

CONFLICTS MANAGEMENT

**Submitted by Ben A. Indek
Morgan, Lewis & Bockius LLP**

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I. INTRODUCTION¹

In 2003, Stephen Cutler, the then-U.S. Securities and Exchange Commission Director of the Division of Enforcement, gave a major speech regarding conflicts of interest. Noting that “conflicts of interest are inherent in the financial services business,” Mr. Cutler delivered a blunt challenge to the industry: “find the problems and correct them now. I call upon every financial services firm to undertake a top-to-bottom review of its business operations with the goal of addressing conflicts of interest of every kind.”² Since that time, firms and regulators have been keenly focused on identifying and remedying potential conflicts of interest. Indeed, in remarks made during a March 2010 SIFMA Compliance and Legal Society luncheon, Richard Ketchum, the CEO of FINRA, harkened back to Mr. Cutler’s 2003 speech and again emphasized the importance of institutionalizing the process for identifying and dealing with conflicts.

This outline describes various approaches to systematically addressing conflicts of interest and lists various potential conflicts that have recently been raised by firms, regulators and the media.

II. IDENTIFYING AND MANAGING CONFLICTS³

A. Systematic Approach to Assess Conflicts

1. Framework to identify, assess, monitor and control conflicts
2. Alternatives:
 - a. Top-down, organization-wide, theme-based assessment
 - b. To complement regular and *ad hoc* assessments

B. Working Definition of a Conflict

1. Any activity or relationship in which a broker-dealer’s or its employees’ interests compete with the interests of its clients; or in which the interests of one set of clients may be adverse or different than another set of clients
2. Conflicts are sometime described as the problem of “wearing two hats”
3. Self interest is always one of the elements in a conflict, and self interest may clash with fiduciary or legal obligations
4. Conflicts may involve divided loyalty as well as self-dealing

¹ This outline solely represents the views of its author, Ben A. Indek.

² Stephen M. Cutler, Remarks before the National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference, September 9, 2003.

³ This section of the outline was drawn from the outstanding work of John V. Ayanian and Patricia Harrison (with assistance from Katy Courtney) contained in their outline entitled “Conflicts of Interest (Small Firms)” presented at the 2009 National Society of Compliance Professionals National Meeting in October 2009.

5. Suggestion: “Follow the Money”

C. Assessment Process

1. Define the mandate and scope of your assessment
 - a. Should this best be done on a top-down, business-unit basis or other basis?
 - b. Should the assessment focus on all business units or just ones believed to pose significant conflict issues?
2. How frequently should such an assessment recur?
3. Should you employ outside consultants or counsel to assist?
4. Develop a conflicts checklist
5. Perform interviews
6. Collect, analyze and memorialize findings
7. Make any needed changes designed to eliminate, mitigate or address conflicts

D. Developing a Checklist

1. Develop a comprehensive checklist making a list of areas that need to be addressed for possible conflicts. For this analysis include:
 - a. Organizational chart – by entities and personnel
 - b. Affiliates – affiliated transactions
 - c. Products and services
 - d. Clients and fee relationships
 - e. Distribution practices

E. Collect, Analyze and Memorialize Assessment

1. Written report
 - a. Advantages
 - b. Disadvantages
2. Confidentiality/ Privilege issues

- a. What information is privileged?
 - b. Protecting the privilege
- F. Make Needed Changes
- 1. Make any needed changes designed to eliminate, mitigate or address conflicts
 - a. Limit conflicts
 - b. Assess disclosure requirements
 - c. Monitor conflicts
 - d. Consider how you should institutionalize the conflicts assessment process
 - 2. Limit Conflicts
 - a. Separate internal groups having conflicting interests
 - b. Structure compensation to smooth out conflicts
 - c. Consider how compensation practices complicate or compliment your efforts on conflicts
- G. Assess Disclosure Requirements
- 1. How to Disclose
 - a. In writing?
 - b. What level of detail?
 - 2. Where?
 - a. Client agreements
 - b. Fund offering documents
 - c. Client mailing
 - d. Actual delivery
 - e. Maintain evidence of delivery
 - 3. When to disclose

- a. In advance
 - b. Situational disclosure – point of sale
- 4. Limits of Disclosure
 - a. Will disclosure cure a conflict that is ultimately unfair?
 - b. More required with sales to seniors?
 - c. Can disclosure cure breach of duty?
- H. Monitor Conflicts
 - 1. Consider exception reporting
 - 2. Focus on
 - a. Key relationships or interests
 - b. New products and services
 - c. Proprietary trading
 - d. Informational barriers
 - e. Differential compensation
- I. Consider How to Institutionalize the Conflict Assessment Process
 - 1. Standing conflicts officer or committee?
 - 2. Rotating assessment of business units and services?
- J. Discovery of Conflicts
 - 1. If you discover conflicts during the course of your assessment
 - a. Immediately seek the advice of counsel and address the matter promptly
 - b. Review with management
 - c. Review with department managers
 - d. Set timeline to correct deficiencies
 - e. Take prompt corrective action
 - f. Revise policies and procedures, if necessary

- g. Follow-up report to management
 - h. Review periodic follow-up reports
2. Should you self-report to the regulator?

III. AREAS OF CURRENT SCRUTINY

The following kinds of potential conflicts have recently received firm, regulatory or media attention.

- A. Enhancements/inducements to compensation of registered representatives (*see* August 2009 Letter to Broker-Dealer CCOs from Mary Schapiro)
- B. Staple financing (*see* recent media reports)
- C. Selective disclosure to certain investors over others (*see* SEC settlement with State Street Bank and Trust Company, February 2010)
- D. Fixed income price transparency (*see* recent FINRA efforts to expand TRACE reporting)
- E. Fixed income research/desk analyst activities (*see* March 2010 remarks of Richard Ketchum at FINRA’s Fixed Income Conference)
- F. So-called “research huddles” (*see* recent media reports)
- G. Securities lending arrangements with retail clients (*see* FINRA examination priorities letter dated March 1, 2010)
- H. Information barriers (*see* FINRA targeted examination letter regarding this topic, January 2008)
- I. Inventory and collateral evaluation practices (*see* FINRA examination priorities letter dated March 1, 2010)
- J. Creation and sale of complex structured products (*see* recent media reports)
- K. Fee differentials for proprietary and nonproprietary products and within products (*see, e.g.,* FINRA enforcement actions involving Class B and C mutual fund shares)
- L. Fairness opinions (*see* 2007 FINRA Rules)
- M. Retention and payments to pension consultants (*see* media reports and recent enforcement actions)
- N. Flash orders and dark pools (*see* media reports and regulatory announcements)