News Bulletin

August 14, 2012

FINRA Commences Sweep Request Relating to Conflicts of Interest

In recent years, FINRA has frequently expressed concerns about conflicts of interest in the financial services industry. FINRA is now conducting a sweep of firms to review how firms identify and manage their conflicts of interest. FINRA sent its "Targeted Examination Letter" to a number of firms in July 2012, seeking information by September 14, 2012. The letter also requests a three-hour follow-up meeting during the fourth quarter of 2012 with the firms' executive business and compliance staff. FINRA's focus, according to the letter,[1] is the firms' approaches to conflict identification and mitigation. FINRA wants to know the most significant conflicts each firm is currently managing, and the processes the firms have in place to identify and assess whether their business practices put the firm's or its employees' interests ahead of those of its customers.

FINRA allays possible concerns about enforcement actions emerging from this letter (which apparently was not issued by the Department of Enforcement) by indicating that the goal of the sweep is to better understand industry practices and determine whether firms are taking reasonable steps to properly identify and manage conflicts that could affect their clients or the marketplace. FINRA indicates that it will seek to develop potential guidance for the industry. The unusual nature of the request, including the required three-hour meeting, makes it highly unlikely that FINRA would use the firms' responses as a basis for enforcement action. However, as with any FINRA request, each broker-dealer that receives the letter should take it seriously and make sure that the information it provides is complete and accurate, and provides a positive reflection of the firm's supervisory systems and procedures. And firms should still keep in mind that any time FINRA seeks information from a member firm, the regulator is free to commence informal or formal disciplinary action based upon that information.

The Request

The request seeks a summary of the most significant conflicts the firm is currently managing, as well as the identity of the departments and persons responsible for conducting that firm's conflicts reviews, the reports generated from those reviews, and the departments and persons who receive those reports. The sweep request does not define "conflicts" beyond the phrase "business practices that put the firm's or its employees' interests ahead of those of the customers." To understand the basis of FINRA's interest and what exactly it is looking for, we must look to other FINRA pronouncements.

[1] The letter is posted on FINRA's website at http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P141240

The Meaning of "Conflicts"

FINRA's most recent public pronouncement concerning conflicts comes from the top: at FINRA's annual conference in May 2012, CEO Rick Ketchum discussed FINRA's efforts, in connection with making its risk-based exam program more effective and less intrusive, to make sure that firms identify conflicts and place their customers' interests before the firm's interests. He also put the industry on notice that FINRA would seek focused conversations with firms about the conflicts they have identified and the steps they have taken to eliminate, mitigate, or disclose each of them. Ketchum identified three ways in which firms can identify those conflicts:

- do a better job of assessing and disclosing their conflicts, that is, whether a firm's business practices place that firm's or its employees' interests ahead of their customers;
- ensure that the products a firm sells—particularly complex products—are appropriate for each investor; and
- before any complex product is offered to a retail client, the financial adviser should be able to write down on a single page why this investment is in the best interests of the client.[2]

The need to put the customers' interests ahead of those of the firm should be familiar to any firm adapting to FINRA's new suitability rule, Rule 2111, which became effective on July 9 of this year. In a Regulatory Notice discussing the rule, FINRA explained that the new rule's suitability requirement prohibits a broker from placing his or her interests ahead of the customer's interests, a requirement that is not explicit in the rule, and that elevates the traditional suitability standard to take into consideration possible conflicts of interest.[3]

Further elaboration on the conflicts that have drawn FINRA's attention is contained in FINRA's Annual Examination Priorities Letters. Letters from recent years target the following conflicts:

- conflicts related to the sales and marketing of complex financial instruments;[4]
- conflicts of interest in the context of the creation and redemption process for ETFs, due to potential access by authorized participants or other key players to material information and the ability to interact directly with the ETF issuer;
- concern that the interaction of broker-dealers with non-member firms might pose conflicts of interest that might assist fraudulent schemes;
- conflicts of interest in the context of non-traded REITS—themselves the subject of a sweep letter—between the interests of investors and those of REIT managers;
- incentives in firms' hiring practices and compensation arrangements to engage in conduct contrary to the best interests of clients; and

[2] The speech is available at http://www.finra.org/newsroom/speeches/ketchum/p126481.
[3] FINRA Regulatory Notice 12-25 at 3.
[4] The January 31, 2012 letter refers at page 15 to "high profile civil suits against systemically important financial institutions" relating to proprietary undisclosed instruments in deals that they structured that directly conflict with the positions marketed and sold to their own clients. Presumably, this is a reference to the SEC's well-known cases involving structuring and sales of residential mortgage-backed securities.

- potential conflicts that can arise when a firm engages in a private placement to sell its own securities or those issued by an affiliate.[5]

FINRA's proactive approach to conflicts of interest can also be seen in its October 2010 Concept Proposal.[6] FINRA proposed a rule that would require a firm to provide to new customers a document that sets forth the firm's types of accounts and services, and the potential conflicts associated with those services. FINRA's proposal would require firms to disclose, among other things, financial and other incentives that a firm or its brokers have to recommend certain products, investment strategies, or services over similar ones; this would include any arrangement in which a broker receives different payouts for certain products or services.

Dodd-Frank's Emphasis on Conflicts

In enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress viewed the treatment of conflicts as fundamental to customer protection. For example, Title IX of the Act directs the SEC:

- to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest; and

- to promulgate rules prohibiting or restricting sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.[7]

Moreover, in connection with asset-backed securities, Section 621 of Dodd-Frank prohibits an underwriter, placement agent, and other parties involved in the sale of an asset-backed security from engaging in certain transactions that would involve a conflict of interest. And Title VII of Dodd-Frank, regarding the regulation of over-the-counter derivatives, creates conflict-of-interest requirements throughout the new swaps-clearing environment, including requiring the CFTC and SEC to adopt rules to mitigate conflicts of interest at clearinghouses, clearing agencies, exchanges, and swap execution facilities.

Practically Speaking

This discussion should make it obvious that the potential for a conflict of interest exists in every part of a broker-dealer's business, and every time it deals with a customer or a business partner. FINRA's sweep letter provides a good opportunity for firms—both those targeted by the letter and those passed over by FINRA on this round—to review their procedures for identifying and mitigating conflicts of interest, as well as to review the actual conflicts, themselves. Firms should make sure that whatever system is in place, whether overseen by a designated compliance officer or a firm-wide committee in charge of overseeing conflicts, has actually identified potential conflicts, and that there is a structure in place to determine whether the conflicts present a risk to customers that cannot be overcome or whether that risk is subject to mitigation. That system should clearly identify the personnel responsible for every supervisory procedure, and should provide for documentation of the conflicts, the conflict reviews, the mitigation strategies, and any difficulties encountered in overcoming the conflict. Moreover, firms should review the strength of their procedures regarding their information barriers; ensure that their client

[5] In its February 8, 2011 Letter, at page 7, FINRA references Rule 5122, which "plays an important part in the effort to protect investors in the private placement market where the broker-dealer or a control entity is the issuer."
[6] FINRA Regulatory Notice 10-54.
[7] Dodd-Frank, Section 913.

communications about conflicts are robust; and make sure that they have adequate policies regarding taking on multiple roles in deals.

There are no guarantees, but if a firm conducts those reviews and brings its systems up to date, it is likely that its three-hour meeting with the regulators will be a more pleasant one.

Author

Daniel Nathan
(202) 887-1687
dnathan@mofo.com

Contacts

Lloyd Harmetz
(212) 468-8061
lharmetz@mofo.com

Anna Pinedo
(212) 468-8179
apinedo@mofo.com