

CONFLICTS OF INTEREST RISK

CHALLENGES, IMPACT AND EFFECTIVE
MANAGEMENT STRATEGIES



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AGENDA

- **Why Conflicts of Interest Matter**
- **Typical Conflicts of Interest and Impact**
- **Case Studies & Lessons Learned**
- **Best Practices and Effective Management Strategies**

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Why You Can't Serve Two Masters

Peter B. Madoff, former Chief Compliance Officer, Bernard L. Madoff Investment Securities LLC




CONFLICTS OF INTEREST MATTER


NYSE Definition

The New York Stock Exchange's Corporate Governance Rules defines conflicts of interest as the following:

"A conflict of interest occurs when an individual's private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company.... The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company."



Why Conflicts of Interest Matter

- A conflict of interest increases risk of bias or poor judgment because of an obligation or commitment to two or more competing interests
 - A perceived conflict can tarnish public image and erode community trust
 - Government regulators expect companies to assess their exposure to the risks of conflicts of interest
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Comments from the SEC on Conflicts of Interest

“The types of conflicts that I find most challenging are situations where people who profess to be ethical and clear-thinking are led astray by cultural pressure (poor tone at the top), misaligned financial incentives, herd behavior (everyone is doing it), or just personal weakness – vanity, self-delusion or poor judgment. The best anecdote for this type of conflict is a strong ethics programs for the organization, as well as a strong internalized sense of ethics by everyone in an organization....”

- Carlo V. di Florio, Director, SEC Office of Inspections and Examination, 10/22/12

Human Nature of Conflicts of Interest

- One should avoid conflicts of interest, or situations that can give rise to the appearance of a conflict of interest
 - But if you don’t think you have one, you can’t or won’t avoid it
 - We are often a poor judge of our own conflicts and not motivated to resolve or disclose them
- A wide range of activities are prone to potential conflict situations
 - Multiple roles are increasingly common for individuals and organizations
 - Conflict situations are likely with accomplished and well-connected individuals (company leaders)

Duty of Loyalty and Care

- *Duty of Loyalty* is the obligation to give primacy to the interests of the company rather than personal concerns – to avoid self dealing at the corporation's expense.
- *Duty of Care* is to act in good faith, in a manner which is reasonably believed to be in the best interests of the company, with the care a reasonably prudent person would use in similar circumstances.



Arrogance and Greed Result in Prison Terms

Martha Stewart



Samuel Waksal



Typical Conflicts of Interest

Use of Company Information for Private Gain

General Financial Interest (hidden ownership, bid-rigging, procurement fraud)

Moonlighting (current employment and future job offers)

Service on a Board of Directors

Family and Romantic Relationships

Typical Conflicts of Interest

Spouses, Domestic Partners, Immediate Family Members or Relatives as Suppliers, Vendors, Customers

Implied Pressure on Employees to Use a Manager's Relative or Friend

Vendor Relationships – Kickbacks and Rebates

Gifts from Vendors, Customers or Others

Improper Use of Company Assets

Kickbacks

The giving or receiving of any “thing of value” to influence a business decision without the employer’s knowledge and consent

Kickbacks can take many forms:

- Cash
- Gifts and Gratuities
- Travel and Entertainment
- Cars
- Jewelry
- Loans at less than market interest
- Debt forgiveness
- Payment of personal expenses
- Medical treatment
- Sexual favors

Employees Should Ask the Following Questions:

- “Would I be concerned if other people found out about it?”
- “How would it look if it was in the newspaper?”
- *The Wall Street Journal Rule*
- “How would I feel if it involved someone else?”
- “What is the right thing to do?”

Ex-Best Buy CEO Had Inappropriate Relationship With Employee

Former CEO Brian Dunn



Report
Of The
Audit Committee of the Board
of Directors of Best Buy
To The
Board of Directors of Best Buy
Regarding
Investigation of Alleged
Misconduct By Former Chief
Executive Officer
May 12, 2012

“A CASE OF DIVIDED LOYALTIES”

*Fool me once, shame on you.
Fool me twice, shame on me.*

- Anonymous

Background

- IT Program Manager, responsible for developing POCs and managing tools to show customers best-in-class implementation
- Hired partner using third party payment provider
 - \$500K in BIF POs set-up with third party payment provider
 - PO did not reference actual partner engaged to perform work
 - Employee told manager the payment provider was doing the POC
 - Deliverables were very soft with no measureable engagement details
 - Much of the work was labeled as “project management”



How Were the Issues Discovered?

- New manager of the new employee saw an odd name on the PO where it mentioned the true company performing work
- New manager visited the Website and saw a contact e-mail similar to the name of his new employee
- New manager escalated issue to HR who contacted the company's investigations team



How Did This Happen?

- Original manager was “rubber-stamping” the PO approvals
- Many small POs did not raise red flags
- Lack of management oversight and tangible milestones
- Purchase orders (contractual obligations) with deliverables not clearly defined
- POs for third party payment providers
- Employee was directly calling third party payment provider to arrange payment to his company




**BEST PRACTICES & EFFECTIVE
MANAGEMENT STRATEGIES**

Performing a Risk Assessment

- **Goals**
 - Integrate into existing risk assessment processes
 - Identify key risk areas
 - Gather sufficient information for making sound policy decisions
 - Assist in designing effective compliance policies and processes
- **Risk assessment will help determine who will need to complete a disclosure statement**
 - Regulatory considerations
 - Organizational requirements/objectives
 - Higher level employees are generally at a higher risk
 - Indicators identified from Helpline/Hotline calls
 - Consider third party risk



Code of Conduct

- **Specificity versus Flexibility**
 - Code of conduct/ethics for stating general principles to guide employees and the program
 - Specific policies for more detailed guidance in high risk areas yet still broad enough to provide flexibility
 - Scenarios and FAQs
- **Principles-based versus bright line rules**
 - Principles: case-by-case application to facts and circumstances
 - Bright line rules: provide specific rules
- **Benchmarking with industry peers**
- **Ongoing review and modification**



Code of Conduct

- Code creation and revision involve collaboration across company departments
- A detailed conflict of interest policy should be incorporated in a code of business conduct
 - Explain the issue of conflicts of interest and how the policy applies to all employees including executives and directors
 - Discuss why conflicts create legal and reputational risk and must be avoided
 - Detail that even the appearances of a conflict of interest can be problematic
 - Disclosure requirements
- Best-in-class codes contain situational examples (scenarios) of ethical challenges and questions and answers around conflict issues to further reinforce compliance




Gifts: Standards and Policy


- Tailor your policy to the needs of your industry and company
 - Relevant laws and regulations
 - Industry and marketplace practices
- Benchmark with industry peers
 - Request codes and policies, obtain those publicly available
- Develop a policy that minimizes the likelihood of a violation
 - Provide resource for questions and obtaining required approvals
 - Identify specific prohibitions
 - Determine and communicate gift thresholds




Holiday Season Gift Policy

- Conflicts of interest can be particularly challenging during the holiday season
 - Business relationships vs. business risk
 - Clear guidance and common sense
 - Good judgment, discretion & moderation
 - Prohibitions: cash, personal gifts, gifts prohibited by recipient's company
 - Limits, exceptions, and government officials
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Training and Communication

- Evangelize the code of conduct and a culture of compliance
 - Ongoing company-wide conflicts of interest awareness and prevention communication
 - Interactive, scenario-based training including conflicts of interest examples
 - Encourage employees to ask questions and seek guidance before they engage in possible conflicts of interest
 - Communicate existence of hotline for reporting including whistleblower and non-retaliation policies
 - Training at new employee orientation, new manager training, management and executive seminars
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Promoting Tone at the Top/Message in the Middle

- Have the executives/managers completed the required training and ethics courses?
 - Have the executives/managers handled compliance matters appropriately when they have occurred in their organization?
 - Have the executives/managers communicated the importance of knowing and following the code of conduct and company policies and procedures throughout their organization?
 - Have the executives/managers set the appropriate “tone at the top/message in the middle” and is it communicated and practiced?
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Hotlines: Build It Right and They Will Call

- Well-communicated and easily accessible
 - Available in many forms (telephone, e-mail, mail, and fax)
 - Operated 24/7 with live operators
 - Available to callers in every country the organization operates
 - Language capability
 - Use a third-party vendor of hotline services
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Certifications and Disclosures

- **Certifications**

- Used by organizations for select (mostly high-level) or all employees
- Provide employees opportunity to report potential conflicts
- Typically require employees to certify that they have read and are familiar with the conflicts of interest policy (and code of conduct)
- Certify they are not aware of any violations of the policy

- **Questionnaires**

- Request employees to supply information and respond to more detailed questions, not just certify
- Large organizations utilize Web and electronic systems to manage the process and data
- Exit interviews



Attestation

- The conflict of interest attestation section that the employee signs upon completion of the disclosure form should include the following statements:

- I have read the organization's code of conduct and the conflicts of interest policy
- I understand and acknowledge the policy's requirements
- I agree to comply with the conflict of interest policy and the overall ethical code
- I agree to immediately report any potential conflicts of interest whether mine or that of another employee or vendor
- I am not currently aware of any conflict of interest on my part or that of any other employee or third party
- To my knowledge, I attest that the answers provided in this disclosure form are true and accurate



Conflict of Interest Review Processes

- Reviews should be conducted by an independent body such as a Conflict Review Committee
- It should also encompass the behavioral ethics concept of “motivated blindness”
 - a reviewer should not be someone who may – due to the relationships involved – be inclined to approve a conflict-laden relationship or transaction.
- If supervisors are allowed to approve (waive) COIs:
 - Require approvals in writing before engaging in a conflict-based transactions
 - Provide and publicize avenues for supervisors to ask questions
 - Include the issue of COI reviews in supervisor training and provide written guidance (e.g., FAQs) regarding such reviews.
 - Check on the supervisors’ actions in reviewing or approving COIs, such as through audits



Auditing the Certification Process

- Interview individuals responsible for the process (legal, compliance, internal audit)
- Review conflict of interest training materials to determine if they have been modified and updated as appropriate
- Validate employee certifications and training completion logs
- Evaluate data collected from employee questionnaires:
 - What is the overall response rate?
 - What are the most common types of conflicts reported?
 - What are the consequences for failure to complete the certification?
- Review employee surveys, focus groups, targeted interviews



Auditing the Certification Process (cont'd)

- Random and targeted audits of expense reports
- Proactive data analytics
- Gauge employee awareness of the conflicts of interest policy and effectiveness of training and communication
 - Perception of work environment, corporate culture and willingness to report misconduct including conflicts of interest
 - Awareness and understanding of conflict of interest policies and related training received
- Include vendors/suppliers in certification and disclosure process
- Determine if reported conflicts have been appropriately reported and investigated/assess whether reported issues have increased or declined



Compliance Benchmarking

- Benchmark your conflict of interests policies and procedures, as well as your overall compliance program, against other companies for a comparative analysis of:
 - Policies
 - Risk assessments
 - Training and communication
 - Investigations
 - Incentives and discipline
 - Program modification
 - Overall best practices
- Facilitate a compliance summit with several companies participating or just one-on-one meetings



Effective Management of Conflicts of Interest

- We'll always face conflicts of interests but best-in-class compliance program practices can make a difference in detection, prevention and mitigation.
- Companies should not wait for ethical issues and misconduct to occur before evaluating and enhancing corporate policies and procedures.
- Best-in-class organizations are constantly looking at opportunities to provide their employees with the most current guidance on new and emerging ethical issues.
- "When it comes to compliance, you have to live, eat, breathe and drink it. It has to be embedded in a firm's DNA." – Harvey Pitt, former SEC Chairman

THANK YOU!

QUESTIONS?

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