FINRA Issues Report on Conflicts of Interest

On October 14, 2013, FINRA published its Report on Conflicts of Interest (the “Report”). The Report summarizes, in great detail, FINRA’s findings of its study of the ways in which broker-dealers identify and manage potential conflicts. The Report follows a set of FINRA examinations of conflict of interest policies and procedures, mostly focused on very large broker-dealers. The Report identifies best practices for firms to consider in evaluating their conflicts management practices. Although the considerations are presented as only recommendations, FINRA cautions that it will consider rulemaking with respect to the management of conflicts if firms do not make adequate progress in this area. FINRA already has included a specific provision in its proposed supervision rule related to the impact of conflicts of interest (Proposed FINRA Rule 3110(b)(6)(D)). Firms should expect management of conflicts to be incorporated into FINRA’s examination process, and firms that do not sufficiently address the Reports’ criticisms and suggested best practices in their policies and procedures could be subject to enforcement, particularly if the proposed supervision rule is adopted. A copy of the 44-page Report is available on the FINRA website.

The report focuses on three key areas that firms should address when identifying and managing conflicts. These areas include:

- instituting an enterprise-level framework;
- managing conflicts associated with new financial products; and
- addressing conflicts of interest with respect to financial compensation.

Enterprise-Level Framework

The Report advocates for the implementation of an enterprise-level framework, including affiliates outside the broker-dealer. An enterprise-level framework requires a firm-wide process for dealing with conflicts of interest. In order to be effective, a firm should examine all aspects of its current conflicts management practices, taking into account its underlying ethics culture, organizational structures, policies, processes and incentive structures that shape the firm’s management of conflicts of interest.

New Financial Products

The second focus of the Report is a discussion of conflicts associated with the introduction of new financial products. FINRA believes that the industry has failed to effectively manage conflicts in this area. In an effort to correct this issue, FINRA encourages firms to implement additional measures, including new product review processes, plain English standards and post-launch reviews.

In particular, FINRA encourages firms that manufacture new products and services to adopt “Know-Your-Distributor” policies and procedures. In order to be effective, FINRA suggests that firms should consider adopting
several measures, including: conducting background checks on distributors, reviewing the financial soundness of the distributor, making distributors complete a detailed questionnaire, interviewing the distributor to develop an understanding of the firm’s compliance culture and obtaining information about the composition and nature of the distributor's customer base. “Know-Your-Distributor” is a new suggestion and appears to create a new area of potential liability for the product manufacturing firms.

Financial Compensation

Lastly, one-third of the Report addresses potential conflicts of interest in the compensation of registered representatives. According to the Report, financial compensation remains one of the main causes of conflicts of interest. In addressing this area, FINRA is encouraging the use of several practices it found to be effective, including: the use of “product agnostic” compensation grids and “fee-capping”, increased surveillance based on breakpoints in compensation or significant life-cycle events for customers, and increased use of compensation “claw-backs” for individuals who fail to properly manage conflicts. The emphasis on this area suggests that the details of firms' compensation plans will be the focus of greater scrutiny in future FINRA examinations. For this reason, firms should consider involving Legal and Compliance early in the process of creating and vetting compensation plans.

Conclusion

The Report represents the culmination of a more than one-year study conducted by the FINRA staff. Firms should consider whether to update their existing conflicts management practices in light of the Report, and how they will respond to FINRA inquiries about conflicts of interest. Future findings by FINRA likely will be in the form of enforcement action rather than mere best practice recommendations.

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