FINRA Issues Report on Broker-Dealer Conflicts of Interest

October 22, 2013

On October 14, 2013, FINRA issued a **Report on Conflicts of Interest**. The report summarizes FINRA's observations following an initiative, launched in July 2012, to review conflict management policies and procedures at a number of broker-dealer firms. The report focuses on approaches to identifying and managing conflicts of interest in three broad areas: enterprise-level conflicts governance frameworks; new product conflicts reviews; and compensation practices.

While the report does not break new ground or create or alter legal or regulatory requirements, it offers insight into the approach that FINRA expects firms to take in implementing a robust conflict management framework. In particular, the report identifies effective practices that FINRA observed at various firms. Broker-dealers should use this report as a basis for reviewing and potentially strengthening their policies and procedures relating to managing conflicts of interests.

Although several of the topics covered in the report are particularly relevant to the design and sale of structured products, the report is not so limited. Many of the report's observations apply to securities offerings of all types, as well as a broker-dealer's over-the-counter equity derivatives activities.

The report indicates that FINRA plans to continue to review practices at various broker-dealers, and may consider whether rulemaking in this area is warranted.

Enterprise-level Conflicts Governance Framework

FINRA first outlines the key features of an effective and comprehensive conflicts management framework. These are:

- "Tone from the top" establishing a culture of ethics and compliance.
- Organizational structures that facilitate conflict management.
- Policies, procedures, and processes for conflict management.
- Appropriate incentive standards.
- Adoption of "best interest of client" policies.

Other key features of an effective framework identified are articulated structures, policies and processes, which should include:

- Descriptions of conflicts of interest containing examples relevant to the firm.
- Delineation of employees' responsibilities in identifying and managing conflict.
- Defined escalation procedures.
- Ongoing and periodic systematic identification and categorization of conflicts.
- Disclosures that go beyond the minimum legal and regulatory requirements to help achieve customer's understanding of the product (*e.g.*, using graphics and scenarios).
- Disclosure to customers of multiple roles that the firm plays.
- Obtaining customer consent and requiring investors to attest to their understanding of more complex products when appropriate.
- Transparent reporting of material conflicts to management and the board.

- Periodic testing of the conflicts framework.

The report reiterates FINRA's concern over the number of firms that are willing to hire associated persons with problematic disciplinary histories. FINRA also emphasizes the importance of firms carefully considering the conflicts clearance and business selection areas of their conflict management system.

New Product Conflicts

FINRA warns that some member firms have not adequately addressed conflicts of interest that arise in two related circumstances: conflicts present in the business or product; and conflicts that may exist when a firm evaluates whether to engage in a new business line or offer a new product or service. FINRA repeats its earlier concerns that these conflicts "may be particularly acute where complex financial products are sold to less knowledgeable investors, including retail investors."

The report notes a number of observed practices that FINRA found helpful to mitigate potential conflicts, while highlighting two underlying themes: firms must invest in and document proper processes and systems that identify and mitigate conflicts, and, at the same time, these efforts must not lapse into pro forma procedures or be too narrowly defined in scope. Similar to its release on Complex Products in Notice to Members 12-03, FINRA makes clear that it will continue to focus on the substance of these review processes when evaluating firms: the "tone from the top," "thoughtful analysis" and a culture of "robust debate" are needed in addition to the documented internal processes in order to advance the objective of protecting customer interests. Noting that there is "no one-size-fits-all," the report offers examples of a number of practices to consider when evaluating their business lines and their approval processes. Several of the more interesting and important examples in the report are described below.

New Products and Services Approval

New product committees have long been a part of firms' compliance framework, and FINRA highlights practices that can help make that process more effective, such as including multiple internal departments in the approval process, and limiting the types of customers to whom a product may be sold. FINRA implicitly endorses the view that new products and services should be read broadly to encompass new business and new markets, as well as offering an existing product or service in a new jurisdiction, through a new distribution channel or to a new customer segment.

Post-launch Review

Echoing prior guidance, FINRA suggests that firms should perform post-launch reviews of new products to identify potential problems that may not have been readily apparent during the initial review process. While FINRA does not specify a time period of future evaluation and notes a variety of different approaches, FINRA highlights that one firm re-evaluates products nine months after launch and reviews existing products on a one-, two- or three-year cycle based on the nature and risk of the product.

Complex Products with Embedded Conflicts; Retail Proprietary Indices; Is Disclosure Sufficient?

The report notes that disclosure is fundamentally important when an issuer or an affiliate makes a variety of critical decisions affecting the value of a product that may cause the economic interests of the issuer and investors to diverge. One example occurs when the issuer or an affiliate acts as a calculation agent or index calculation agent, especially when it has a valuation function or other broad authority. To be effective, disclosures should clearly articulate, in terms understandable to the customer, the multiple conflicts of interest that may arise and the degree of discretion the calculation agent may have. FINRA indicates that issuers with affiliated calculation agents should establish governance and supervisory review processes. Moreover, FINRA re-emphasizes its previous concerns with complexity and costs in retail products, noting "this could become a more serious issue for a structured product the performance of which is linked to a proprietary index … as additional fees associated with the use of the index can be high and in some cases difficult to assess." FINRA notes its concern with the "retailization" of complex products and states that it “remains concerned that reliance on disclosure may be an inadequate antidote to conflicts, unless the firm is confident that the customer can effectively evaluate these disclosures.” More generally, FINRA emphasizes its long-standing policy that promotional materials must be fair and balanced and notes that “simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials.”

Know-your-distributor

The report details a number of elements of a know-your-distributor process that FINRA views as effective practices, including background checks, review of the distributor’s financial soundness, detailed questionnaires, interviews of distributors, review of the distributor’s compliance and related materials and written agreements with distributors mandating suitability reviews and other distributor obligations. FINRA makes clear that good diligence practices need to be applied even in “reverse inquiries,” in which a distributor requests a specific product from a firm that is customized for the customers of the distributor.

Distribution Channels, Open Architecture and Revenue Sharing

The report states that one of the “fundamental potential conflicts in the securities industry” occurs in the distribution channel, namely “the sale of products or services to generate revenue or profit without proper regard to suitability standards.” In this regard, FINRA notes with approval the increase in open architecture sales by distribution channels of products of multiple issuers, especially if those products are placed out to competitive bid across multiple firms. However, firms need to pay heed to situations where, due to affiliation or revenue sharing agreements, distribution channels have an incentive to sell certain products over other competing products. FINRA points out that private wealth businesses, in particular, should operate with an appropriate degree of independence from other business lines.

Decline to Offer Certain Products

FINRA suggests that firms should carefully evaluate and decline to offer products to customers when the conflicts associated with those products are too significant to be mitigated effectively. FINRA continues to look to international regulatory practices. In its survey of conflicts regulation in selected international jurisdictions, FINRA notes that each of Australia, Canada and the European Union agree that the management of conflicts of interest cannot be achieved solely through disclosure, and that investment firms should seek first to avoid or control conflicts before relying on disclosure to resolve the conflict.

Compensation Practices

Finally, the report looks at potential conflicts of interest in compensation arrangements, focusing particularly on brokerage and other compensation for associated persons. The report highlights the following examples of effective practices used by firms to mitigate instances where the compensation structure may potentially affect the behavior of registered representatives:

- Avoiding compensation thresholds where a registered representative can increase his or her compensation disproportionately after reaching a certain threshold of sales.
- Using neutral compensation grids, which avoids favoring one product over another by having a flat payout percentage regardless of product type sold.
- Introducing fee-caps (*i.e.*, capping the gross dealer concession that will be credited to a representative’s production) to minimize the incentive to favor one mutual fund over another.
- Refraining from higher compensation or other rewards for the sale of proprietary products when there are comparable products.
- Implementing surveillance and monitoring to ensure that registered representatives are not being unduly motivated by thresholds that qualify the representative to receive a back-end bonus,

qualify the representative to participate in a recognition club, or move the representative to a higher payout level in the firm's compensation grid.

- Monitoring the suitability of recommendations around key liquidity events in the investor's lifecycle where the recommendation is particularly significant.
- Using red flag processes and clawbacks to penalize employees for not properly managing conflicts of interest.

FINRA suggests that firms establish compensation governance structures that mandate identifying and managing the conflicts that compensation structures may create. This would allow firms to adjust the compensation structure to eliminate or reduce conflicts and establish oversight mechanisms appropriate to the scale of conflicts that may remain. FINRA further notes that firms should consider using clawbacks throughout their businesses and not just for senior executives. Finally, FINRA notes that firms that are dually registered as a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer.

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