Guidance on Conflicts of Interest for Investment Advisers

By Joshua Horn and Amit Shah

I. Introduction

Conflicts of interest arise in any fiduciary relationship, and perhaps no more so than in the financial services industry. In October 2013, FINRA released a report on conflicts of interest in the retail broker-dealer context.[1] The report focused on identifying and managing conflicts in a firm's three critical areas: (1) enterprise level frameworks to identify and manage conflicts; (2) approaches to handling conflicts of interest; and (3) compensation for associated persons.[2] The report provides retail broker-dealers with summaries of how the industry manages and mitigates conflicts of interest. While FINRA has no authority over investment advisers, the conflicts that arise in retail broker-dealer context are substantially similar to the conflicts that arise for investment advisers.

Whether analyzing corporate, political or personal conflicts, one can usually find conflicts by using the familiar adage of "follow the money." Because investment advisers provide financial services and advice, there should be no surprise that conflicts in that industry can and do arise frequently. The nature of the conflicts that can arise for investment advisers can be divided into the following categories:

- investment advisory firm v. client;
- client v. client;
- employee v. client;
- employee v. investment advisory firm; and
- vendor v. client.

This article will focus on generally explaining the potential conflicts and providing recommendations on how investment advisers can manage conflicts. While different types of conflicts may necessitate different practices and policies, investment advisers should understand that they are fiduciaries under the law.[3] The fiduciary relationship requires a heightened level of responsibility and any policies and practices recommended by FINRA or adopted by retail broker-dealers should be viewed as the floor and not the ceiling when it comes to addressing and mitigating conflicts for investment advisers.

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II. Firm Culture and Procedures

All investment advisers face conflicts of interest which are inherent in the business. Recognizing conflicts and taking appropriate measures to address them must start at the very top of the organization. The top down approach, where senior management emphasizes the importance of ethical treatment of customers and recognition and resolution of conflicts, is necessary to properly address conflicts and comply with the adviser's fiduciary responsibilities. In this culture of compliance, conflicts should be addressed through proactive decision-making using established written policies, and not on an ad hoc basis, which often occurs when senior management is not actively engaged in addressing and dealing with conflicts. While written policies and procedures are extremely important and serve as a guide in addressing conflicts, the investment advisory firm's culture – set through senior management – is paramount in dealing with conflicts. If senior management leads, the others will follow.[4]

The size of an investment adviser firm will generally dictate the best way to establish a culture of compliance for the treatment of conflicts. In a small investment advisory firm, a sufficient top down approach could be the principal setting forth an ethical tone, along with implementing supervisory procedures and an appropriate compensation structure. By contrast, large investment advisory firms may require detailed written policies and procedures, one or more employees responsible for managing and evaluating conflicts as they arise, and routine in-house training. Further, given the size and complexity of large advisory firms, sophisticated information technology systems may be necessary to notify the firm of conflicts to proactively address them. Mid-sized investment advisers may use a combination of methods used by small and large investment advisers to manage their conflicts.

According to FINRA, many retail broker-dealers use a distributed model to address conflict management where identification and oversight of conflicts is spread within the firm and conflicts are handled by different senior level committees or persons.[5] By contrast, other firms use a centralized approach where a "conflicts department" handles all conflicts.[6] Similar to retail broker-dealers, an investment advisory firm could use either approach to manage conflicts. Deciding which approach to use will depend heavily on the size of the investment adviser, the nature of its business and the overhead required. For example, larger firms may have the luxury (and need) of hiring employees specifically to address conflicts. Smaller firms may require their employees to wear multiple hats and serve on an ad hoc conflicts committee.

It is important to note that the SEC does not require a complex conflict management system. Indeed, inflexible and complex systems that cannot easily be monitored, revised and adjusted could hinder an investment adviser's ability to appropriately manage conflicts. Instead of a complex, formalistic system, an investment adviser firm is only required to have established procedures and policies in place to identify and manage conflicts. In other words, advisers need adequate and flexible protocols to address conflicts as they arise. The most important part of a conflict management system is preparing and distributing appropriate policies and procedures to all staff (from the top down) detailing the management of conflicts. However, while written procedures and policies are necessary, they alone are not sufficient. The investment advisory firm must also train employees on the written policies and then properly and consistently implement them. The lack of sufficient and routine training sends a message to the employees that conflict management is not a priority of senior management; it could also lead to haphazard conflict management.

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Further, the investment advisory firm must be open and honest about conflicts. Conflicts could result in loss of business, which not only affects the investment adviser as a whole, but affects employee compensation. This structure creates a conflict within a conflict – where the employee charged with analyzing conflicts has a conflict because of its effect on his/her compensation, as well as how the employee is compensated (i.e. salary, commission or a combination). A strong culture with zero tolerance for hiding conflicts is the best way to avoid this all too common pitfall.

While senior management may view a conflict management system as a necessary cost, it can also be an asset and marketing tool. Many investment adviser customers are sophisticated

and completely aware of the possibility of conflicts. An appropriate conflicts management system can be a potential selling point to customers who may be wary of adviser conflicts. To that end, the SEC requires registered investment advisers to provide the Form ADV Part 2A on a yearly basis to each customer.[7] Form ADV Part 2A requires investment advisers to describe, among other things, the advisory firm and its principals, explain the advisory services offered, explain the fee and compensation structure, identify the amount of customer assets managed on a discretionary basis, disclose information on performance based fees, identify the types of customers the investment adviser provides services, describe disciplinary information (including criminal, civil and regulatory) that would be material to a client's evaluation, identify and describe financial industry activities and affiliations, describe how often the investment adviser reviews client accounts and financial plans and whether a person who is not a customer provides economic benefit to the investment adviser.[8] In other words, Form ADV Part 2A is a conflict disclosure tool: it contains questions that require the disclosure of "conflict" type information. For example, item 5 on Form ADV Part 2A requires the adviser to disclose its fee and compensation structure.[9] Further, item 6 requires the adviser to disclose any performance based fees and item 10 requires the disclosure of any other financial industry activities and affiliations.[10]

While the disclosures on Form ADV Part 2A are required, there is no reason an investment adviser cannot voluntarily provide additional disclosures regarding conflicts (i.e., when a customer is buying or selling securities out of the firm's own inventory of securities) that it finds necessary. Further, because investment advisory firms are fiduciaries, any additional information could only help the adviser in procuring and retaining potential clients while, at the same time, upholding the fiduciary duty to its clients.

III. Investment Advisory Firm v. Client Conflicts

Conflicts between the investment advisory firm and its client are usually the most common and well known ones. The conflicts often arise when an investment adviser offers or recommends a product for which the investment adviser receives greater compensation than other products, or that may not be suitable for the customer. Conflicts can also arise when the firm performs multiple roles with respect to a client or transaction or when the adviser engages in business and trading activities while other clients are active in relevant markets at the same time. Finally, conflicts arise where the investment adviser may recommend or sell products that it or affiliated companies issue.

Many of these conflicts can be communicated to clients by accurately disclosing the potential conflicts on Form ADV Part 2A. However, as fiduciaries, investment advisers should not merely rely on required regulatory forms to disclose conflicts. To the contrary, investment advisers should, at the minimum, consider implementing the following procedures:

- the investment adviser should have procedures that immediately notify the specific employee involved and appropriate conflicts personnel of the potential conflicts;
- the appropriate personnel should review and analyze the potential conflict to determine whether the investment adviser can execute the specific trade or provide other services to the client; and
- if the investment adviser decides that it can proceed even though there is a conflict, the investment adviser should immediately notify the client of the conflict.

Importantly, merely notifying the client of the conflict does not, standing alone, satisfy an adviser's fiduciary responsibilities. To the contrary, certain conflicts should result in the investment adviser deciding not to provide the advice or retain the client. For example, certain advisers that focus on short term or aggressive trading strategy should not provide advice to clients that have income only needs. Further, an adviser may inform the client to go long on a particular position when the advisory firm is shorting the position at the same time. Notwithstanding the client's understanding of the conflict, an adviser must always make investment recommendations consistent with its fiduciary duty.

IV. Client v. Client Conflicts

Conflicts between clients present unique challenges for investment advisory firms. The conflicts most often arise when multiple clients are interested in acquiring the same company or assets. In such situations, the adviser may need to choose which clients can receive the product. It is easy for an investment adviser to favor the larger client, but an adviser must avoid resolving conflicts on the basis of the benefits to itself. The conflicts should be managed by the investment adviser by disclosing the conflict to the clients and conducting a thorough analysis of which clients the product is

most suitable. By relying on an independent measure of the investment propriety, the investment adviser can avoid any question as to which client should have received the product. The investment adviser can also seek to resolve the conflict by making a full disclosure and obtaining the customer's written acknowledge of the conflict. Often times, this may be the most difficult approach, but also the best. Like the example given above, an adviser may think that her client should go long on a security, but the firm is shorting the stock. That scenario could present an awkward and difficult situation for the adviser disclosing the conflict and obtaining client acknowledgement.

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Conflicts also arise when the investment adviser charges clients different fees for the same investment strategy. While this is common practice, investment advisers should have written policies setting forth a clear fee policy. There is no doubt that financial services firms can charge different fees to different clients, but grossly different fees for substantially similar clients can raise a question as to whether an adviser is complying with its fiduciary responsibilities. Clearly defined guidelines that are consistently applied and that are communicated to clients prior to entering into a fee arrangement will avoid any question as to the investment adviser's duties. Any deviation from these policies should only be permitted with the consent of proper management personnel.

V. Employee v. Client Conflicts

Conflicts between an individual employee and clients typically arise when an employee's compensation arrangement or incentives affect whether the employee recommends or offers a particular product. Form ADV Part 2A requires an investment adviser to disclose the compensation structure of its employees. As stated above, however, the investment adviser should not rely solely on regulatory forms that are distributed once a year to discuss conflicts with clients. To the contrary, the best practice is for employees and investment advisers to disclose the conflicts at the time the employee makes a recommendation or trade. For investment advisers with sophisticated information technology systems, the notifications could be sent automatically, either on a routine basis or when a specific trade is made. For investment advisers that do not have such sophisticated systems, employees should be educated on and familiar with the investment adviser's compensation structure and notify clients when the conflict arises. By way of example, the adviser may receive extra compensation if she sells a firm/affiliate firm proprietary product. In that scenario, the customer should be told that the adviser has such an interest so the client can make an informed decision.

In addition, employee/client conflicts can arise when an employee is engaged in outside business activities. The SEC requires investment advisers to maintain records of employees' outside business activities. Employees can avoid potential conflicts by notifying clients of any relevant outside business activities, particularly any associated with an investment recommendation. Investment advisers and their firms should also have systems in place to monitor when an employee makes a trade in securities where the employee is also engaged in outside business activities with the issuer of the securities. For larger investment advisory firms, information technology systems can notify appropriate personnel that the trades are occurring. For investment advisory firms without sophisticated information technology systems, the adviser should engage in additional and frequent training of employees. In addition, the firm should conduct frequent manual surveillance of its advisors to determine if the adviser is engaged in some outside business activity that should have been disclosed to the firm. The use of this type of surveillance is important because it can demonstrate if the adviser is living beyond her means based upon firm compensation, which can help the firm uncover possible insider trading or Ponzi schemes engaged in or conducted by its employees.

VI. Employee v. Investment Advisory Firm Conflicts

While the most common conflicts relate to the investment advisory firm's relationship with clients, conflicts arise between employees and their firms when an employee competes with the investment adviser for purchase or sale of property, assets and services. Investment advisory firms can establish their

own policies on how to manage these conflicts. To minimize any misunderstandings, investment advisory firms should inform and provide employees with specific written policies and practices on these conflicts and their management.

VII. Vendor v. Client Conflicts

Vendor versus client conflicts arise when third party vendors retained by the investment adviser misuse or fail to protect confidential client information. Although investment advisory firms can enter into indemnity agreements with vendors to protect themselves from liability, investment advisers have independent fiduciary duties that require them to take some measures to manage client confidences. At a minimum, prior to retaining a third party vendor, investment advisers should research the vendor's experience in handling confidential information and whether the vendor has previously misused or failed to protect client confidential information. Further, investment advisers should inform vendors of the vendor's obligations to have policies and practices in place to protect and avoid misuse of client confidential information.

VIII. Conclusion

Investment advisers have a fiduciary obligation to their clients and responsibilities to their employees to manage conflicts of interests, which must be managed from the top down in a culture of compliance. Investment advisers should be aware that merely complying with regulatory requirements could still expose them and their employees to liability for conflicts. Investment advisory firms should have thorough, written and well defined plans to manage conflicts. The way one investment adviser manages conflicts may not necessarily work for other investment advisers. Each investment adviser should establish guidelines, principles and policies that are appropriate for the investment adviser's business model and clients and apply them consistently. Advisers should at least have a process to identify conflicts and inform the appropriate firm personnel when they arise. Further, investment advisers should err on the side of informing clients about potential conflicts.

ENDNOTES

1 FINRA Report on Conflicts of Interest ("FINRA's Report"), p. 1, http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.
2 *Id*.
3 SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).
4 FINRA's Report, pp. 6-7.
5 *Id*. at p. 7.
6 *Id*.
7 Form ADV Uniform Application for Investment Adviser Registration, p .6, http://www.sec.gov/about/forms/formadv-part2.pdf.
8 *Id*. at pp. 6-13.
9 *Id*. at p. 3.
10 *Id*. at p. 5.