



Morgan Lewis

CONFLICTS OF INTEREST

SEC STAFF TRAINING

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Overview

- What is a Conflict?
- Regulatory Focus on Conflicts
- Framework for Addressing Conflicts

What is a Conflict?

- Any activity or relationship that results in competing or conflicting interests
 - Competing interests that may incline an adviser – consciously or unconsciously – to render advice that is not disinterested
 - In other words, any situation that threatens the objectivity of the advice provided to the client
- Conflicts may involve self-dealing as well as divided loyalty
 - Conflicts between the adviser's interests and those of its clients
 - Conflicts among the interests of different clients
- Adviser or its affiliates acting in multiple roles with respect to a client or transaction (adviser, broker, lender, principal counterparty, derivative counterparty, index provider)

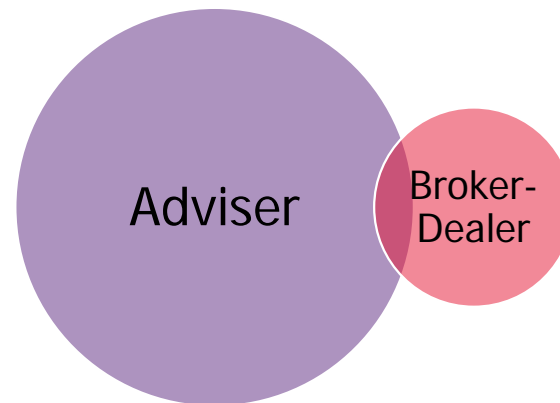
What is a Conflict?

- Allocation of investment opportunities (among clients and to proprietary accounts)
- Performance fees and side-by-side management
- Trade sequencing
- Principal trading
- Personal securities trading
- Selective dissemination of holdings
- Use of brokerage for soft dollars, client referrals and other benefits
- Valuation
- Related-party transactions
- Fee and expense allocations
- Preferential fund rights
- Outside business activities
- Pay-to-play
- Gifts and entertainment

What is a Conflict?

- Dual Registrant or Affiliated Broker-Dealer Model
 - Incentives to use affiliated broker and impact on best execution
 - Receipt of transaction-based compensation
 - Differential compensation
 - Appropriateness of an advisory vs. brokerage relationship

Affiliated Broker-Dealer Model



Dual Registrant Model



Regulatory Focus on Conflicts

“In nearly every ongoing matter in the Asset Management Unit, we are examining, at least in part, whether the adviser in question has discharged its fiduciary obligation to identify its conflicts of interest and either (1) eliminate them, or (2) mitigate them and disclose their existence to boards or investors.”

- Julie M. Riewe, Co-Chief, Asset Management Unit
(Feb. 26, 2015)



Regulatory Focus on Conflicts

- Cutler Challenge 2003*
 - “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.”
- FINRA Targeted Examination Letter on Conflicts (July 2012)
 - “[W]e would like your firm to present on . . . the most significant conflicts your firm is currently managing and the processes in place to identify and assess whether business practices put your firm’s – or your employee’s – interests ahead of those of your customers.”
- FSA Report on Conflicts of Interest (November 2012)
 - “The review was prompted by evidence from our other supervisory work that some firms no longer saw conflicts of interest as a key source of potential detriment to their customers and had relaxed controls that we had considered to be well-established market norms.”

* Remarks Before The National Regulatory Services Investment Adviser and Broker-Dealer Compliance/Risk Management Conference, Stephen M. Cutler, Sept. 9, 2003.

Regulatory Focus on Conflicts

- OCIE Examination Priorities for 2013 (February 2013)
 - Conflicts of interest are a key part of OCIE's risk-based examination strategy. OCIE will focus on specific conflicts of interest, steps registrants have taken to mitigate conflicts, and the sufficiency of disclosures made to investors. The staff will also look at the overall risk governance framework that firms have in place to manage conflicts on an ongoing basis.
- Duties of Brokers, Dealers, and Investment Advisers, Advisers Act Release 3558 (March 2013)
 - In connection with Dodd-Frank Act, Section 913 Study, the staff requests data on the nature of broker-dealer or investment adviser conflicts of interest and the benefits and costs of these conflicts to retail customers, as well as actions to eliminate, mitigate, or disclose conflicts of interest.

Regulatory Focus on Conflicts

- FINRA Report on Conflicts of Interest (October 2013)
 - “FINRA expects firms to consider the practices presented in this report, and to implement a strong conflict management framework. If firms do not make adequate progress on conflicts management, FINRA will evaluate whether rulemaking to require reasonable policies to identify, manage and mitigate conflicts would enhance investor protection.”
- OCIE Examination Priorities for 2014 (January 2014)
 - OCIE will continue to meet with senior management and boards of entities registered with the SEC, including their affiliates where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. This initiative is designed to: (i) evaluate firms’ control environment and “tone at the top,” (ii) understand firms’ approach to conflict and risk management, and (iii) initiate a dialogue on key risks and regulatory requirements.
- Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View, Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement (Feb. 26, 2015)

Framework for Addressing Conflicts

Firm Culture and “Tone at the Top”

Conflicts
Management
Policies

Conflicts
Management
Processes

Disclosure

Training and Education

Framework for Addressing Conflicts

Firm Culture and “Tone from the Top”

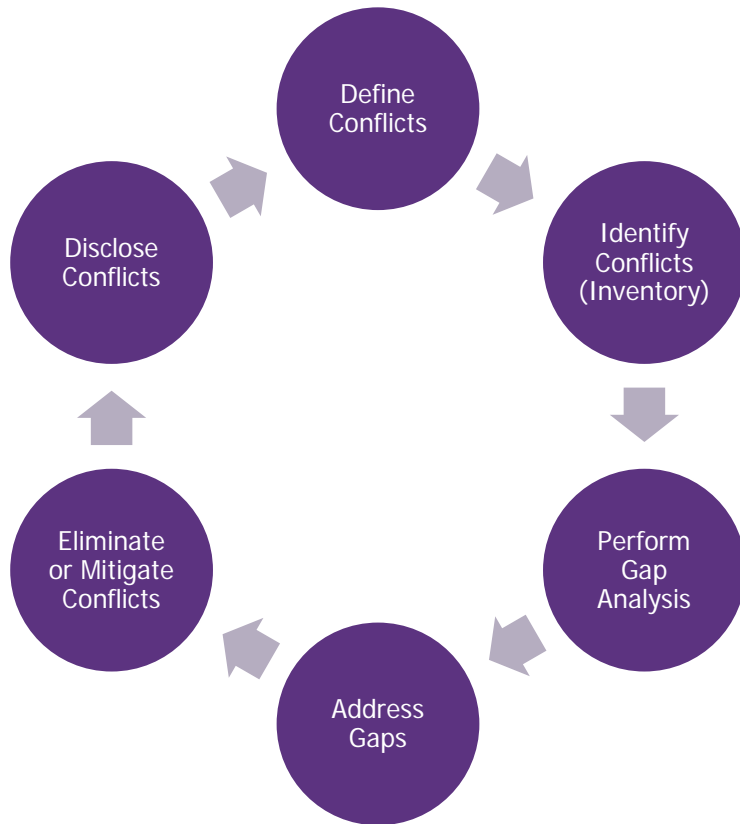
- Focus on interests of clients and fair handling of conflicts
- Integration of conflicts process into firm’s overall risk governance structure and key business processes
- Willingness to avoid severe conflicts
- Consequences for failing to respect conflicts

Conflicts Management Policies and Process

- Code of conduct or enterprise-level conflict policy (documentation)
- Conflicts inventory reviews
 - Regular, ongoing processes and periodic reviews to identify and create an inventory of conflicts
- Escalation procedures
- Monitoring and assessment processes
 - Risk control self-assessments, internal audit reviews
 - Evaluate the effectiveness of the conflicts management process

Framework for Addressing Conflicts

Conflicts Inventory



Questions to Consider

- Nature of the conflict?
- Type and frequency of activities posing conflict?
- Business units affected?
- Existing policy or procedure governing the conflict?
- Is the conflict disclosed? Where?
- Actions taken to mitigate conflicts and their effectiveness?
- Risk level?

Framework for Addressing Conflicts

Disclosure of Conflicts

- Form ADV
- Advisory agreements
- Fund offering documents
- “Relationship” brochures
- Website disclosure
- Responses to client inquiries

Limits of Disclosure

- Consent must be informed
- Disclosure is not enough for retirement accounts (accounts subject to ERISA and IRC 4975)
- Disclosure generally does not cure a breach of the duty of care
- Disclosure may not cure a conflict that is ultimately unfair

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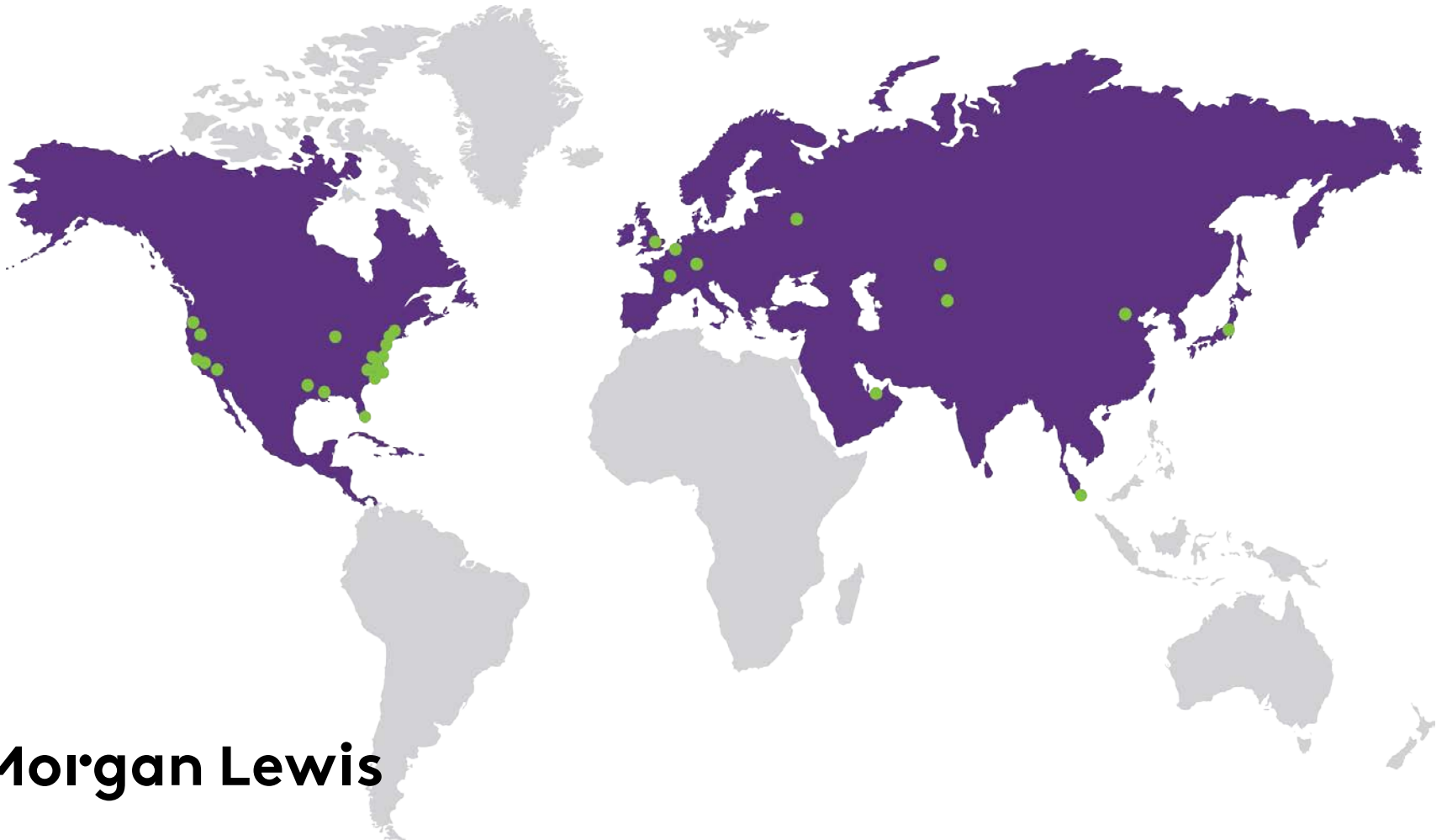
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