Product Management – Managing Conflicts of Interest and Other Key Regulatory Challenges

Forward

By Michael Freeman, President, Due Diligence Works

For the past several years, the Department of Labor's Fiduciary Rule demanded the attention of Broker-Dealers and Registered Investment Advisors . Now, with a pause on potential regulation from the DOL, many firms are turning their focus to similar action by FINRA and the SEC, with the understanding that, regardless of the the regulator writing the rule, an evolution must take place in oversight and management of products to meet heightened standards of care. DDW clients have been consistent in their question and concern for three key constutuents as they work with us to evolve their own programs: "How do we design an effective Product Due Diligence and Product Shelf Management program that meets the needs of Clients, Advisors, and Regulators?"

- **Clients and Advisors:** Firms need to have a keen focus on their product shelf and ensure they have the best products for their advisors to offer. To do this, firms need to review the market of products (independent of conflicts), continually benchmark against their current products, and actively manage their product shelf, executing on what the research uncovers. In addition, advisors need to understand client needs through enhanced profiling. Advisors need to have proper documentation of products being recommended, ensuring the best product is selected, given the client's particular need. Doing this consistently across the organization can be difficult.

- **Regulators:.** To meet regulatory requirements, products on a firm's shelf need to be reviewed, monitored, and removed from time to time in favor of better ones. For most firms, it is difficult to do this day in and day out. However, ***with the increasing regulatory focus on product reviews, firms need to make sure their product files are up to date, that their process is repeatable and being followed, and that they understand the outside market and are able to document why products are on their shelf.*** The good news is that, while building the Product Managment program takes effort and resources upfront, the resulting process can create economies of scale and significantly reduce risk to the firm.

For better perspective on key regulatory areas of focus, Due Diligence Works commissioned a White Paper to address the spectrum of regulatory requirements when it comes to Due Diligence and Product Shelf Management across the many regulators.

The product vetting process is a key component of a B/D control infrastructure. Much more than providing an inventory of products to be sold or even meeting Suitability and Supervisory regulatory requirements, product management due diligence serves a foundational element for the entire firm. It sets the architecture for how and what financial services are to be provided to customers and helps the organization identify and retain top representatives that share a common vision for how to help their clients. The Product Management vetting and due diligence process is all of these things and is, as such, under tremendous and ongoing scrutiny by the industry, public and regulators to ensure the process is comprehensive, effective, efficient and meets the wide number of existing and evolving regulations and regulatory expectations.

The regulatory environment has changed significantly over the past 10 years and the expectations on firms to have a product management process in place that serves a highly competitive business environment while meeting a diverse set of regulatory expectations is difficult. The complexity of new product offerings, expectations by representatives and business leadership, rules and regulations, and budget constraints introduce significant conflicts of interest and challenge even the largest firms to meet these diverse requirements. This article will briefly address some of the inherent conflicts of interest between the product management team and product providers in connection to the product management process.

The Best Interest Contract requirement, related DOL Fiduciary rule expectations, and FINRA Conflict of Interest priorities, stipulate that firms need to avoid conflicts of interest that could impact their ability to serve in the client's best interest. FINRA and other regulators have a high focus on product suitability and a firm's product management life cycle including maintaining dedicated teams in connection with their regular examination process that assess a firm's products, sales process, and distribution arrangements.

To illustrate, NTM 05-26 clearly outlines FINRA's expectations that firms avoid, manage or disclose potential conflicts of interest when vetting products for distribution. The NTM is, in respect to best practices for reviewing products, identifying their concern regarding the complexity of new products (not to be confused with later NTM documents written in respect to Complex Products, like Structured Notes, or inverse or leveraged exchange traded funds) that may have unique features that may not be well understood by investors or, as FINRA indicates in the executive summary, "others raise concerns about suitability and potential conflicts of interest." FINRA is not specific to different conflict types. ("Notice to Members").

- The NTM outlines, "At a minimum, those (Product Vetting) procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution."

- The NTM specifically identifies that some new products may appear to offer benefits similar to products already available and at a lower cost or less risk.

Importantly, FINRA specifically identifies the need for firms to take a proactive stance in the review of new products, indicating a need to "reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur." ("Notice to Members").

This is an important paragraph in that it identifies two very subjective responsibilities on behalf of a B/D, both of which can be extremely difficult for a firm's internal product management firm to address and are currently under heightened review by FINRA and other regulators. The first relates to the review including a "regulatory perspective". To be discussed later in greater detail, this would reasonably include a responsibility to assess a product's unique characteristics considering regulatory requirements. It should also, especially, include an assessment of a product's characteristics against prevailing regulatory concerns or areas of examination focus.

The second relates to an expectation by FINRA that firms review products through procedures that "greatly enhance a firm's ability to detect and avoid conflicts". ("Notice to Members"). Again, FINRA does not delineate all the different conflicts that could occur, rightly, as these will vary by firm, product, and sales activities. Importantly, as potential conflicts of interest have been an increasing area of focus for regulators, as a result of sales practice concerns (sales to seniors, etc.), increased product complexity (as identified in this NTM) and new rules like the DOL Fiduciary Rule, those activities that might have been acceptable in the past are now potential conflicts to which simple disclosure is insufficient.

Typically, a B/D product review/ vetting process is conducted internally by seasoned staff members that have a comprehensive understanding of the firm's strategic plan, sales process, marketing program, sales targets and other key pieces of information that, they would view, can assist them in the determination of the best products for the firm's representatives to offer to the public. Arguably, this information is necessary as the product management team was similarly responsible for the relationship management and contractual negotiations with the product sponsor.

While this contract negotiation and relationship management aspect of the Product Management Team's responsibilities has typically been considered both appropriate and endemic to the overall product vetting process, current regulatory expectations under new rules, exam priorities and, in fact the NTM 05-26 would reasonably suggest that there exist potential conflicts of interest in connection with the Product Management Team's vetting a product sponsors' products.

Negotiating how much revenue share or marketing expense should be paid by a particular product sponsor to the B/D in connection with product sales targets while simultaneously responsible for reviewing and assessing products from several different sponsors introduces potential conflicts of interest to the product vetting process. The NTM expresses specific concern in respect to this conflict, stipulating, in connection to the section on "Ask the Right Questions":

> *How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (i.e., revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.* ("Notice to Members").

FINRA recognizes this conflict, among other requirements, and therefore the need for clear product vetting procedures that are "rigorously implemented" and approved by senior management, to help firms manage their overall Suitability (Rule 2111) responsibilities. What isn't specifically addressed is how these potential conflicts should be managed or avoided. Many B/Ds continue to participate in revenue sharing, marketing/ training support programs, stipulating that the disclosure of these revenue streams is sufficient to mitigate the appearance of a conflict of interest.

The issue isn't simply the receipt of additional revenue in connection to a product sale, it's the fact that the individuals responsible for negotiating those arrangements are also the individuals responsible for reviewing and recommending the products (through their governance process) that will ultimately offered to the public. The conflict becomes somewhat complex as it isn't (at least directly) a conflict that would immediately injure or affect a client. This is to say that most conflicts, as contemplated by FINRA, are recognized as having the potential impact to affect a client directly. For example, a representative receiving more commission from one product over an identical product type would be viewed as having an impact on the client in that the decision to select the product would be unduly influenced by the higher compensation.

In the case of the product management team being aware or directly responsible for establishing the revenue, marketing or training "sharing" payments while also reviewing and recommending the products and their corresponding manufacturers, the client isn't directly affected. The client is impacted only to the extent that the representative is limited in the products they can offer. While it is absolutely possible that the products made available for sale by the representative, through the product vetting process of the product management team, are more expensive limited than other products from manufacturers that didn't offer revenue or similar payments, that really is an indirect issue.

The conflict that should be considered relates to the fact that the product management team conducting the review and making the recommendation while being potentially influenced by additional revenue streams to the firm. This conflict potentially taints the review process such that the firm's product offerings from which the representative can select is sufficiently limited to place the firm in jeopardy under the suitability requirements to have "reasonable basis" in making a recommendation for a customer.

Reasonable-basis (requires a firm or associated person to perform reasonable diligence to understand the nature of a recommended security or investment strategy involving a security, as well as its potential risks and rewards, and determine whether the recommendation is suitable for at least some investors based on that understanding). ("Regulatory Notice 13-31").

While the "Reasonable Basis" aspect of the Suitability rule 2111 doesn't specifically contemplate the role of the firm to mitigate revenue based conflicts in connection to the firm's selection of those products it will offer to clients for sale, it is strongly suggested though the related rule texts, including NTM 05-26 and Rule 3110 Supervision. The stipulation for procedures rigorously followed is to ensure the firms process for assessing products is not impacted by, among, other things, this type of conflict.

Further, in 2013, FINRA more formally recognized the importance of conflicts of interest management in connection to possible breakdowns in a firm's compliance or supervisory program. FINRA outlined their concerns online:

Conflicts of interest represent a recurring challenge that contributes to compliance and supervisory breakdowns. These breakdowns can compromise the quality of service that firms and representatives provide to their clients. We issued the Report on Conflicts of Interest in October 2013, and FINRA continues to monitor the efforts employed by firms to identify, mitigate and manage conflicts of interest.

Several rules govern the ethical obligations of firms and brokers:

- *The Securities Exchange Act of 1934 broadly prohibits misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.*

- *Section 15(c) of the Act prohibits a broker from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance.*

- *FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) states that a firm "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."*

- *FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) provides that no firm "shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."*

- *FINRA Rule 2241 (Research Analysts and Research Reports), addresses conflicts of interest relating to the publication and distribution of equity research reports.*

- *FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports), which becomes effective on February 22, 2016, addresses conflicts of interest relating to the publication and distribution of debt research reports.*

In addition to these broad obligations, FINRA and the SEC have implemented measures that mandate disclosures and outright prohibitions on certain activities.

In addition to examining for firms' compliance with these and other rules that govern ethical obligations of industry participants, FINRA assesses how firms identify, mitigate and manage conflicts of interest, including conflicts related to compensation practices. ("Key Topics: Conflicts of Interest").

Additionally, FINRA released Notices to Members to more specifically require firms to bolster their product management due diligence programs. Again, these notices do not stipulate specific requirements for B/D's to prevent certain conflicts, they do set standards and expectations for firms to improve and strengthen the assessment process overall, especially for unique and more complex product offerings.

Regulatory Notice 13-31 pertaining to suitability and due diligence, released by FINRA in September 2013 provides some practices for broker dealers as it relates to requirement to "have a 'reasonable basis' that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable due diligence of the member". ("Regulatory Notice 13-31").

Ultimately, to meet the standards as set forth by FINRA, the SEC and DOL, as well as heighted scrutiny by the public and litigating attorneys, broker dealers must develop a program that comprehensively and consistently compiles the necessary information for on-going due diligence for the life of each program on their platform. The DOL Fiduciary rule, in addition to existing regulatory expectations, is expected to increase this burden, as the regulations demand a fiduciary standard for broker dealers and their representatives that specifically targets avoidance or at least active management of compensation/ revenue related conflicts.

Arguably, the team that performs this function is, in essence, doing so on behalf of the representative and the customer, in an effort to ensure that the products offered can support the firm's meeting the suitability, conflict management, and (as required) Best Interest standards set forth in the regulations. The process for doing this, as well as the people involved, need to be sufficiently free of material conflicts so that regulators will recognize the independence of the function and its inherent operational integrity. While not specifically demanded by the existing rules, demonstrating sufficient independence between financial/ revenue based decisions and the product management vetting process will be critical to meeting regulatory and customer expectations.

The Product Management Team, and their related processes, is an integral component of the firm's business development and control program. Leveraging third party resources in coordination with the Product Management team's oversight and the existing product governance, can shift the appearance of any bias towards a product or manufacturer. The additional subject matter support further frees resources to support a B/D's continued access to alternative revenue sources from these manufacturers, while ensuring that the product review process for their platform is sufficiently agnostic to revenue source influence.

Leveraging additional tools and third party services in connection to its product management can help a firm demonstrate independence, consistent methodology and review thoroughness. A comprehensive and dynamic program will be key to helping mitigate regulatory, legal, and reputational risks related to meeting client suitability and product vetting/ due diligence. Firms should consider enhancing their product management governance thought the use of a third-party solution to provide independent and unbiased assessment of products through a coordinated quantitative methodology. Thus helping demonstrate a proactive strategy to prevent or manage the appearance of conflicts of interest while meeting heightened regulatory standards.

The views and opinions expressed in this paper are my own and do not reflect those of my employer or Intercontinental Exchange, Inc.

JOHN ROBBINS
John Robbins, CFA has an established career leading compliance and risk management programs for some of the world's largest financial services firms, investment advisors and mutual fund complexes. As Chief Compliance Officer for Intercontinental Exchange (NYSE:ICE) Data Services' Registered Investment Adviser, Interactive Data Pricing and Reference Data LLC, John oversees the compliance program for the company's investment advisory evaluation services businesses. Prior to his role with ICE, John served as M&T Bank's Wilmington Trust Chief Compliance Officer overseeing their investment management, wealth, trust, and broker dealer compliance activities for four years. John was Managing Director and Regional Head of Compliance, Americas for BlackRock after serving as Babson Capital Management's Global Head of Compliance from 2009 through 2011.

Prior to his role with Babson Capital Management, John served as the Global Head of Compliance for AIG Investments overseeing the global compliance program and assisting the organization prepare the company for sale. As the Regional Head of Compliance – Americas, and Chief Compliance Officer of Deutsche Asset Management's SEC registered adviser, John served as the Global Head of Institutional Compliance from 2005 through 2007. John joined GE in 1999 as the compliance leader for the GE Financial Assurance Investment Department and with the integration of the investment businesses, the Chief Compliance Officer for GE Asset Management, Inc. In this capacity, he was also the CCO for the GE Mutual Funds and GE Investment Distributors, Inc., a registered broker/dealer, until leaving for Deutsche Bank in 2005.

Preceding GE, John worked for nine years as a Chief Compliance Officer for Pacific Capital, a registered investment advisory and hedge fund manager in Seattle, Washington. He is a graduate of Occidental College and the holder of the Chartered Financial Analyst designation. John maintains several securities licenses, and has served as an expert witness, securities arbiter and on several industry committees including the disciplinary oversight committee for the CFA Institute.

End Notes

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