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# A Fiduciary Approach to Conflicts of Interest and Risk Governance

Presenters:

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# Topics for discussion

- The nature of conflicts in financial services
- Heightened regulatory attention to conflicts
- How should fiduciaries address conflicts?
- High-priority conflicts for regulators
- Conflict management and risk governance
- The big picture: conflicts and professionalism

# What is a Conflict of Interest?

- SEC (di Florio): “A scenario where a person or firm has an incentive to serve one interest at the expense of another interest or obligation”
- fi360 – Conflict of interest in a fiduciary context: “A circumstance that makes fulfillment of the duty of loyalty less reliable”

# Fiduciary versus Non-Fiduciary Roles and Standards of Conduct



<b>Product Originator</b>	<b>Traditional Broker</b>	<b>Advisor</b>
Counter-party	Agent	Fiduciary
Manufacturer	Salesperson	Professional
Opposite side of table	Intermediary	Same side of table
Buyer beware	Buyer be aware	Trust assumed (verify)
“Product safety”	Fair dealing	Best interest
Rules-based	Rules-based	Principles-based

# Context is important



- **Product originator:** Conflicts are expected as counterparties due to singular duty of loyalty to product manufacturer
- **Broker:** Conflicts are accepted as part of sales process due to divided loyalties
- **Advisor:** Conflicts are avoided or mitigated due to the singular duty of loyalty to client

# Regulators are Concerned with Conflicts of Interest



- SEC: Speech of Robert di Florio, Director of OCIE (October 31, 2012)
- FSA: Conflicts of Interest Between Asset Managers and Their Customers (November, 2012)
- CSA: Consultation Paper “The Standard of Conduct for Advisers and Dealers” (October 25, 2012)

# How Should a Fiduciary Address a Conflict of Interest?



- Identify the conflict
- Avoid the conflict.
- If the conflict cannot be avoided:
  - Control the conflict
  - Disclose the conflict (even if it's controlled)
  - Obtain the client's consent



# SEC Examiners Look For Six High-Priority Conflicts



- Compensation-related conflicts and incentives
- Portfolio management-related conflicts
- Affiliations between investment advisers and broker-dealers
- Valuation
- Transfer agent conflicts
- Exchange conflicts

# Compensation-Related Conflicts and Incentives



- Financial incentives for recommending new or risky products
- Lack of oversight of outside business activities
- Incentives to place investors in high fee products

# Portfolio Management- Related Conflicts



- Side-by-side accounts
- Risks beyond the tolerance levels in the prospectus or IPS

# Investment Advisers and Broker-Dealers



- Is the client put into an IA account or a BD account?
- Using an affiliated BD for portfolio trades (best execution)

# Valuation



- Temptation to provide high values for illiquid positions
- Inflating valuations to attract investors and charge higher fees

# Transfer Agent Conflicts



- Conflicting incentives when transfer agents are affiliated with issuers, vendors, or other service providers

# Exchange Conflicts

- Blurred lines between exchange business and SRO regulatory functions

# Effective Practices for Managing Conflicts



- Identify and understand all conflicts in the business model
- Good compliance and ethics program
- Integration of conflicts process into the firm's overall risk governance structure



# Identifying and Understanding Conflicts

- Cross-functional team to identify and understand conflicts
  - Practical business implications
  - Relevant legal standards
- Risk-assess and prioritize conflicts
- Recognize that conflicts are dynamic

# Complete Compliance and Ethics Program



- U.S. Federal Sentencing Guidelines
- Seven factors, including:
  - Standards and procedures
  - Leadership
  - Monitoring
  - Incentives and discipline

# Integration of Conflicts Management into Firm's Risk Governance



- Business units are the first line of defense
- Key risk and control functions (compliance) are the second line
- Internal audit is the third line
- Senior management and board involvement

# Key Findings of the FSA Report



- Firm culture is key to identifying conflicts
- Best control frameworks are designed jointly by business and compliance
- Monitoring conflicts is more effective when conducted by business and compliance
- Boards monitor conflicts best when given adequate information
- Conflicts were better managed when boards had conflicts committees

# CSA Consultation Paper 33-403: The Standard of Conduct for Advisers and Dealers



- Issue: Should Canadian advisers and dealers have an obligation to act in the best interests of their clients when providing advice?
- Current standard: a duty to deal fairly, honestly, and in good faith with clients
  - Investors may incorrectly assume that their adviser/dealer must give advice that is in the investor's best interest
  - Advisers/dealers must recommend suitable investments, not necessarily in the client's best interest
- Request for comments: Is a statutory best interest duty to clients appropriate?

# Objectivity is the Cornerstone of Professionalism



*“Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior [for fiduciaries]. ... Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions. ... [The fiduciary standard] will not consciously be lowered by any judgment of this court.”*

*[Judge Benjamin Cardozo Meinhard v. Salmon, (1928)]*

The fastest way for you to get fired as an advisor is to lose the trust of your client.

The surest way for a profession to destroy its credibility is for it to accommodate conflicts of interest by its members.

# Additional Announcements



- Looking for more high quality, fiduciary-focused content and CE? Join us at the 2013 fi360 Conference in Scottsdale, AZ. Visit our website to learn more and register ([www.fi360.com/conference](http://www.fi360.com/conference)).
- The 2013 AIF and AIFA Designation Training calendar is now available. Visit our website to find an upcoming program near you ([www.fi360.com/trainingcalendar](http://www.fi360.com/trainingcalendar)) or contact us directly at 866-390-5080 ext. 228 or via email at [solutions@fi360.com](mailto:solutions@fi360.com).



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