

# Conflicts of Interest

## What Should be Keeping You Up at Night

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# Disclaimer

The following presentation is an educational tool that is general in nature. It is not intended to be an exhaustive review of Conflict of Interest laws and regulations and is not intended to provide legal advice. My comments do not necessarily reflect the position or opinion of the State of Indiana or FIRMA.

# Goals of Presentation

- Definitions
- Types of Conflicts of Interest
- Risks Associated with Conflicts of Interest
- Risk Management Program
- Examination/Audit Procedures
- Likely Situations and Risk Mitigation
- Supervisory Roles
- How to Minimize Potential Liability
- Questions

# Definitions

- Trust department/trust companies may be required to manage or avoid various actual or potential conflicts of interest.
- *Conflicts of interest* arise whenever a trust department engages in self-dealing and in any situation where a trust department's ability to act in the best interest of its account beneficiaries or clients is impaired.
- *Self-dealing* occurs when trust department, as a fiduciary, engages in a transaction with itself or related parties and interests.
- conflicts of interest may also arise when a bank benefits from undisclosed compensation or receives unreasonable compensation, or when a bank or a trust department employee engages in unethical conduct.
- Certain circumstances may require a trust department to manage conflicting interests between accounts or among beneficiaries of a particular account.

# Definitions (continued)

- Conflicts of interest are present whenever the interest of a bank, its affiliates, or inside parties differ from the interests of the beneficiaries of an account managed by the bank, or when the interests of one or more fiduciary account or beneficiaries are in conflict.
- Some conflicts of interest are prohibited under all circumstances, while other are permitted subject to certain conditions and proper oversight by bank management.

# Types of Conflicts of Interest

- Self-dealing between related parties and interests and fiduciary accounts.
  - ✓ Except under limited circumstances, the following are not permitted in fiduciary accounts for which a bank has investment discretion
    - ❖ Investing in stocks or obligations of companies owned or controlled by related parties and interests
    - ❖ Investing in asset of, or acquired from, related parties and interests
    - ❖ Lending, selling, or otherwise transferring assets to related parties and interests

# Types of Conflicts of Interest (continued)

- Dealings with affiliated service providers and allocation of brokerage services to affiliates
  - ✓ Delegation of activities to affiliates
  - ✓ Purchase of services from related parties and interests on behalf of fiduciary accounts
  - ✓ Allocation of brokerage business to affiliated broker-dealers
  - ✓ Investment In proprietary products

# Types of Conflicts of Interest (continued)

- Dealing with third parties that result in financial benefits to related parties and interests
  - ✓ Includes arrangement such as
    - ❖ Business referral arrangements
    - ❖ Rebates or discounts on other services
    - ❖ Brokerage and research services
    - ❖ Payments for “order flow”
    - ❖ Securities Exchange Act of 1934 Rule 12(b)1
    - ❖ Seminars and travel expenses
    - ❖ Computer goods and services



# Types of Conflicts of Interest (continued)

- Authorization of otherwise impermissible activities
  - ✓ Federal, state, and other jurisdictions
  - ✓ Governing instrument
  - ✓ Court order
  - ✓ Grantor consent
  - ✓ Beneficiary consent
    - ❖ *In most circumstances*, obtaining the proper consent of all beneficiaries may be impractical or even impossible, especially when there are multiple principal, income, and contingent beneficiaries.

# Types of Conflicts of Interest (continued)

- Employee conduct

- ✓ Unethical conduct by a director, officer, or employee can undermine a fiduciary's ability to fulfill its duty of loyalty to account beneficiaries.
- ✓ An employee code of ethics should clearly establish management's expectations for employee behavior
  - ❖ Not to serve as co-fiduciary with the bank for a fee, without Board approval
  - ❖ Not to compete with the bank
  - ❖ Not to accept a loan from a fiduciary client
  - ❖ Not to accept a gift or bequest from a fiduciary client
  - ❖ Not to accept goods or services from vendors
  - ❖ Not to engage in personal securities transactions that constitute “front running” of other use of material non-public information

# Risks Associated With Conflicts of Interest

- Compliance Risk
  - ✓ Administrative and asset management actions may prohibited except under certain circumstances
- Operational Risk
  - ✓ Risk is heightened if a bank has inadequate processes or management information systems (MIS) that fail to provide timely and accurate information to prevent, detect, or properly escalate conflicts of interest situations.
- Reputation Risk
  - ✓ Actual or apparent conflicts of interest can jeopardize existing and potential clients' confidence that a bank will deal with them fairly and transparently
- Legal Risk
  - ✓ Improper conflicts of interest may result in regulatory sanctions or costly, highly publicized litigation

# Risk Management Program

- Board and management supervision
  - ✓ Evidence of group judgement and good corporate governance
- Policies and Procedures
  - ✓ Must match current practices and approved by Board
- Personnel
  - ✓ Structure incentive compensation plans to avoid encouraging employees to engage in unethical behavior
- Control systems
  - ✓ Compliance
  - ✓ Audit

# Examination/Audit Procedures

- Obtain and review minutes from any management or board of directors committee responsible for oversight of conflicts of interest
- Obtain and review the trust department's policies, procedures, and reports (MIS) reports bank management uses to supervise conflicts of interest, including *internal risk assessments*.
  - ✓ Should encompass compliance with applicable Federal and State laws and regulations and unique aspects of trust accounts under administration
- Determine how the bank identifies and monitors potential conflicts of interest and how impermissible conflicts are reported and resolved

# Likely Situations and Risk Mitigation

- Situations in which it is more likely to find evidence of self dealing or conflicts of interest include:
  - ✓ Investment in or retention of shares of stock or obligations of the bank, holding company, affiliates, or other related organizations
    - ❖ New account due diligence, written direction, avoid voting shares, and divestiture
  - ✓ Deposit of fiduciary funds in the commercial bank or related banks
    - ❖ Comparison of rates of return with non affiliate bank and client disclosure
  - ✓ Use of proprietary mutual funds and/or collective investment funds
    - ❖ Comparison of performance, fees and expenses with non affiliate mutual funds
  - ✓ Use of insider information
    - ✓ Self reporting of securities trades by employees and follow up

# Likely Situations and Risk Mitigation (continued)

- ✓ Purchase of securities for fiduciary accounts from syndicates in which the bank has participated
  - ❖ Strong MIS reporting and internal controls
- ✓ Use of affiliated discount brokerage companies
  - ❖ Comparison of performance, fees, and expenses with non affiliate brokerage firms
- ✓ Voting of own-bank stock or holding company stock
  - ❖ Independent analysis of issues if voting and consideration of abstaining from voting
- ✓ Security transaction(s) between trust accounts
  - ❖ Not prohibited *if* the transaction is fair to both accounts
  - ❖ Almost impossible to achieve fairness, since rest of trust accounts could also have benefited from transaction

# Supervisory Roles

- Internal/External Auditors - Looks at the past
- Compliance - Looks at the present
- Risk Management - Looks at the future
- Senior Bank Management - Promote appropriate corporate culture
- Board of Directors - Ultimate responsibility
- Regulators - Surveys entire process and procedures



# How to Minimize Potential Liability

- Strong new account acceptance procedures/due diligence review
- Follow the terms of the governing instrument/trust agreement
- Obtain a court order/approval/legal advice from outside counsel
- Maintain evidence of proprietary investment product(s) performance and fee structures
- Maintain evidence of affiliate discount brokerage fees and comparison trades

# How to Minimize Potential Liability (continued)

- Full and complete disclosure(s) on client statements, communications, and meetings
  - ✓ “Boilerplate” disclosure language approved by bank legal department
- Written consent of the beneficiary(s) as long as it is “informed” consent and not induced
  - ✓ Difficult to obtain consent from unknown or unborn beneficiary(s)
- Required educational courses for officers and staff, along with audit and compliance reviews
- *Every employee and Board member must be committed to understanding how conflicts of interest can occur and how they must be avoided or resolved*

# Actual Conflicts of Interest Examples

- Both presenter and audience can expand upon actual examples such as:
  - ✓ Loans made from trust accounts to circumvent affiliate bank restrictions
  - ✓ Unsecured notes issued by affiliate bank purchased by trust accounts
  - ✓ Affiliate bank officers purchased items from an estate under probate public auction
  - ✓ Spouse of trust officer hired to perform trust department vendor services
  - ✓ Affiliate bank stock shares voted by trust department without independent analysis of issues
  - ✓ Receipt of 12(b)1 fees not disclosed to trust account clients
  - ✓ Proprietary mutual funds used in trust account asset portfolios despite higher than peer fees/expenses and/or less than benchmark performance results
  - ✓ Trust account asset portfolio rebalancing done by “no brokerage fee” security trades between trust accounts

# Reference Materials

- Federal Deposit Insurance Corporation (FDIC) Trust Examination Manual
  - ✓ <https://www.fdic.gov/regulations/examinations/trustmanual/index.html>
- Office of the Comptroller of the Currency (OCC)
  - ✓ [https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/conflictinterest.pdf](https://www OCC.gov/publications/publications-by-type/comptrollers-handbook/conflictinterest.pdf)

# Questions?

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