

FIFTH ANNUAL

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IA Compliance SUMMIT

Managing Conflicts



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Managing Conflicts

- ① What is a Conflict?
- ② Categorizing Conflicts
- ③ Framework for Regulating Conflicts
- ④ Conflict Management Techniques
- ⑤ Form ADV Disclosure of Conflicts
- ⑥ Conflict Limiting Techniques
- ⑦ Three Steps to Conflict Management

True or False?

- *Conflicts seldom happen in the securities and investment management industries . . . current Wall Street scandals are isolated occurrences*
- *Conflicts arise only in brokerage firms -- not my company*
- *Conflicts shouldn't occur in the securities and investment management industries*
- *Conflicts are easy to manage*

Pervasive Conflicts

- Current scrutiny
 - Yesterday's Wall Street settlement regarding research analysts & IPO conflicts
 - State & Public Pension Fund *Investment Protection Principles*
 - Periodic disclosure of client relationships posing conflicts
 - Annual disclosure on how portfolio managers and analysts are compensated
 - Safeguards to ensure that adviser's decisions are not influenced by client relationships of financial service affiliates

Pervasive Conflicts

- Because of the abundance of conflicts, the industry has long had a heightened awareness of conflicts
- It has also been the most scrutinized and the most supervised for conflicts, both real and potential
- However, this has occurred in a piecemeal fashion – issue by issue, conflict by conflict – rather than thematically around the concept of conflicts

What is a Conflict?

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"Actually, I wear two hats."

What is a Conflict?

- A “conflict of interest” denotes a situation in which two or more interests are competing
- Conflicts are sometime described as the problem of “wearing two hats”
 - Frequently, the situation is more aptly described as “hydra hatted”
 - 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

Categorizing 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
 - Batching client trades
 - Sequence of client trades

Categorizing Conflicts

- Conflicts between Clients' and Adviser's Own Interests – Self-Dealing Conflicts
 - Soft dollars, including mixed use products and commitment to pay residual in hard dollars
 - Principal trading (§ 206(3))
 - Interests in securities (both as to investment and proxy voting)
 - Affiliate stock
 - Client stock
 - Managed mutual fund
 - Underwritings by an affiliate
 - Directorships in companies
 - Allocation of investment opportunities (e.g., IPOs)
 - Trade errors
 - Performance based fees
 - Fee differentials for proprietary and nonproprietary products
 - Double dipping
 - Proprietary and personal securities trading
 - Parallel trading and front running
 - Scalping
 - Receipt of transaction-based compensation
 - Use of brokerage for referrals and fund sales
 - Solicitation arrangements

Categorizing Conflicts

- Conflicts Between Client Obligations And Legal Requirements
 - Conflicts between obligation to use information in adviser's possession for benefit of client and any legal restrictions on use of confidential or material, nonpublic information
 - Conflict between obligation to enhance shareholder value and legal restrictions applicable to shareholder activism
- Conflicts Between Legal Requirements

Framework for Regulating Conflicts

- A century ago, the mere presence of a conflict was a reason to void a transaction
- This approach has been abandoned by a more flexible approach that focuses on principles of
 - Disclosure
 - Consent
 - Ultimate fairness
- Most of the SEC's requirements as they relate to conflicts are found under
 - § 206 – the general antifraud rule under the Investment Advisers Act of 1940 and Form ADV
 - § 17 of the Investment Company Act
 - § 10(b) of the Securities Exchange Act of 1934

Framework for Regulating Conflicts

- For retirement accounts, ERISA and the IRC add additional requirements
- ERISA § 406 & IRC § 4975(c) list a number of "prohibited transactions"
 - These are either transactions between a plan and a party-in-interest (PII) or specific conflict-of-interest transactions involving a fiduciary
 - Broad categories of prohibited transactions include:
 - Sales, exchanges or leases of property between a plan and a PII
 - Loans between a plan and a PII
 - Provision of goods, services or facilities between a plan and a PII
 - A transfer of plan assets to - or use by - a PII

Conflict Management Techniques

- Disclosure
 - Implied consent?
 - What level of detail?
 - Just what ADV asks?
 - Existence of conflict
 - Manner addressed
 - Where?
 - Form ADV
 - Separate document
 - Limitations
 - Disclosure generally cannot cure breach of duty of care
- Express 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
 - Advance
 - Generally best
 - Sometimes not practical or allowed
 - Situational
- Other Requirements in Special Circumstances
 - Regulatory limitations - vary by conflict
 - Exemptive relief (e.g., under the 1940 Act)

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
 - Item 12 - Investment or Brokerage Discretion
 - Item 13 - Additional Compensation
- Schedule H
- Proposed Form ADV Part 2

Conflict Limiting Techniques

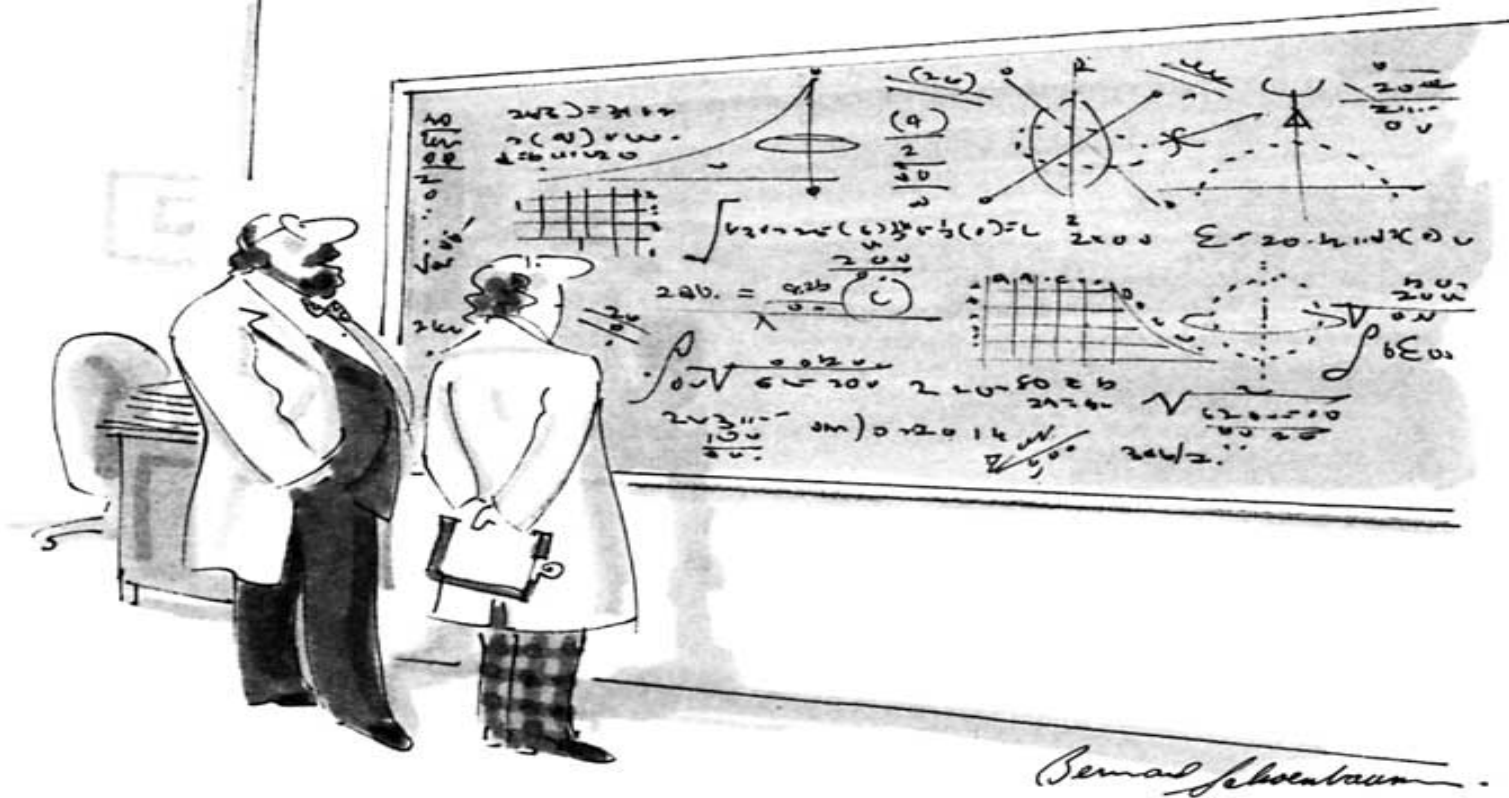
- Define your relationship around the conflict
- Separate internal groups having conflicting interests (e.g., Chinese Walls)
- Structure compensation to smooth out conflicts
 - Consider how compensation practices complicate or compliment your efforts on conflicts
 - 1995 Report of the Committee on Compensation Practices (*Tully Report*)
 - Disgorgement
- Disinterested or independent approval

Three Steps to Conflict Management

- ① Identify conflicts
 - Take an inventory
- ② Confront conflicts
 - Limit to the extent possible
 - Establish objective controls
 - Employ practices reasonably designed to achieve fairness
 - Assess disclosure, consent and other requirements
- ③ Monitor conflicts
 - Consider exception reporting
 - Focus on key relationships or interests

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"Oh, if only it were so simple."

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