

Morgan Lewis

BROKER-DEALER COMPENSATION & CONFLICTS MITIGATION

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Broker-Dealer Compensation & Conflicts Mitigation

- Broker-Dealer Business Models
- How Compensation Arrangements Often Work
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* The perspectives and observations in this presentation of firm practices related to compensation and conflict mitigation are based on discussions with select firms and our experiences generally but are not comprehensive or based on a broad-based survey of firm practices. These are designed to aid the SEC in evaluating broker-dealer conflict mitigation practices, but do not supplant efforts by the SEC to gather appropriate data and information to inform decisions on these matters.

Broker-Dealer Business Models

Basic Business Models*

Wirehouses	Bank-Affiliated B-Ds	Placement Agents
Independent B-Ds	Discount B-Ds	Mutual Fund Distributors
Regional B-Ds	Introducing B-Ds	Limited-Purpose B-Ds
Insurance-Related B-Ds	Clearing B-Ds	Municipal Securities B-Ds

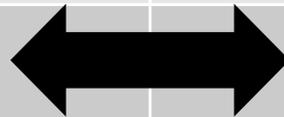
* A broker-dealer may also be dually registered as, or affiliated with, an investment adviser

Varying Client Bases

Retail	High Net Worth
Mass Affluent	Very High Net Worth

Differing Characteristics

Centralized business	Geographically dispersed business
Employees	Independent contractors
Closed architecture / proprietary products	Open architecture / 3d party & proprietary products
Centralized advice	Representative-driven advice
More limited, curated programs	Myriad programs to accommodate diverse representative community



How Compensation Arrangements Often Work

Firm Revenues

- Firms receive compensation for the sale of products and services, which might include:
 - Commissions/markups on equities, bonds, and structured notes;
 - Loads, 12b-1 fees, and share of management fees for mutual funds;
 - Up-front and trailer payments on hedge funds and private equity funds; and
 - Advisory fees for advisory programs.
- Firms might also receive other types of compensation from third parties (e.g., payment for order flow, cash sweep payments, mutual fund revenue sharing or marketing support payments, or cash referral fees from investment advisers) that are not tied directly to securities transactions, but that might be calculated based on total transactions or aggregate assets invested.
- Revenues can vary (as can client fees and charges) (1) between products types, (2) within product types, and (3) between proprietary and third-party products. For example, compensation can generally vary depending on discounts permitted by a firm or offered by a representative; mutual fund compensation can differ between available funds and between share classes of the same fund; and commissions on equity trades can differ whether charged on a cents per share basis or on the principal value of transactions.
- Firms may or may not receive the various types of compensation listed.

Representative Compensation

- Representative compensation arrangements vary between firms.
- Representatives might receive flat or variable payouts on revenue generated for selling products and services.
 - Variable payouts might be based on the product or service, size of account, overall revenue generated, years of service, or performance metrics (e.g., service or sales ratings).
 - Some firms use compensation grids based on revenue and/or size of trade, and the payout might also increase with overall production.
- Compensation may be tied to meeting certain periodic thresholds for new customer business (e.g., based on new assets or households).
- Firms might provide recruiting incentives (e.g., back-end bonuses for representatives in good standing to pay off forgivable loans) for representatives transitioning from other firms.
- Firms might exclude certain revenues (e.g., payment for order flow, cash sweep payments, mutual fund revenue sharing or marketing support payments) from representative compensation.
- Branch manager or supervisor compensation may include discretionary bonuses or overrides based on the team's overall production.

How Firms Can Seek to Mitigate Compensation-Related Conflicts

- Firm compensation arrangements can create incentives for representatives to recommend products and services that generate greater revenues (e.g., a “salesperson’s stake,” which is a primary basis for broker-dealer regulation).
- Broker-dealers, in seeking to address compensation-related conflicts, can take various appropriate steps, including:
 - Design (and periodically review) compensation arrangements to align the interest of the firm, its representatives, and its clients;
 - Firm new product review and approval before offering new products and services;
 - Policies designed to charge fair prices;
 - Training and continuing education designed to ensure representatives understand the potential risks, rewards, and conflicts of interest of recommended products and services;
 - Website or other customer disclosure about compensation practices;
 - Suitability reviews of recommended transactions; and
 - Surveillance for activity inconsistent with client interests.
- The Commission should recognize that firms may appropriately employ only some – or various combinations – of these approaches depending on their businesses and business models, compensation structures, and related conflicts of interest, and should not prescribe a one-size-fits-all approach to mitigating compensation-related conflicts.

How Firms Can Seek to Mitigate Compensation-Related Conflicts

- Design of Compensation Arrangements: Firms can design (and periodically review) compensation arrangements to align the interests of the firm, its representatives, and its clients and, as part of this:
 - Articulate overarching principles to foster such alignment;
 - Identify conflicts of interest created, and evaluate mechanisms designed to mitigate those conflicts;
 - Limit types of cash and non-cash compensation, including sales contests;
 - Evaluate and monitor representatives' financial interests apart from the firm, including employment or compensation from outside business activities and so-called "private securities transactions" or selling away;
 - Use deterrents (e.g., clawbacks and grid reductions) designed to prevent behavior not aligned with clients' interests;
 - Restrict payment of transaction-based compensation to non-licensed persons;
 - Prohibit supervisors from reporting to or having their compensation determined by a person they supervise, or include supervisors in a separate reporting line; and
 - Consider qualitative factors (e.g., customer complaints or fines) in deciding discretionary compensation for supervisors.
- Offering New Products and Services: Firms, whether they offer only proprietary products or have an open or semi-open architecture, can consider ways to mitigate incentives to recommend one product or service over another on the basis of compensation when offering new products and services, for example:
 - Using neutral commission grids;
 - Leveling amounts received for similar products within the same product type (e.g., fee leveling);
 - Setting the maximum amount that will be credited toward production (e.g., fee capping); and
 - Waiving the advisory or distribution fees for proprietary products offered in advisory programs, but not brokerage.Such steps might not be needed, and other ways can also suffice.
- Fair Prices and Commissions: Firms can adopt policies and procedures designed to ensure that prices and commissions for securities transactions are fair, and that other charges are reasonable and not unfairly discriminatory.
- Training on Products and Services: Firms can provide training and continuing education designed to help representatives understand the potential risks and rewards of recommended products and services (i.e., reasonable-basis suitability). Firms can also provide training and continuing education on firm ethics and conflicts of interest policies designed to help representatives understand how to identify conflicts of interest and handle them consistent with applicable policies and procedures.
- Disclosure: Firms can provide customers with website or other disclosure about compensation practices, including:
 - Types of charges clients might incur for products and services;
 - How representatives are generally compensated; and
 - Recruitment practices as required by FINRA Rule 2273.
- Suitability Review: Firms can employ surveillance for suitability designed to identify, for example:
 - Activity outside of a client's chosen investment objective;
 - Activity that involves outsized risk in relation to the client's investment objectives and financial circumstances (e.g., higher-risk products with higher revenue);
 - Recommendations of securities not offered by the firm;
 - Recommendations inconsistent with published research; and
 - Recommendations of products for which the firm has established limitations on customer investment.
- Surveillance. Firms can conduct surveillance (whether transactional, periodic, or forensic) to identify activity that appears to be driven by compensation considerations, whether at the representative, team, or business level, rather than client interest.
 - Firms can look for material changes in business mix, year-over-year compensation, and concentration in higher revenue generating products.
 - Firms can also monitor recommendations made by representatives that are close to a production level needed to advance to higher payout percentage or approaching year-end milestones for compensation decisions or to receive back-end bonuses, or recommendations made around key liquidity events in an investor's life.
 - Firms can escalate conflicts issues internally, as appropriate.

Recommended Revisions to the Conflict of Interest Obligations

(additions underlined; deletions in strikethrough)

(iii) ~~Conflict of Interest Obligations~~ Policies and Procedures.

(A) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify ~~and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations~~ achieve compliance with the Disclosure Obligation and the Care Obligation.

(B) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify, ~~and disclose and mitigate, or eliminate,~~ material conflicts of interest arising from financial incentives for an associated person of a broker or dealer associated with such recommendations.

Disclosure About Compensation & Conflicts

- A broker-dealer should be deemed to satisfy applicable disclosure obligations where the disclosure is reasonably designed in substance and timing to communicate material information about conflicts and the steps the broker-dealer takes to address conflicts.
- The Commission should allow for flexibility in satisfying disclosure obligations, and indeed recognize and support commercially practicable approaches, including:
 - Prospective and periodic disclosure (whether tailored, as is the case with an investment adviser's Form ADV Part 2A, or standardized across the industry, as in FINRA's standardized disclosure on recruitment practices as required by FINRA Rule 2273);
 - Transactional disclosure (as is the case with trade confirmations provided by broker-dealers); and
 - Situational disclosures as might be appropriate.
- The Commission could look to Form ADV Part 2 in identifying the types of firm and representative compensation and conflicts that firms might disclose, as summarized on slide 9. Providing consistency in the types of disclosure about compensation and conflicts required of broker-dealers and investment advisers could help dual registrants as they seek to comply with applicable obligations.
- In adopting a final rule, the Commission should:
 - Recognize that prospective disclosure can be helpful in setting customer expectations at the onset of a relationship and periodically thereafter, including when the timing of the disclosure does not necessarily coincide with a recommendation;
 - Recognize that point-of-sale disclosure is often impractical and unnecessary given the layers of disclosure that broker-dealers provide to their customers; and
 - Allow broker-dealers flexibility in determining appropriate ways to disclose conflicts of interest.

Form ADV Part 2 Disclosure About Compensation & Conflicts

Firm Compensation and Conflicts Disclosure in Form ADV Part 2A

- “Describe how you are compensated for your advisory services. Provide your fee schedule. Disclose whether the fees are negotiable.” (Item 5.A)
- “Describe any other types of fees or expenses clients may pay in connection with your advisory services, such as custodian fees or mutual fund expenses. Disclose that clients will incur brokerage and other transaction costs, and direct clients to the section(s) of your brochure that discuss brokerage.” (Item 5.C)
- “If you or any of your supervised persons accepts compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds, disclose this fact and respond to Items 5.E.1, 5.E.2, 5.E.3 and 5.E.4.” (Item 5.E)
 - “Explain that this practice presents a conflict of interest and gives you or your supervised persons an incentive to recommend investment products based on the compensation received, rather than on a client’s needs. Describe generally how you address conflicts that arise, including your procedures for disclosing the conflicts to clients. If you primarily recommend mutual funds, disclose whether you will recommend ‘no-load’ funds.” (Item 5.E.1)
 - “Explain that clients have the option to purchase investment products that you recommend through other brokers or agents that are not affiliated with you.” (Item 5.E.2)
- “If someone who is not a client provides an economic benefit to you for providing investment advice or other advisory services to your clients, generally describe the arrangement, explain the conflicts of interest, and describe how you address the conflicts of interest. For purposes of this Item, economic benefits include any sales awards or other prizes.” (Item 14.A)

Representative Compensation and Conflicts Disclosure in Form ADV Part 2B

- “If the supervised person receives commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution or service (‘trail’) fees from the sale of mutual funds, disclose this fact. If this compensation is not cash, explain what type of compensation the supervised person receives. Explain that this practice gives the supervised person an incentive to recommend investment products based on the compensation received, rather than on the client’s needs.” (Item 4.A.2)
- “If the supervised person is actively engaged in any business or occupation for compensation not discussed in response to Item 4.A, above, and the other business activity or activities provide a substantial source of the supervised person’s income or involve a substantial amount of the supervised person’s time, disclose this fact and describe the nature of that business. If the other business activities represent less than 10 percent of the supervised person’s time and income, you may presume that they are not substantial.” (Item 4.B)
- “If someone who is not a client provides an economic benefit to the supervised person for providing advisory services, generally describe the arrangement. For purposes of this Item, economic benefits include sales awards and other prizes, but do not include the supervised person’s regular salary. Any bonus that is based, at least in part, on the number or amount of sales, client referrals, or new accounts should be considered an economic benefit, but other regular bonuses should not.” (Item 5)

THANK YOU

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