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FINRA Report on Broker-Dealer Management of Conflicts of Interest

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued a report providing general observations, commentary and descriptions of effective practices in the area of broker-dealer firms' conflicts management practices. A copy of the report is available here.

Conflicts of interest are a FINRA and Securities and Exchange Commission ("SEC") priority and have been addressed through a variety of rulemaking, oversight and enforcement action efforts. To assist member firms in identifying and managing conflicts of interest, FINRA launched a conflicts initiative in 2012 and began collecting information on firms' conflicts practices through response letters, in-person interviews and compensation questionnaires. FINRA's report is based on the findings from the conflicts initiative and focuses on firms' approaches to identifying and managing conflicts in three areas deemed critical by FINRA:

- *conflicts of interest framework—how firms address conflicts across their business lines from a top-down perspective;*
- *new products conflicts—how firms manage conflicts arising from the creation and distribution of new products; and*
- *compensation practices—how incentive structures relating to compensation can impact conflicts of interest.*

FINRA notes that the report is not intended to address many of the potential conflicts of interest that broker-dealer firms may encounter which are already addressed by other federal securities laws, SEC rules or FINRA rules such as investment banking-research separation, outside business activities, soft dollars, payments for order flow or securities allocations to customers. FINRA also stresses that the report is not intended to express any legal position and does not create any new legal requirements or change any existing regulatory obligation. FINRA does note that they expect firms to consider the practices presented in the report and implement changes to their own conflict management frameworks. If member firms do not make adequate progress on conflicts management, FINRA indicated that it will evaluate whether rulemaking to require reasonable policies to identify, manage and mitigate conflicts would enhance investor protection.

Conflicts of Interest Framework

The FINRA report recommends that firms take a holistic approach to managing conflicts of interest. FINRA notes that an effective practice is to implement a firm-wide framework to manage conflicts of interest constructed from the top down. FINRA observed that the key to making such a framework effective generally begins with firm leadership placing customers' interests above the firm's interests and a commitment to the highest ethical standards. The FINRA report describes a number of practices that may be elements of an effective conflicts framework including:

- defining conflicts of interest in a way that is relevant to a firm's business and helps staff to identify conflicts situations;
- articulating employee's roles and responsibilities with respect to managing conflicts of interest and implementing appropriate training with respect to these roles and responsibilities;
- establishing mechanisms to identify conflicts of interest;
- defining escalation procedures for conflicts of interest within and across business lines;
- disclosing conflicts of interest to clients;

- avoiding severe conflicts even if that avoidance means foregoing an otherwise attractive business opportunity; and
- reporting on significant conflicts issues to the Chief Executive Officer and board.

New Products Conflicts

FINRA notes that financial innovation often creates novel conflicts of interest issues and that firms that develop and use new financial products are uniquely obligated to identify conflicts of interest that arise from the creation and distribution of such products. The FINRA report describes a number of practices to address these new products conflicts including:

- incorporating conflicts analysis into new product review processes, which is typically done by a new products review committee, in order to identify and mitigate conflicts of interest;
- disclosing those conflicts to customers in plain English and in a manner that effectively conveys the conflicts of interest presented by the new product;
- establishing Know-Your-Distributor (KYD) policies and procedures that mitigate the incentive to use distribution channels that may not have sufficient controls to protect customers' interests;
- performing post-launch reviews of new products to identify conflicts of interests that may not have existed at the time of their creation; and
- carefully evaluating and potentially refusing to offer new products when the conflicts of interest are too significant and cannot be effectively mitigated;
- for firms with private wealth businesses, operating such private wealth businesses with appropriate independence from their other business lines; and
- for firms with revenue sharing or partnering arrangements, seeking to protect their customers' interests by exercising the necessary independent judgment and appropriate diligence.

Compensation Practices

FINRA notes that many firms have considered and taken additional measures that directly address conflicts issues by changing compensation arrangements and supervising the sales activity of registered representatives. FINRA observed that the use of "product agnostic" compensation grids, also known as "neutral grids," can help reduce the incentives for registered representatives to prefer certain products over others by paying a flat fee percentage of generated revenue regardless of what product is recommended. However, FINRA also noted that these grids do not eliminate the incentive for registered representatives to favor products with higher commissions and suggested that firms should take steps to mitigate the incentives created by differences in product compensation.

FINRA notes several additional effective practices that enhanced supervision and surveillance of registered representatives' recommendations and the management of conflicts including:

- connecting the recommendations of registered representatives with certain thresholds in the firm's compensation structure in order to flag recommendations or potential churning practices that may be influenced by a desire to advance in the compensation structure;
- implementing heightened supervision and surveillance of registered representatives as they get closer to achieving compensation milestones;
- strengthening supervision and surveillance of registered representatives' recommendations around critical junctures in the investor's life cycle, such as rolling over a 401(k);
- limiting the credit a registered representative can receive for a mutual fund or variable annuity family, which can diminish the incentive for registered representatives to favor one fund over a comparable fund (e.g. capping the gross dealer concessions (GDC) of comparable funds at a specific threshold reducing the incentive for the registered representative to consistently recommend the funds with higher paying GDC); and
- adjusting the compensation of registered representatives who do not adequately manage conflicts of interest.

What Should I Do Now?

As FINRA notes in the report, there is no "one-size-fits-all" framework through which firms can manage conflicts so firms must assess what approach is most effective given their particular circumstances. FINRA indicates that its observations in the report are intended to stimulate firms' thinking and to offer examples of how some firms address conflicts with the expectation that firms can use this information to implement their own appropriate conflict management framework. In addition to providing a summary of conflict management practices, the report also provides selected examples of conflicts regulation in Appendix I. FINRA's issuance of the report may be an opportunity to assess and further develop your firm's own conflicts management framework and practices.

For More Information

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