



**Risk Management Update  
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**IDENTIFYING CONFLICTS OF INTEREST FOR BROKER-DEALERS**

The Financial Industry Regulatory Authority (“FINRA”) recently published a Report on Conflicts of Interest (hereinafter, the “Report”)<sup>1</sup> wherein FINRA reviewed the conflicts management practices of several large firms in order to better understand how the industry is identifying and managing conflicts of interest in their practice. A conflict of interest can arise when, in any relationship, there exists a duty of care or trust between two or more parties. Conflicts occur frequently in the financial services industry, but it is the way in which a conflict is identified and then managed that is of importance.

**Conflicts Regulation in the U.S.**

FINRA and the Securities and Exchange Commission (“SEC”) have implemented several rules which require disclosure for certain trading activity and which prohibit certain activity in order to manage conflicts of interest. Section 15(c)<sup>2</sup> of the Securities Exchange Act of 1934 (the “Act”) “prohibits a broker from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by any means of any manipulative, deceptive, or other fraudulent device or contrivance.” Rules 15c1-5<sup>3</sup> and 15c1-6<sup>4</sup> of the Act require disclosure to a customer if a broker-dealer has any control, affiliation, or interest in a security it is offering or in the issuer of the security. It is important to be aware of those rules and regulations governing disclosure of conflicts of interest. FINRA has summarized some of the most common disclosure requirements in its Report.<sup>5</sup>

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<sup>1</sup> Available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>.

<sup>2</sup> Available at <http://www.sec.gov/about/laws/sea34.pdf>.

<sup>3</sup> § 240.15c1-5 - Disclosure of control. The term *manipulative, deceptive, or other fraudulent device or contrivance*, as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker, dealer or municipal securities dealer controlled by, controlling, or under common control with, the issuer of any security, designed to effect with or for the account of a customer any transaction in, or to induce the purchase or sale by such customer of, such security unless such broker, dealer or municipal securities dealer, before entering into any contract with or for such customer for the purchase or sale of such security, discloses to such customer the existence of such control, and unless such disclosure, if not made in writing, is supplemented by the giving or sending of written disclosure at or before the completion of the transaction. [41 FR 22825, June 7, 1976].

<sup>4</sup> § 240.15c1-6 - Disclosure of interest in distribution. The term *manipulative, deceptive, or other fraudulent device or contrivance*, as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker who is acting for a customer or for both such customer and some other person, or of any dealer or municipal securities dealer who receives or has promise of receiving a fee from a customer for advising such customer with respect to securities, designed to effect with or for the account of such customer any transaction in, or to induce the purchase or sale by such customer of, any security in the primary or secondary distribution of which such broker, dealer or municipal securities dealer is participating or is otherwise financially interested unless such broker, dealer or municipal securities dealer, at or before the completion of each such transaction gives or sends to such customer written notification of the existence of such participation or interest. [41 FR 22826, June 7, 1976].

<sup>5</sup> *Id.*

## **Types of Conflicts of Interest**

The most significant conflicts arising in the financial industry are General Conflicts, Supervision and Compliance Conflicts and Research-related Conflicts. Conflicts also commonly arise in banking and capital markets as well as in the retail/private wealth. Below we have highlighted some of the most common conflicts within each of these categories. Additional examples may be found in the Report.<sup>6</sup>

**General Conflict** – A general conflict typically exists when an employee engages in a business activity outside of the firm for compensation. For instance, assume John is a new employee of XYZ Investment Management where he is operating as an investment adviser representative while he is a registered representative of a broker-dealer. This could definitely pose a conflict of interest. As John may make recommendations to the other entity based on the compensation he may receive. In addition, the number of hours John may work at the adviser could interfere with and impact the amount of time he can devote to broker-dealer activities. Full disclosure of this conflict must be made to the client such as in the representatives Form U4 and Form ADV Part 2B as well as in the advisory firm’s disclosure brochure.

**Supervision and Compliance Conflict** – A supervision and compliance conflict could occur if supervisory or compliance staff is pressured from the sales management team to protect certain revenue generating financial advisers who have circumvented the firm’s compliance program and violated firm policies. For instance, assume John failed to report certain personal trading transactions. When compliance recommends imposing remedial measures, management asks the compliance team to give him some wiggle room and not execute such measures.

**Research-related Conflict** – A research-related conflict could occur if research is disseminated at different times, thereby favoring one customer over another. For example: ABC Brokerage Firm maintains a dedicated research department that issues “sell-side” research. One of the department’s research analysts create a report downgrading a stock, which gets simultaneously issued internally and only to certain customers, and then is disseminated to all remaining customers at a later date. The customers receiving the report at a later date are potentially disadvantaged since the other customers may have acted upon the report (*i.e.*, selling the stock due to the downgrade), which may have caused a depression in the stock price.

## **Avoiding Conflicts of Interest**

FINRA recognizes that there is no “one size fits all” approach to conflict management but there are ways for any firm to identify and avoid conflicts of interest. Two practices include the use of internal audit reviews and conducting a conflict inventory and risk control mitigation assessment. Ensuring these steps are a regular part of a firm’s compliance program will help both identify new conflicts of interest that may not have been known as well as manage known conflicts through disclosure.

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<sup>6</sup> *Id.*

Below are some examples of ways to avoid conflicts of interest when conducting business in the financial services industry.

- Define conflicts of interest in a way that is relevant to a firm's business and which helps staff identify conflict situations
- Articulate the employee's role and responsibility with respect to identifying and managing conflicts
- Establish mechanisms to identify conflicts in a firm's business as it evolves
- Define escalation procedures for conflicts of interest within and across business lines
- Disclose conflicts of interest to clients, taking into consideration the different needs and sophistication of retail and institutional clients
- Train staff to identify and manage conflicts in accordance with firm policies and procedures

### **The Importance of Disclosure**

A broker-dealer's obligation for disclosure depends on the nature of the relationship with the customer. To make disclosure truly effective, firms must look beyond the *minimum* requirements under statute, regulation and case law, and identify what practices are effective at helping customers make informed decisions. To be meaningful, the disclosure should help the customer to be fully informed and aware of the services being offered, the product that they are purchasing and those conflicts and conditions associated therewith.

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