

Client Alert

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FINRA Tells Broker-Dealers How to Better Manage Conflicts of Interest

By Jay Baris and Daniel Nathan

A much-anticipated FINRA [report](#) concludes that broker-dealers must do more to manage conflicts of interest.

FINRA said that the report, published on October 14, 2013, highlights “effective conflicts management practices that may go beyond current regulatory requirements and identify potential problem areas,” according to the statement of FINRA CEO Rick Ketchum.

The report focuses on how firms can strengthen their conflicts frameworks, starting with a “tone from the top” and flowing through the firm’s structures, policies, processes, training and culture. FINRA states that the report emphasizes the process of and approach to identifying and managing conflicts, rather than listing an inventory of conflicts that firms face.

Conflicts of interest have long been a focus of FINRA. (See the discussion of FINRA’s historic statements about conflicts of interest in our prior [Client Alert](#).) The new report states that conflicts can arise in any relationship where a duty of care or trust exists, and therefore they are widespread across the financial services industry. FINRA inventoried the conflicts that firms reported in response to the July 2012 sweep request across several broad categories, including “General Conflicts” (such as outside business interests, or gifts and entertainment), “Supervision and Compliance Conflicts” (between a firm’s oversight roles and revenue generation objectives), “Research-Related Conflicts” (including pressure from investment bankers or issuers), “Banking and Capital Markets” and “Retail/Private Wealth.”

In the end, FINRA focuses on three approaches to identifying and managing conflicts:

- enterprise-level frameworks to identify and manage conflicts;
- approaches to handling conflicts in manufacturing and distributing new products; and
- approaches to compensating brokers.

The report summarizes best practices that FINRA observed related to each of these approaches, and attempts to distinguish between procedures at large and small firms. The best practices include the following:

- set a “tone at the top” that emphasizes the importance of ethical behavior and carries through to the entire organization;
- establish independent product review processes that are independent from the businesses that propose the products;

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- avoiding pressure to favor proprietary products or other products that offer the brokers better compensation terms;
- minimizing conflicts in compensation structures, and using heightened supervision to mitigate remaining conflicts; and
- using hiring practices and training to ensure that the firm's brokers treat customers ethically.

True to FINRA's word, the release of this report does not appear to be accompanied by any informal or formal activity against any particular firms. Moreover, in boldface type, FINRA stresses that it does not intend to express any legal position, and does not create new legal requirements or change any existing regulatory obligations. FINRA ominously notes, however, that as it continues to review how firms manage conflicts, if it finds that firms have not made adequate progress, it will evaluate rulemaking to require reasonable policies in this area. In this spirit, FINRA's report may indicate how FINRA interprets existing compliance obligations, and could serve as a roadmap for evolving enforcement cases.

Please also see our companion article, "[FINRA's Report on Conflicts of Interest: Issues for the Structured Products Market](#)."

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