Recognizing and Dealing with Conflicts of Interest Arising from Having and Doing Business with Affiliated Entities

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Conflicts in Operating Multiple Business Lines

- Compensation Conflicts
- Portfolio Management Conflicts
- Valuation Conflicts
- Information Sharing
- Large Firm v. Small Firm
- Specific Scenarios
Compensation Conflicts

• RIA clients in Proprietary Products
• Multiple Hedge Funds Management
• Proprietary Funds of Funds
• Affiliated Broker/Custodian Fees
  • Best execution
• Soft Dollars
Portfolio Management Conflicts

• Bunching Orders/Parallel Trading
  • Allocations Among Funds
  • Allocations between Funds and Separate Accounts
• Retail Customers vs. Institutional Customers
• Activities outside risk tolerance or investment objective
• Different standards for IA and BD
• Investments in affiliated entities
• Cross Trades between Funds
• Incentives created by yearly performance in long term fund
Valuation of Illiquid Investments

• Affect on Fees
• AUM to Prospective Investors
Information Sharing

- Research
- Use of Client Confidential Information
- Usurping Opportunities
Large Firm v. Small Firm

- Chinese Wall v. Wearing Multiple Hats
- # of Locations and Businesses
- Monitoring Resources
- Tone at the Top
Adviser to Mutual Fund Conflicts

- Interests of Adviser and Mutual Fund are generally aligned

- Where can interests diverge?
  - Approval of investment management contracts
  - Approval of Rule 12b-1 plans
  - Correcting trade or operational errors impacting a fund
  - Adviser as major shareholder (seed money)
  - Capital support for money market funds
  - Paying for compliance program

- What’s the role of independent trustee counsel?

- What about conflicts for fund-of-funds?
Conflict Issues for Insurers

• State insurance laws that limit directors and officers of insurance companies from investing along-side insurer, or buying property from company.

• State procurement laws that limit investments in certain foreign companies, such as those governing investments in the Iranian oil industry.
  – What’s impact if insurer is a large or majority investor in an investment fund that holds such an investment?
Political or Legislative Conflicts

• What about legislative initiatives that benefit one subsidiary at the expense of another?
  – Who decides?

• How you handle pay-to-play laws?
  – Need to make sure one affiliate is not acting on behalf of another
    • “Doing indirectly” prohibitions
Recognizing Conflicts with Clients

CONFLICTS: Where an individual or entity has an incentive to act not in the client’s best interest.

MAY VIOLATE:

- Laws/Regulations
- Fiduciary Duties
- Ethical standards/practices
Historically, Conflicts Behind Passage of Most Securities Laws:

- 1933/1934 Act
- 1940 Advisers and Investment Company Acts
- 2007 Crisis and Dodd/Frank
- Most collapses of financial service firms
Conflicts May Lead To

- Criminal sanctions
- SEC and administrative actions (bars/restrictions)
- Civil suits/Arbitrations
- Reputational issues
First Step: Survey Conflicts in Business Model/Practice

- Employee Practices
- Fee Practices
- Trading Practices
- Portfolio Practices
- Informational Barriers

Conflicts not always problematic, but need management
Examples of Employee Practices:

• Preference for higher payouts
• Churning (B/Ds)
• Front Running (RIAs)
• Gifts/Entertainment, Pay-to-Play
• Outside Businesses
• Insider Trading
• Enhancing performance/undue risks
Second Step: Develop Compliance Policies/Procedures

- Required for B/Ds, RIAs and RICs
- “Reasonably designed to prevent violations”
- Codes of Ethics tailored for business
- Chief Compliance Officer and compliance regimen
- Appropriate disclosures to clients and in filings
Compliance Implementation:

7 Factors from U.S. Sentencing Guidelines

- Procedures
- Oversight
- Leadership (tone-at-the-top)
- Education/Training
- Auditing/Monitoring
- Incentives/Discipline
- Response to Problems and Prevention
Ethical Conflicts for Lawyers

• Model Rule 1.13
  – A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7.

• Model Rule 1.7
  – Unless an exception is allowed, a lawyer shall not represent a client if the representation involves a concurrent conflict of interest
Ethical Conflicts for Lawyers

• How does this apply when representing a corporate family?

• Are the subsidiaries “wholly-owned”?
  – If so, there usually is no conflict

• Can “constituents” include entities that are stockholders in other entities?
  – Yes, but here are some issues to consider
Ethical Conflicts for Lawyers

• Will the interests of the other stockholders in the affiliates diverge?

• Who are the decision makers, and do they include representatives of the affiliate?

• Do all agree that collective representation is best?

• Are there measures to employ to avoid problems or help to diffuse conflicts or privilege issues that arise, such as written consents, joint defense agreements, separate counsel, or agreements that parent controls privilege?
Ethical Conflicts for Lawyers

• Don’t forget about the ending
  – Will the affiliate have reasonable, ongoing expectations of a relationship based on your work history?
  – If so, you need to end the engagement clearly and unambiguously when the work is done.