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Conflicts of Interest Facing Investment Advisers

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Conflicts of Interest Facing Investment Advisers

- Goal: “Systematic Approach” to Conflicts
- Ties into Overall Firm Risk Audit Process
- Working Definition of “Conflict of Interest”
- Identification of Conflicts of Interest
 - Development of a Checklist
 - Interviews
- Review of Policies and Procedures
- Disclosure

Current Scrutiny

“Firms that ignore conflicts of interest do so at their peril...” “You cannot hide under the shade of ‘standard industry practice’”.

-- Annette L. Nazareth, Dir. SEC Div. Market Reg.

“Shed the blinders of ‘industry practice’ that may have made it possible for you not to see the conflicts that surround you daily. Just because the industry has always done something ‘that way’, don’t assume it’s acceptable.”

“But in case your thinking is not sufficiently long-term oriented, there’s another reason why you should be thinking hard about conflicts of interest these days: the SEC and the entire regulatory community are doing so.”

-- Stephen M. Cutler, Dir. SEC Div. of Enforcement

Current Scrutiny

“For the securities industry ... it should be clear that we are in a new era, with higher standards and enhanced scrutiny... There are and will be new bright line rules to be observed. ...

Every firm needs to conduct a fundamental assessment of its obligations to its customers. These assessments must be done at the highest levels, and senior management and the board should be ready to issue directives - or codes of ethics - about precisely what it means to put the customer first.

They must identify, eliminate, manage and/or disclose the conflicts of interest between their firms and their customers.

Moreover, there must be a commitment to giving these ideas teeth - meaning that those who stand in violation should face swift and severe punishment.”

-- SEC Chairman William H. Donaldson

Current Scrutiny

- The new “directed brokerage” (brokerage for to pay for referrals)
- Shelf space payments
- Mutual fund late trading and market timing
- Proxy voting
- Selective disclosure of portfolio holdings
- Side-by-side management of hedge funds and other client accounts
- Personal securities trading
- Wall Street settlement regarding research analysts & IPO conflicts
- State & Public Pension Fund *Investment Protection Principles*

SEC Final Compliance Rule 12/03

- “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.”

01/04 Conflicts Inquiries

- Whether the firm has conducted an assessment of conflicts of interest in its functions and activities during the last year;
- If the firm has conducted such an assessment, please 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, please describe whether an assessment is planned, or other ways that the firm identifies and addresses conflicts of interest.



Goal: Systemic Approach to Conflicts

- Framework to identify, assess, monitor and control conflicts
- Limits of piecemeal approaches
- SEC mandate:
 - Top-down, organization-wide, theme-based assessment
 - To complement regular and ad hoc assessments

Working Definition of 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”

Assessment Process

- 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 a conflicts checklist
- Perform interviews
- Collect, analyze and memorialize findings
- Make any needed changes designed to eliminate, mitigate or address conflicts

Developing a Checklist

- Where to start?
 - Develop a comprehensive checklist
 - Items to include:
 - Organizational chart – by entities and personnel
 - Affiliates – Affiliated transactions
 - Products and services
 - Clients and fee relationships
 - Distribution practices

Developing a Checklist

- 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

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

Collect, Analyze & Memorialize Assessment

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

Make Needed Changes

- 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

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 compliment your efforts on conflicts

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

Assess Consent Requirements

- 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

Monitor Conflicts

- Consider exception reporting
- Focus on
 - Key relationships or interests
 - New products and services



Consider How You Should Institutionalize the Conflicts Assessment Process

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

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



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