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Morgan Lewis
C O U N S E L O R S A T L A W

Designing Disclosures and Procedures to Address Conflicts of Interest

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An Invitation from OCIE

- Has the firm conducted an assessment of conflicts in its functions and activities during the last year?
- If yes, describe the nature of the assessment, its mandate and scope, how it was performed, and the findings of that assessment
- Describe any changes made as a result of the assessment, including any changes designed to eliminate, mitigate or address conflicts of interest
- Describe any proposed actions or responses taken or planned to address conflicts, whether as a result of the assessment or otherwise
- If your firm has not conducted an assessment, describe whether an assessment is planned, or other ways that the firm identifies and addresses conflicts

Have You Assessed Conflicts?

- Has the firm conducted an assessment of conflicts in its functions and activities during the last year

Have You Assessed Conflicts?



- 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
 - A conflict would be material if there is a substantial likelihood that disclosure of the conflict would be viewed by a reasonable investor as significantly altering the ‘total mix’ of information available about the fund”
 - “This would include, for example, a conflict that a reasonable investor would consider likely to affect the manager’s professional judgment with respect to management of the fund”

What Exactly Did You Do?

- If yes, describe
 - Nature of the assessment
 - Its mandate and scope
 - How it was performed
 - Findings



What Changes or Actions?

- Describe any changes made as a result of the assessment
 - changes designed to eliminate, mitigate or address conflicts
- Describe any proposed actions or responses taken or planned to address conflicts, whether as a result of the assessment or otherwise

And if . . .

- If your firm has not conducted an assessment, please describe whether an assessment is planned, or other ways that the firm identifies and addresses conflicts

What are You Going to Do?



- Plot a Strategy for Responding
 - Say “yes” . . . Here’s what we did . . .
With its limits and findings
 - Say “not really” but we did a initial check .
. . . But we’re working on a rigorous
process

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 Kind of an Assessment Process Should You Undertake?



- Define the mandate and scope of your 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

Developing a Checklist – Conflicts 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

Developing a 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/marketing the close
- Possession of material, nonpublic information
- Proprietary and personal securities trading, including in own mutual funds & 401(k) accounts
- Receipt of transaction-based compensation
- Scalping
- Selective dissemination of holdings information
- Side-by-side management of hedge funds and other accounts
- Soft dollars, including mixed use products and commitment to pay residual in hard dollars
- Solicitation arrangements
- “Sticky” deals/waivers of transfer limits, redemption fees or trading windows
- Trade errors
- Use of brokerage for referrals and fund sales
- Valuation issues

What Kind of Charts?



Conflict	Category	Cross Group	Risk	Current Approach and Comment	Disclosure	Additional Mitigants
Personal Trading	E-C	Y	H	Code of Ethics Insider Trading Policy 17j-1 Procedure

Conflicts – Large v. 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

- **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

How Should We Collect, Analyze & Memorialize Assessments?



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



How Should We React?

- 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



How do We 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

How do We Assess Need or Utility for 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

Do We Need to Institutionalize the Conflicts Assessment Process?



- Conflicts policy?
- Standing conflicts officer or committee?
- Rotating assessment of business units and services?
- Education

Conflicts – Time Out



- What If . . .
 - Say you discover violations during the course of your investigation?
 - Immediately seek the advice of your counsel and address the matter promptly
 - Prompt corrective action
 - Review with management
 - Review with department managers
 - Set timeline to correct deficiencies
 - Revise policies and procedures, if necessary
 - Prompt action (30 – 60 days)
 - Follow-up report to management
 - Periodic follow-up reviews

Conflicts – Time Out



- What if . . .
 - You get a request from the SEC staff to have an “open and honest dialogue” on your conflict processes and assessments?
 - Should you take them up on the offer?

Conflicts – Time Out



- What if . . .
 - You find a material violation in the course of your assessment, should you “blow the whistle” on yourself?
 - “For if we find it on our own, I assure you that the consequences will be worse.” -- Stephen M. Cutler, Dir. SEC Div. of Enforcement
 - No self reporting obligation under the Advisers Act
 - Compare with Rule 17a-11(d) under the Exchange Act for broker-dealer records