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FINRA Publishes Report on Conflicts of Interest and Provides Guidance to Broker-Dealers about Managing and Mitigating Conflicts

AMY NATTERSON KROLL AND RUSSELL M. FECTEAU

The authors review the key issues in the conflicts of interest report published recently by the Financial Industry Regulatory Authority, Inc.

The Financial Industry Regulatory Authority, Inc., (“FINRA”) has published its “Report on Conflicts of Interest” (the “Report”) with the stated goal of assisting broker-dealers to effectively “[m]anage and mitigate conflicts of interest in their businesses.”¹ The Report captures the results of a targeted exam initiative that FINRA began in July 2012 to identify firms’ conflicts of interest practices.² As part of the exam, FINRA consulted with firms about their practices and identified three main areas of focus: enterprise-level conflicts; new businesses and new products conflicts; and compensation conflicts.³

Within each area discussed in the Report, FINRA described effective practices that it observed regarding conflicts of interest. Although recognizing

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that small firms may find the Report less applicable than large firms, FINRA explained that all firms, regardless of size, are expected to consider the practices outlined in the Report and “[i]mplement a strong conflict management framework.”⁴ Firms are cautioned that failure to make adequate progress on conflicts management could lead FINRA to consider new rules in this area.

GOVERNANCE FRAMEWORK FOR ENTERPRISE-LEVEL CONFLICTS

With respect to the governance framework for enterprise-level conflicts, FINRA identified the following effective practices to manage and mitigate conflicts at the enterprise-level:⁵

- An ethics and fairness based “tone from the top;”
- Articulated structures, policies, and processes to identify and manage conflicts;
- A willingness to avoid severe conflicts;
- Effective disclosure to clients;
- Hiring practices that rigorously review potential employees’ ethical, financial, and regulatory history;
- Training that focuses on ethical treatment of customers and enables staff to identify and manage conflicts; and
- An information technology infrastructure that supports conflicts management.

Tone from the Top and Conflict Management Structures

As a starting point, FINRA observed that the tone from the top should emphasize “[t]he importance of ethical decision making and fair treatment of customers.”⁶ To achieve these important goals, some firms use a distributed model where the business lines primarily have the conflict management responsibility. Other firms use a centralized model with a centralized conflicts office to identify and mitigate conflicts in partnership with the business lines.

FINRA noted, however, that the lack of a defined conflict management structure presents challenges to identifying and managing conflicts. At a minimum, therefore, firms should choose between implementing a distributed model and a centralized model as appropriate.

Conflict Management Policies, Processes and Disclosures

The conflict management structures also should be reinforced by firms' enterprise-level conflict policies, processes and disclosures. These policies should explain the objectives and rationale behind the conflict policy; provide general guidance to employees; identify the roles and responsibilities of the persons responsible for ensuring compliance with the policy; and clearly describe the escalation policy for resolving conflict concerns within the firm. Firms also can conduct ongoing (real-time) and periodic (retrospective) conflict inventory reviews. FINRA noted that no firm it surveyed used both methodologies, and firms should therefore consider implementing aspects of both types of reviews. In addition, firms should meaningfully disclose conflicts of interest to clients. One articulation of a meaningful disclosure is to ask whether an investor could "[l]egitimately say, 'I did not realize that could happen.'"⁷

Hiring Practices, Training and Information Technology

FINRA also stressed the importance of hiring ethical individuals, and expressed concern about hiring individuals with problematic disciplinary histories.⁸ Training employees to recognize conflicts and to make appropriate decisions and using information technology to identify, track, and manage conflicts also were viewed as effective practices. FINRA highlighted that conflict clearance and business selection are more "complex and nuanced;" and therefore, firms should consequently devote the appropriate resources to addressing this area.⁹

Conflicts Review for New Businesses and New Products

With respect to the conflicts review for new businesses and new products, FINRA identified the following effective practices to manage and mitigate conflicts in this area:¹⁰

- Include a mandate for new product review committees to identify and mitigate conflicts;
- Decline to offer new products where the conflict cannot be effectively mitigated;
- Differentiate product eligibility between institutional and retail clients;
- Implement strong know-your-distributor policies and processes as a product manufacturing firm;
- Conduct post-launch reviews of a product;
- Evaluate registered representatives' ability to understand a product, provide training, and limit registered representatives' access to certain products as appropriate;
- Clearly disclose product risks to customers; and
- Require written attestations that clients understand certain products and their risks.

Product Manufacturers

Product manufacturers should consider conflicts in the product review process. FINRA noted that in some firms, employees from various groups within the firm, such as information technology; operations; finance; legal; compliance and senior management participate in vetting the conflicts. Firms engaged in the process typically ask, “[I]s the firm prepared to introduce the new business and.... Will the new business adversely affect the firm’s broader business and reputation?”¹¹

Some firms develop new products at the distributor’s request, a process known as “reverse inquiry.”¹² Under such circumstances, among others, good know-your-distributor policies and procedures serve to identify and mitigate potential conflicts of interest. The policies and procedures in this area also should incorporate an effective due diligence and suitability analysis of the distributor and the product, respectively. Firms also should pay particular attention to identifying and mitigating conflicts associated with structured and complex products, as these products, in particular, present embedded conflict challenges of the sort that concerns FINRA.¹³

Product Distributors

Product distributors face many of the same conflict of interests that product manufacturers face, and therefore the mitigation remedies are similar. Like manufacturers, distributors should consider new product vetting structures that involve the participation of various groups in the firm. FINRA noted that some firms have new product review committees and departments that are separate from the business lines so they can evaluate the conflicts on a more independent basis. Revenue sharing agreements present another potential conflict, and the arrangements in such circumstances should be clearly disclosed to customers.

COMPENSATION CONFLICTS

With respect to the conflicts surrounding compensation incentives at firms, FINRA identified the following effective practices to manage and mitigate such conflicts:¹⁴

- Avoid compensation thresholds;
- Monitor activity of representatives approaching compensation thresholds if applicable;
- Implement neutral grids;
- Use fee-capping;
- Do not provide higher compensation or other rewards for the sale of proprietary or preferred provider products;
- Monitor the suitability of registered representatives' recommendations around key liquidity events; and
- Impose compensation penalties for employees who do not properly manage conflicts.

Compensation Grids

FINRA identified two basic approaches that firms use concerning compensation grids: payout by product type and neutral grids that pay flat percentages in a given product band.¹⁵ When calculating the payout percentages

under either approach, some firms elect to compensate registered representatives on a rolling basis, while other firms use retroactive adjustments to compensate the representatives. Firms also should consider procedures to monitor, among other things, whether customers are appropriately placed in either commission-based or fee-based accounts.

Supervision, Surveillance and Conflicts Management

FINRA specifically noted three effective practices concerning supervision and surveillance of compensation conflicts.

First, firms should consider linking their surveillance to representatives' achievement of certain compensation thresholds. FINRA, in fact, noted a concern about firms' limited ability to review representatives' recommendations and representations as they approach these compensation thresholds, which should be viewed as an area for firms to focus.

Second, firms should consider monitoring the suitability of recommendations for registered representatives who are close to entry into firm recognition programs.

Third, firms should implement surveillance as representatives approach certain milestones for bonus payments.

Compensation for Supervisory Staff and Deterrents to Poor Conflicts Management

The compensation that supervisory and branch management staff receives can create potential conflicts of interest. To mitigate those conflicts, firms can consider both quantitative measures (*e.g.*, branch revenue and growth) and qualitative measures (*e.g.*, staff development) in determining compensation. Some firms also factor in "negative control issues," such as customer complaints and fines when making compensation decisions.¹⁶ FINRA also noted that it is an effective practice to develop metrics for good and bad behavior, to measure individuals against those metrics, and to base compensation decisions on an individual's performance. Some firms also evaluate red flags in committees, and make determinations to reduce payouts where appropriate. Similarly, some firms use clawbacks to revoke some or all of an employee's compensation when warranted.¹⁷

CONCLUSION

FINRA expects all firms to consider the guidance contained in the Report and to make adjustments to their conflict management structures as appropriate. Firms are urged to look beyond legal requirements and to consider ethical models when implementing a conflicts framework. The import of these expectations is to strengthen the investing public's trust and confidence in the securities industry. FINRA cautions that failure to make the appropriate conflict management changes could result in rule-making to enhance investor protection.

NOTES

¹ Report on Conflicts of Interest at 1, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf> (the "Report") (last visited Oct. 24, 2013). *See also* Richard Ketchum's, FINRA's Chairman and CEO, communication to firms about the Report, issued the same day as the Report, available at <http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P359972> (last visited Oct. 24, 2013). On October 22, 2013, Mr. Ketchum also provided additional background about the Report via a video segment, available at <http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P369762> (last visited Oct. 24, 2013).

² Broker-dealers are subject to a regulatory framework concerning conflicts of interest in the United States and internationally, depending on the broker-dealer's business model. *See* Report, at 37-39 ("APPENDIX I - CONFLICTS REGULATION IN THE UNITED STATES AND SELECTED INTERNATIONAL JURISDICTIONS").

³ FINRA summarized significant conflicts of interest that broker-dealers identified in response to FINRA's targeted exam letter from July 2012. *See id.* at 40-42 ("APPENDIX II - TEXT OF FINRA LETTER TO FIRMS ANNOUNCING CONFLICTS REVIEW;" and "APPENDIX III - SUMMARY OF CONFLICTS IDENTIFIED BY FIRMS").

⁴ *Id.* at 2.

⁵ *Id.* at 5-6 ("Effective Practices Summary: Comprehensive Conflicts Governance Framework").

⁶ *Id.* at 6.

⁷ *Id.* at 13.

⁸ Report, at 14.

⁹ *Id.* at 16 -17.

¹⁰ *Id.* at 18 -19 (“Effective Practices Summary: New Product Conflicts Review”).

¹¹ *Id.* at 19.

¹² *Id.* at 20.

¹³ *Id.* at 21- 23.

¹⁴ Report, at 26 -27 (“Effective Practices Summary: Compensation and Oversight”).

¹⁵ *See id.* at 27, Table One (“Illustrative product neutral and non-neutral grid”).

¹⁶ *Id.* at 32.

¹⁷ In general, there are three types of clawbacks: performance based (performance of firm or unit), risk-based (imprudent risk or violates risk policies) and behavior based (employee misconduct). *See id.* at 35 -36.