Conflicts of Interest in the Corporate Environment

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Conflicts Defined

Conflict of interest. A real or seeming incompatibility between one's private interests and one's public or fiduciary duties.


From the company’s perspective: A conflict of interest exists when one’s personal interests interfere in any way with the interests of the Company.
Conflicts of interest are one of the most complex areas of compliance law

- Lack of unified law
- Wide scope of activities prone to conflicts
- Highly personal context in which conflicts arise
- Discretionary nature of transactions
- Proclivity for individuals to conceal conflicts of interest
Background

Most of the scandals of the past several years have arisen from conflicts-related issues

- Backdating of stock options
- Research analysts
- Mutual fund scandals
- Financial reporting: conflicts between executives and shareholders
- Friends and family stock
- Corporate directors’ independence issues
- Outside auditors’ independence issues
Managing Conflicts

• Scandals demonstrate the need for a proactive approach

• Many companies are seeking guidance on dealing with conflicts, including how to:
  • Recognize
  • Audit for
  • Control for
  • Handle
  • Document and demonstrate compliance efforts

• There is no one-size-fits-all approach

• Focus on how to respond adequately within particular context
Approaching Conflicts Management

Lessons from recent scandals

• Conflicts are easy to overlook and under-appreciate

• Government regulators expect companies to assess their exposure to conflicts risks

  SEC enforcement chief calls for “top to bottom” conflicts risk analysis in financial services companies (Sept 2003)

• Need to understand all relevant duties that could give rise to conflicts, both personal and organizational

• Companies can best control their risk by first understanding what their risks are
Approaching Conflicts Management

Conflicts are increasingly a fact of life, as modern organizations and individuals

- assume more diverse roles
- change roles more frequently over time

Understand some “positive” reasons for conflicts

- Efficiency/Shared costs
- Specialization
Focus on Ethical Handling

Identifying a conflict is not necessarily the end of the analysis

- Zero tolerance isn’t always desirable
- Zero tolerance is not typically required
- Conflicts “experience” often progresses from prohibition regime to disclosure one
- But, very important to ensure that conflicts are dealt with adequately
Focus on Ethical Handling

SEC regulations promulgated under SOX § 406

- require companies to disclose whether they have adopted a code of ethics for senior financial officers and if not, why not
- define a code as written standards that promote, among other things, honest and ethical conduct, including ethical handling of conflicts
The Role of Compliance & Ethics Programs

- Consider various elements of compliance programs and their ability to address conflicts
  
  Revised Sentencing Guidelines’ emphasis on considering risks on an element-by-element basis underscores this

- Risk assessment
- Policy formulation
- Oversight
- Training
- Controls, e.g. auditing, monitoring, pre-approvals
- Investigation and discipline
- Documentation
- Periodic assessment
Risk Assessment

Goals
- To cast a wide net, but pinpoint key risk areas
- To gather sufficient info for making sound policy decisions
- To gather the type of info that can be used to design effective compliance procedures and policies

Think Broadly
- Consider underlying principles
- Consider industry experience, but don’t be bound by it
- Weigh potential harm
- Consider applicability to agents and third parties

Integrate into existing risk assessment process if possible
Consider fiduciary duties potentially giving rise to conflicts

- General fiduciary duty of loyalty, e.g., to
  - Company
  - Clients
- Fiduciary duties arising from relationships of trust
- Gatekeeper duties
  - SOX 307
  - Outside auditors
  - Analysts
- Professional standards, which can create duties
- These can overlap
Risk Assessment: How Do Conflicts Arise?

• Duties can arise at the organizational level
  • To whom are duties owed?
  • What interests are in possible conflict?
• Duties can arise at the individual level
  • Who is in a position to profit/cause harm from acting in a conflicted way? (Incentives)
  • Is the individual exercising discretion? (Opportunity)
  • As general matter, risks tend to be higher for high-level persons
Risk Assessment: How Do Conflicts Arise?

Are agents covered by your conflicts policies?
  • Often are considered high risk
  • *But,* don’t always have the same duties that employees do
  • What is the harm that a conflicted agent could cause your organization?
Conflicts Policies

Defining a conflict is only the beginning...

Specificity v. Flexibility

• Stating general principles to guide the program
  • Policies broad enough to provide flexibility
• Providing a certain level of specificity, e.g.
  • Address specific risk areas
    • Equity interests
    • Working for business partners or competitors
    • Family members in the industry
    • Personal use of company property
    • Corporate opportunities
• Definitions of family
• Gift and entertainment standards
Handling Risk on a Policy Level: *Prohibition* v. *Disclosure*

- Zero Tolerance?
  - Not always desirable, depends on degree of risk aversion and impact on business
  - Not required by Sarbanes-Oxley
  - Consider the impact of “waiver” v. “pre-approval”

- “Adequate” controls
  - Tailored to meet goals
  - Integrated into the compliance system
  - Meet disclosure requirements
Moody’s Code of Business Conduct and Ethics: Conflicts Of Interest Section

1) Addresses importance of topic: Moody’s long-established internal policies to mitigate conflicts of interest are essential for our credibility in the market and the independence of our employees.

2) Defines conflicts: A conflict of interest exists when your personal interest interferes in any way with the interests of the Company.

3) Sets forth employee obligations related to conflicts: Your obligation to conduct the Company’s business in an honest and ethical manner includes the ethical handling of actual, apparent and potential conflicts of interest between personal and business relationships. This includes full disclosure of any actual, apparent or potential conflicts of interest as set forth below.

4) Creates separate obligations for executive officers and directors: full disclosure to GC and Chair of Audit Committee, and prior written approval of Audit Committee.
Conflicts Policies

Moody’s Code of Business Conduct and Ethics: Conflicts Of Interest Section

Provides additional guidance regarding specific conflicts scenarios:
  1) Interests in outside companies
  2) Positions with outside companies
  3) Employees as consultants
  4) Independent contractors/contract workers
  5) Purchases
  6) Use of company resources
  7) Improper personal benefits from the company
  8) MIS rating process: special rules applicable to those employees involved in the ratings process
Conflicts Policies

Moody’s Code of Business Conduct and Ethics: Corporate Opportunities Handled Separately

Employees and directors owe a duty to the Company to advance its legitimate interests when the opportunity to do so arises. If you learn of a business or investment opportunity through the use of corporate property or information or your position at the Company, such as from a competitor or actual or potential customer, supplier or business associate of the Company, you may not participate in the opportunity or make the investment without the prior written approval of the General Counsel. Directors must obtain the prior approval of the Board. Such an opportunity must be considered an investment opportunity for the Company in the first instance. You may not use corporate property or information or your position at the Company for personal gain, and you may not compete with the Company.
Moody’s Code of Ethics for Chief Executive and Senior Financial Officers:

Your obligation to conduct the Company's business in an honest and ethical manner includes the ethical handling of actual or apparent conflicts of interest between personal and professional relationships. **No Senior Officer shall make** any investment, accept any position or benefits, participate in any transaction or business arrangement, or otherwise act in a manner that creates or appears to create a conflict of interest unless the Senior Officer makes **full disclosure** of all facts and circumstances **to the General Counsel and the Chairman of the Audit Committee** of the Board of Directors and **obtains the prior written approval of the full Board** of Directors.
Conflicts Policies

Ownership of Competitor or Supplier/Customer Stock

- In the past, employees typically did not own a large number of different securities, and a company could prohibit ownership of certain securities (e.g., of a competitor or supplier)

- Today
  - Stock a greater portion of employee wealth
  - Mutual funds and 401(k)'s are main investment vehicles
  - Nobody wants liability for dictating wealth strategy to employees
  - States are starting to limit restrictions on employee ownership of competitor stock (California)

Policy Considerations
Conflicts Policies

Business Arrangements with the Company

• Before Enron, not on the radar screen as a risk area for most companies

• Today, many companies include this in conflicts policy
  • E.g., Without full disclosure and written consent, an employee may not participate in a joint venture, partnership or other business arrangement with the Company
Conflicts Policies

Public Service and Charities

• Can also create conflicts

• May wish to include discussion in conflicts policy

  e.g., Even contributions to charities and community organizations can create conflicts of interest, and such contributions always require compliance with applicable laws. Employees are encouraged to make contributions of personal time or financial resources to charitable, educational, and community-service organizations. We must, however, be alert to possible conflicts of interest between our organization and the charitable organization that we wish to serve. If a charitable organization that you are involved with seeks to do business with our company or seeks donations from our company, you should fully disclose the situation to the compliance officer.
Conflicts Policies

Nepotism
• Policies emanate from a concern that un- or under-qualified individuals will be hired, promoted or otherwise favored because of relationships with another employee
• The most stringent anti-nepotism rules prohibit employment of relatives of an employee anywhere in the organization
• Less restrictive rules may prohibit the employment of relatives at the same location or in the same department
• Companies may also choose to prohibit relatives from supervising or having direct or indirect influence over the employment conditions of the other
• If organization operates in Europe, must be careful not to violate privacy or labor laws with enforcement of nepotism policy
As a manager, I have been working with a Company supplier for a number of years. He recently offered to do some personal work for me at a substantial discount. Can I take him up on his offer?

No. The contractor would be granting you a special favor due to his relationship with the Company.
I am an information services manager at Moody’s. For many years, I have owned stock in Acme Software Company that is now worth $20,000. My manager assigned me to develop specifications for the purchase of a new software package, and Acme is one of the major vendors. Should I say anything?

Yes. I need to inform my manager, and allow her to decide whether I should be reassigned.
As the analyst for XYZ Corp., I have been working with my contacts at XYZ, including Zed Yeager, for several years. Recently Zed and I began dating. Is this a conflict of interest? What should I do?

Yes, this creates a conflict of interest. A conflict of interest may arise from the personal relationship of an employee with an employee of a customer, investor, or other business contact. I should notify a higher-up to assess the situation.
Can an employee sell products (e.g. Mary Kay cosmetics, Amway products) to other employees or customers?

Generally, no. Company time, resources should not be used to engage in an outside business activity. This does not generally prohibit solicitation for charitable organizations, provided that the employees who are solicited are not subordinates of the soliciting employee.
Certifications and Questionnaires

• Certifications
  • Increasingly used by companies for either high-level or all employees
  • Typically require employees to certify that they
    • have read and are familiar with the conflicts of interest policy
    • are not aware of any violations of the policy during the past year or have reported any facts or situations during the past year that have raised any questions under the conflicts of interest policy
  • Typically also provide employees with an opportunity to report

• Questionnaires
  • Asking employee to provide info, rather than just to certify
  • Large companies may need a system to manage this data
Auditing for Conflicts

- Auditing for implementation of the policy
  - employees have received and signed certifications attesting that they received conflicts policy
  - employees participated in conflicts training
  - employees' awareness of internal reporting mechanisms
- Auditing for violations of the policy
  - Review waivers/prohibitions for consistent application
  - Review expenditures
    - T&E receipts for sensitive procurement areas
  - May wish to seek information from third parties
    - Some companies now asking suppliers to confirm that payments have not been made/gifts not given to employees (a variation on the annual holiday letter to suppliers)
Discipline for Conflicts Violations

Particularly challenging due to lack of governing legal standards

Appropriate discipline has several dimensions

• Deterrence
  • responses calculated to deter future misconduct
• Rigor
  • crafting the response to effectively fix what’s broken
• Fairness
  • perceptions by employees, regulators and the public
• Commitment to Compliance
  • having high-level review is particularly important
  • responding by adjusting company practices
Pre-Approvals & Waivers

Different Approval Models:

• Central Approval (e.g. ethics or law office)
  • Safety in numbers
  • Have the decisions made by committee
  • Lends a certain level of independence

• Approval by Supervisors
  • Consider *written* approval requirement
  • Avenues for supervisors to seek approval or ask questions
Conflicts Management

Things to Consider

• Create a demonstrably proactive, rational approach.
• Assessment and reassessment of risk
• Adjusting conflicts policies to reflect changing risk profile
  • Prohibition of conflict v. disclosure of conflict
  • Policies should fit the company’s ability to bear risk
• Structure, frequency and detail of any reporting
• Assure that personnel managing the process are not themselves conflicted