicts of interest to clients

**Develop Compliance Policies and Procedures:** Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt and implement written policies and procedures “reasonably designed to prevent violation” of the Advisers Act and the rules thereunder.

The Adopting Release to Rule 206(4)-7 notes that, “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.”

# Regulatory Requirements (cont'd)

## Disclose Conflicts of Portfolio Manager

**Compensation/Fund Ownership:** Item 15 of Form N-1A requires that portfolio managers disclose compensation and fund ownership.

**Other Managed Accounts:** Under Item 15, portfolio managers must also disclose “material” conflicts between the investment strategy of a fund and the investment strategy of other managed accounts and in allocation of investment opportunities between a fund and other managed accounts.

# SEC Oversight: Current Areas of Scrutiny

- Pension consultant arrangements and related “pay to play issues”
- Gifts and gratuities
- Revenue sharing or “shelf space” payments
- Mutual fund late trading and market timing
- Proxy voting: recent sweep exam
- Wall Street settlement regarding research analysts & IPO conflicts
- The new “directed brokerage” – now banned by the SEC
- Selective disclosure of portfolio holdings
- Side-by-side management of hedge funds and other client accounts
- Personal securities trading – now subject to requirements under the SEC’s new code of ethics rule
- State & Public Pension Fund Investment Protection Principles

## Dually-Registered Advisers and Broker-Dealers: SEC Areas of Scrutiny

- Revenue sharing
- Supervision
- Suitability
- Best execution
- Disclosure

# Recent SEC Enforcement Cases

## Mutual Fund Market Timing Cases

### American Express Financial Corporation (“AEFC”) (Dec. 1, 2005)

Prospectus disclosure added to prohibit market timing in January 2002, but no monitoring to prohibit timing in 401(k) accounts until October 2003, and a known timer permitted to time a variable annuity product until October 2003.

**Violations:** The SEC alleged violations of Sections 206(1) and 206(2) of the Advisers Act and Section 34(b) of the 1940 Act, and without admitting or denying the SEC’s allegations, AEFC consented to a cease-and-desist order from committing or causing any violations of these provisions and consented to censure, \$10 million disgorgement and \$5 million civil penalty.

# Recent SEC Enforcement Cases

## Mutual Fund Market Timing Cases (cont'd)

Federated Investment Management Company, et al. (“Federated”) (Nov. 28, 2005) – Federated approved, but did not disclose, three market timing arrangements, or the associated conflicts of interest between the funds’ adviser and the funds involved in the arrangements, either to fund shareholders or to the funds’ boards of trustees. In addition, the funds’ transfer agent allowed a customer and a Federated employee to late trade .

**Violations:** The SEC alleged violations of Sections 206(1) and 206(2) of the Advisers Act and Section 17(d) of the 1940 Act and Rules 17d-1 and Rule 22c-1(1) under the 1940 Act. Without admitting or denying the SEC’s allegations, Federated consented to a cease-and-desist order from committing or causing any violations of these provisions. In addition, it agreed censure and to pay disgorgement in the total amount of \$27 million and a civil penalty in the amount of \$45 million.

# Recent SEC Enforcement Cases

## Mutual Fund Sales Practices Cases

In the Matter of Putnam Investment Management LLC (March 23, 2005) – The SEC alleged that Putnam failed to adequately disclose to the Putnam Funds Board of Trustees and the Putnam Funds’ shareholders the conflicts of interest that arose from the “shelf space” arrangements with broker-dealers that provided increased visibility within the broker-dealers’ distribution systems.

**Violations:** The SEC alleged violations of Section 206(2) of the Advisers Act and Section 34(b) of the Investment Company Act of 1940 (“1940 Act”) - without admitting or denying the SEC’s allegations, Putnam consented to a cease-and-desist order from committing or causing any violations of these provisions. In addition, it consented to an SEC order censuring the firm, agreed to direct a senior level employee to implement and maintain policies with respect to preferred marketing arrangements and related disclosures, and agreed to make a nominal disgorgement payment and pay a \$40 million civil penalty.

# Recent SEC Enforcement Cases

## Mutual Fund Sales Practices Cases (cont'd)

In the Matter of Citigroup Global Markets, Inc. (“CGMI”) (March 23, 2005) - The SEC alleged that CGMI failed to fully disclose to its customers material information about its revenue-sharing program, under which approximately 75 mutual fund complexes made revenue sharing payments to CGMI in exchange for “shelf space” within CMGI’s retail brokerage network and other benefits, such as increased access to branch offices. The SEC also alleged that CGMI recommended and sold Class B shares to certain customers who would have received a higher rate of return if they had purchased Class A shares, because they would have qualified for breakpoints beginning at the \$50,000 level.

**Violations:** The SEC alleged violations of Section 17(a)(2) of the Securities Act of 1933 and Rule 10b-10 under the Exchange Act of 1934, and, without admitting or denying the SEC’s allegations, CGMI consented to a cease-and-desist order from committing or causing any violations of these provisions. In addition, it consented to censure and a \$20 million civil penalty, in addition to certain undertakings, such as retaining an independent consultant to review its fund sales practices.

# Recent SEC Enforcement Cases

## Investment Adviser “Marking-the-Close” Case

Schultz Investment Advisors, Inc. (“Schultz”) (Dec. 28, 2005) From at least June 2002 through December 2003, Schultz engaged in “marking-the-close” transactions in four closed-end funds by regularly placing large, end-of-the-quarter trades in four thinly-traded closed-end funds to boost the reported performance results of its clients’ portfolios. As a result of the marking-the-close trades, the adviser benefited by collecting higher management fees from enhanced performance results.

**Violations:** The SEC alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 13(d) of the Exchange Act and Rule 13(d)-1(b)(1) thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4) thereunder. Schultz consented to a cease-and-desist order from committing or causing any violations of these provisions and also consented to censure, disgorgement in the amount of \$14,534 and a \$100,000 payment to the U.S. Treasury. In addition, Schultz consented to certain undertakings, such as (i) a restriction on all advertising regarding Schultz Investment for a one-year period; and (ii) retaining an independent consultant to review its trading practices for a two-year period.

## Conflicts and Risk Assessment – the Process

- Define the mandate and the 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 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

# Risk Area – 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

# Risk Area - 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

## 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

## Trade aggregation and block trading

- Risk that trade allocation/block trading favors one client over another
- Risk that adviser experiences trade errors and does not escalate them for appropriate resolution

# Risk Areas Addressed by Code of Ethics

## Personal trading procedures, including trading in fund shares

- Risk that access persons place their own interests ahead of shareholder 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

# Practice Point: Large vs. Small Advisers

- **Larger Advisers**
  - More potential for conflicts – broader range of activities and products
  - More likely some conflicts – could go undetected for a longer time period
  - Need for coordination among affiliates is heightened – watch out for the “stove pipe” mentality
  - More resources to address conflicts; e.g., internal audit

# Practice Point: Large vs. Small Advisers

- **Smaller Advisers**
  - Need to be careful of complacency
  - Share many of the same “basic” concerns as larger advisers—but on a smaller scale
  - Take advantage of smallness of size to increase awareness of conflicts

# Developing a Conflicts Checklist

- Items to include:
  - 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

# Developing a Conflicts Checklist: Consider the Following:

- 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

# Sample Conflicts Inventory

## Conflict

Category - Cross Group - Risk -Current Approach -Disclosure- Mitigants

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

# Memorializing the Checklist and Assessment

- Written report
  - Advantages
  - Disadvantages
- No written report
  - Advantages
  - Disadvantages
- Confidentiality/ Privilege Issues
  - What information is privileged?
  - Protecting the privilege

# How to Institutionalize the Checklist and Assessment Process

- Incorporate into Rule 206(4)-7 framework and annual reviews?
- Conflicts policy?
- Standing conflicts officer or committee?
- Rotating assessment of business units and services?

# Addressing Conflicts

- Make any needed changes designed to eliminate, mitigate or address conflicts
  - Limit Conflicts
    - Define your relationship around the conflict
    - Separate internal groups having conflicting interests
    - Structure compensation to smooth out conflicts
    - Consider how compensation practices complicate or complement your efforts on conflicts
  - Assess Disclosure Requirements
  - Assess Consent Requirements
  - Monitor Conflicts

## Methods to Identify Violations of Compliance Policies to Prevent Conflicts of Interest

- **Quality Control Testing – Transaction-by-transaction testing coupled with exception reporting to management responsible for the activity.**
- **Forensic Testing – Periodic testing that is focused on evaluating whether the outcomes of operational and investment activities over time are consistent with expectations.**

# Conflict Area: 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

# Conflict Area: Self- Dealing Conflicts

- **Allocation of investment opportunities (e.g., IPOs), including to proprietary accounts**
- **Breakpoints**
- **Brokerage for referrals/fund sales**
- **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**
- **Market timing issues**
- **Parallel trading and front running**
- **Performance based fees**
- **Principal trading**
- **Portfolio pumping/marketing the close**
- **Possession of confidential info.**
- **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**
- **Valuation issues**

# Assess Disclosure Requirements

## How to disclose?

- In writing
- In Plain English

## What level of detail?

- Just what ADV asks?
- Existence of conflict
- Manner addressed

## Where to disclose?

- 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

# Assess Disclosure Consent Requirements

- Where to 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 to seek?
  - In advance
    - » Generally best
    - » Sometimes not practical or allowed
    - » Situational
- Practical limits
  - Client unavailability
- Disinterested or independent approval

# Form ADV Disclosure Requirements

- 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
  - Item 12 - Investment or Brokerage Discretion
  - Item 13 - Additional Compensation
- Schedule H

# Appropriate to Self-Report?

SEC has publicly professed to offer “more leniency” to those firms who bring conflicts to its attention as opposed to finding the conflicts on its own

- No self-reporting requirement under the Advisers Act
  - Compare with Rule 17a-11(d) under the Exchange Act for broker-dealer records
- Disclosure and/or amendment of policies and procedures to address conflicts can often be accomplished without self-reporting
- In light of stiff sanctions in current regulatory environment, counsel should be consulted if self-reporting is being considered

# Steps to Take Upon Discovery of A Conflict of Interest

1. Immediately seek the advice of your counsel and address the matter promptly
2. Take prompt corrective action (30-60 days)
3. Review with management
4. Review with department managers
5. Set timeline to correct deficiencies
6. Revise policies and procedures, if necessary
7. Follow-up report to management
8. Periodic follow-up reviews
- 9. Continue to monitor conflicts
  - a) **Consider exception reporting**
  - b) **Focus on :**
    - (1) **Key relationships or interests**
    - (2) **New products or services**



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