

Conflicts of Interest

Convergence towards global standards on conflicts of interest

The management of conflicts of interest is a key issue for the financial services sector. Greater commonality in regulatory scope and rules and the consequential development of common policies and procedures would lead to the more efficient management of conflicts of interest and reduce cost to the benefit of both firms and their customers.

What does Conflicts of Interests mean?

- Own or contrary interests are ubiquitous. Conflicts of interests regularly arise when private or personal interests might affect the fair and proper discharge of obligations towards others.
- The handling of conflicts of interests is of special importance in the finance industry. The procedure in the case of insider knowledge, for example, but also the preparation of financial analyses, is regulated by the EU Market Abuse Directive. Furthermore, investment firms are subject to new requirements on the management of conflicts of interests – imposed by the EU Markets in Financial Instruments Directive (MiFID).
- A conflict of interest is not necessarily to be seen as misconduct. Nevertheless, it is advisable to avoid conflicts of interest or at least to disclose them.

Corporate Law Framework

- The ***Sarbanes-Oxley Act*** requires companies listed in the USA and their German subsidiaries to adopt a "code of ethics", promoting honest and fair behaviour, including in the case of actual or perceived conflicts of interest → applies only to senior financial officers, however.
- The ***German Corporate Governance Codex*** governs conflicts of interests of management and supervisory board members of companies listed in Germany. (Obligation to represent the interests of the company, non-competition clause, for managing board members also inducements)

Banking / Supervisory law on Col

- **USA:** E.g. New York Stock Exchange (NYSE), National Association of Securities Dealers (NASD) rules
 - May 10, 2002: NYSE Rule 472 and Rule 2711 NASD Rules enacted (w.r.t. Research Reports / Analysts)

- **Japan:** Financial Instruments and Exchange Law („FIEL“)
 - implemented on September 30, 2007
 - Regulation of conduct of “financial instruments business”
 - Prohibited act: transaction raising conflict of interests

- **EU:** Markets in Financial Instruments Directive („**MiFID**“)
 - implemented on November 1, 2007
 - obligation for investment firms to
 - identify, manage, disclose and report possible conflicts of interest
 - establishing a written conflict of interest policy

MiFID Requirements

- Identify
- Manage
- Disclose
- Record

Conflicts of Interest

Identify

- People
 - Firm
 - Relevant Person
 - Group Member

- Business Activities
 - Investment Banking
 - Corporate Finance
 - Investment Advice / Research
 - Equity Capital Management (IPOs)
 - Mergers & Acquisitions

- Types of conflicts (see next page)

Identify - Types of Conflicts

Art. 21 of the Implementing Directive:

- When the firm of any relevant person or a person directly or indirectly linked by control to the firm is likely to make a financial gain or avoid a financial loss at the expense of the client.
(However, see Recital 20 which states that “it is not enough that the firm stands to gain a benefit if there is not also a disadvantage to a client, or that one client to whom the firm owes a duty stands to make a gain or avoid a loss without there being a concomitant loss to another such client.)
- Where the firm or any such person has an interest in the outcome of a service which is distinct from the client’s interest
- Where the firm or such person has a financial interest or other incentive to favour the interests of another client or group of clients over the interests of an client
- When the firm or such person carried on the same business as the client
- Where the firm or that person receives or will receive from a person other than the client an inducement in relation to the service provided to the client in the form of monies, goods or services other than the standard commission

Conflicts of Interest

Manage

- Specify the procedures to be followed and measures adopted to manage such conflicts

- The types of procedures include:
 - Effective procedures to prevent or control the exchange of information where that exchange may harm the interests of one or more clients
 - Separate supervision of relevant persons whose functions may involve them in activities that may give rise to a conflicts from others

- Remuneration where it could give rise to a conflict
 - Measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out his functions
 - Measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate investment or ancillary services where such involvement might impair the proper management of conflicts

Disclose

- Disclosure
 - Must be in a “durable medium”
 - Must contain “sufficient detail”
 - Must take into account the nature of the client to enable the client to make an informed decision whether it wishes to proceed

- Independence
 - Art. 22(3) – relevant persons engaged in different business activities must carry on those activities at a level of independence appropriate to the size and activities of the investment firm and the degree of risk to clients

Conflicts of Interest Record

Art. 23 of Implementing Directive:

- Investment firms must keep and regularly update a record of the kinds of investment or ancillary service or investment activity carried out by or on behalf of the firm in which a conflict of interest entailing a material risk of damage to the interests of one or more clients has arisen or, in the case of an ongoing service or activity, may arise

Col Policy

- Conflicts Policy
 - Must be effective
 - Must be in writing
 - Must be appropriate to the size and organisation of the firm and the nature and scale of its business (including interests of the firm's group)

- Policy must, at a minimum:
 - Identify with reference to specific investment services and activities and ancillary services carried out by or on behalf of the investment firm the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients