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# Rooting Out Conflicts of Interest

## COMPLIANCE WEEK

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# Advice for Conflict-of-Interest Audits

By Jose Tabuena

Compliance Week Columnist

Conflicts of interest are becoming a major focus of late, as many newsworthy corporate scandals have a COI issue at their core; how can you avoid their fate?

Perhaps no other area of business conduct is as fraught with potential peril as are conflicts of interest. In my October 2008 column, I wrote on how abuse of travel and entertainment expenses can hint at bigger fraud problems. We're in luck; similar irregular spending habits can also be red flags for potential conflicts of interests.

The New York Stock Exchange provides a basic definition: 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 can arise when one has interests that may make it difficult to perform work for the company in an objective and effective manner.

You can find conflicts at all levels within a corporation and out in the community. In our neighborhood soccer league, I recently learned that the referee for a game was the uncle of one of the players of the winning team. This little tidbit had not been disclosed, so not surprisingly the losing team protested. In defense, the uncle referee claimed that he couldn't influence the outcome anyway, and that he could be fair no matter which team was playing. Sounds eerily familiar to the physicians who believe that lavish treatment from drug reps does not influence their prescription patterns despite evidence to the contrary.

## Human Nature and Conflicts of Interests

Therein lies part of the dilemma. Most agree that companies and employees should avoid conflicts of interests or situations that give the appearance of a conflict. But if you don't *see* the conflict, or you believe the conflict won't impair your objectivity, you probably won't avoid or disclose it. We can be a poor judge of our own biases and generally aren't predisposed to divulge a possible conflict situation.

As you go up the corporate ladder, running into conflicts of interest becomes even more inevitable. Conflicts are likely to occur with accomplished and well-connected

individuals who become executives and serve on boards. Clearly corporations can't outright ban conflicts of interests from occurring or business would be difficult to conduct. So what do you do?

## Organizations and Conflicts of Interests

Conflicts of interest have received more attention lately because of recognition that many of the recent corporate scandals involved, at their core, a conflict of interest. For instance, the special purpose entities created by Enron (which typically are legitimate structures) involved an inherent conflict of interest with the CFO smack in the middle. Unfortunately the conflict between the SPE and Enron itself, as well as the conflict with the code of conduct, had been conveniently waived by the board of directors. It's also believed that Arthur Andersen's extensive consulting work for Enron may have compromised its external auditor independence and judgment in determining the nature, timing, and extent of audit procedures to be performed.

In the aftermath, Congress and the stock exchanges developed standards and guidelines for instituting codes of conduct and addressing conflicts of interest. Waivers to the code, particularly those involving conflicts of interest, now tend to be viewed with disfavor.

As part of comprehensive changes to its rules on disclosure of executive compensation, the Securities and Exchange Commission adopted a requirement that companies provide disclosure about their policies and procedures governing related-party transactions. While the majority of *related-party transactions* are perfectly normal, the special relationship inherent between the involved parties does create the potential for conflicts.

## Awareness of Conflict-of-Interest Principles?

Most companies now have conflict-of-interest policies that oblige the disclosure of conflicts when they arise; require certification that the employee has read the policy; and further that the individual attests that he has either reported or isn't aware of any violations to the policy. Typically companies use an annual questionnaire that asks the employee to supply information and respond to detailed questions about common scenarios that give rise to a conflict.

Having employees acknowledge and attest to the code and policy can prove handy. Example: A large university fired its financial aid director when it was discovered he owned stock in a company that was being recommended to students and placed on a preferred lender list. It turned out that the director had signed documents acknowledging he understood and agreed to the conflict of interest



policy and other ethical standards. Obviously that policy (and certification) was not significant to prevent this financial aid director's conduct, and it turned out that there was widespread ignorance among the college's financial aid management and the staff about the stated conflict-of-interest principles.

Enter the internal audit department, often working with the compliance and ethics department. This is the group best-suited to monitoring adherence to the policy and assessing effectiveness of the process. Companies should review code-of-conduct provisions and internal policies addressing conflicts of interest, and consider how these will coordinate with a board-level policy for approving related-party transactions.

An organization that fails to prevent and manage conflicts of interests risks public embarrassment as well as legal liabilities. A company is better served by having policies and guidelines that are well understood by leadership and the workforce.

#### Auditing Conflict-of-Interest Practices

An audit of conflict-of-interest practices will entail interviews and critical review of documentation to ensure that the objectives of the process are being met. At a minimum, it should be determined whether required individuals understand the policy and are submitting disclosure questionnaires, and if reported conflicts are addressed appropriately. I've seen organizations so focused on ensuring a high completion rate of the questionnaire that they perform only a cursory review of the reported conflicts and related data.

As I hinted at the start of this column, T&E expense reports can suggest potential conflicts of interest. Random and targeted reviews of travel and entertainment expenses, especially on high-volume areas and high-risk departments, may uncover suspicious spending that involves a possible conflict. Likewise, surveying vendors and suppliers can reveal conflict situations where a disgruntled contractor or prospective seller believes a competitor has been unfairly favored. Continual monitoring efforts should be developed to help identify potential red flags. Monitoring activities can highlight risk areas for more focused review. Examples of periodic monitoring include:

- » Requiring close review and accountability of expense

reports by those with final approval authority.

- » Building notification triggers into the expense-reporting process when thresholds or limits are exceeded.
- » Developing exception reports for expense and entertainment records and data.
- » Reviewing regularly helpline/hotline reports for calls alleging conflicts of interests.

Auditing conflicts of interest can be a challenge, partly because of difficulty in detecting and establishing a negative—how do you identify the conflict of interest that was not reported? Sometimes employees and vendors are your best eyes and ears for non-disclosed situations.

More frequently I see the use of analytic technology emerging as a tool to detect potential conflicts of interests. A data match can be performed between employee and vendor data files to identify relationships that suggest possible conflicts and control weaknesses. The matching would look for employees and vendors with the same address, tax id number, or bank account.

I've used this technique myself, and seen instances where an unexpected relationship between an employee and vendor revealed a conflict of interest that should have been reported, but wasn't. Often the company is surprised to learn that an employee has the same bank account with a seemingly unrelated vendor. In some instances it was more than a policy violation but the committing of procurement.

There are tools available to the internal auditor to support the company's management of conflicts of interest. An organization that fails to prevent and manage conflicts of interests risks public embarrassment as well as legal liabilities. A company is better served by having policies and guidelines that are well understood by leadership and the workforce. Fortunately there are processes and techniques to detect and monitor for potential conflicts, and to help ensure such issues are appropriately addressed. ■

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# Conflicts of Interest

## Why and How to Manage Relationship Risk

Most people would find it difficult to argue about the need for impartiality. However, in an increasingly connected and global business landscape where, as the saying goes, “it’s not what you know, it’s who you know,” properly leveraged networks and relationships can be key to success. In many cases, those relationships can exist without being at the expense of another individual or the business. However, some present clear and real conflicts that need to be avoided entirely. Still more fall somewhere in between. And therein lies the issue: Relationships are inherently complex, as is the understanding, management, and monitoring of those relationships for potentially damaging conflicts in a business context.

Carlo di Florio, former director of the Securities and Exchange Commission’s Office of Compliance Inspections and Examinations, explained conflicts of interest in 2012:

*A simple Google search shows that it is used in varying ways in different contexts. I prefer to think of a conflict of interest as a scenario where a person or firm has an incentive to serve one interest at the expense of another interest or obligation. This might mean serving the interest of the firm over that of a client, or serving the interest of one client over other clients, or an employee or group of employees serving their own interests over those of the firm or its clients.*

In other words, any activity or relationship that affects an employee’s objectivity in making decisions on the company’s behalf presents a conflict of interest.

History has shown that conflicts of interest can be primary drivers of risk and misconduct for organizations. And while it may not be realistic to identify and monitor every situation or relationship, it’s important to understand the specific areas where conflicts typically arise—along with knowing how to address and manage the potential risk they pose to the organization.

### The Impact of COIs

Conflicts of interest—both real and perceived—can call the objectivity and fair dealings of an entire organization into question. Moreover, conflicts may create or exacerbate risk in the form of bribery and corruption, harassment, discrimination, retaliation, insider trading, fraud, and more.

Customer, partner, investor, and employee confidence in a business can be shaken—and long-term financial and reputational stability diminished—if misconduct driven by conflicts of interest

is brought to light.

Several such cases have been in the news in recent years:

- » McGraw-Hill shareholders saw stocks tank by 27 percent in February 2013 after the Justice Department announced it might seek as much as \$5 billion in civil penalties as part of a COI and fraud lawsuit.
- » Goldman Sachs went unpaid in 2012 on a \$20 million advisory fee in the sale of El Paso Corp. to Kinder Morgan Inc. after it was accused of a conflict of interest in the sale. El Paso shareholders filed suit when it was discovered that Goldman had a multibillion-dollar stake in Kinder Morgan.
- » In 2012, law firm Covington & Burling suffered a “major embarrassment” when a court found that the firm exhibited a conflict of interest in helping the Minnesota attorney general bring an environmental case against a previous Covington & Burling client. The COI case remained in the news well into 2013.

If companies leave conflicts of interest unaddressed and unmanaged, they could pay the price—in dollars and reputation.

*The challenge that businesses face today is not just determining whether a relationship poses a conflict of interest, but appraising and addressing the risk stemming from that conflict. In some situations, the likelihood that a relationship creates a conflict of interest may be minimal, but the company should still document the relationship.*

### Handling Potential Conflicts of Interest

The challenge that businesses face today is not just determining whether a relationship poses a conflict of interest, but appraising and addressing the risk stemming from that conflict. In some situations, the likelihood that a relationship creates a conflict of interest may be minimal, but the company should still document the relationship. Being aware of the relationship gives the company the opportunity to decide if the conflict is benign or may have potentially harmful impacts, and if special precautions need to be



taken. Additionally, making the company aware of the conflict fosters an atmosphere of fairness, transparency, and trust.

Reported relationships don't always require blanket approval or strict declination. Once aware of potential conflicts, a company can evaluate the situation and risk potential and, if necessary, delineate conditions under which it accepts a relationship by prescribing specific policies or procedures to remove or reduce the potential risk. For example, a company may acknowledge and accept that its head of purchasing has a brother who works for one of the company's vendors. While this clearly presents a potential risk, the company can set specific parameters that restrict the head of purchasing's interaction with that vendor or require additional oversight.

Rather than the drastic measure of finding a new vendor, this is a sensible and workable solution to a common conflict of interest. But to get to the point where a company can collect and individually assess conflicts, it first needs to have a proactive COI risk and compliance management program in place. This includes policies and training; regular audits; and the ability to collect, document, and track relationship disclosures.

## Policies and Training

A business' first line of defense is its employees. That's why it's important to have clear policies in place that explain how the company defines conflicts of interest, how they can be avoided, why they should be reported and how, if at all, you require the disclosure of relationships that could present a potential conflict.

### Increase Awareness

There may be times when an employee does not report a relationship because they do not realize there is a conflict or don't fully understand or appreciate the impact it may have on the company or its stakeholders. The most effective COI policies encourage employees to report any relationships that have a connection to their job or the company—no matter how remote or inconsequential they perceive the relationship to be. As long as it's reported, a compliance professional can judge whether the relationship presents a risk, as well as if and how the risk is addressed.

If your company has set approaches to specific types of conflicts—such as prohibiting managers from having a romantic relationship with a direct report or stating that decision makers must excuse themselves from the hiring process if they have a connection to an applicant—these should be outlined clearly in your policy.

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### Provide Instructions

Policies should detail how employees can disclose potential conflicts of interest, explain the process for reviewing and ruling on reported relationships, and set clear ramifications for employees who fail to report a conflict. It's also important to remind employees to keep their disclosures up-to-date with any changes in relationships, roles, or business processes.

### Reinforce With Training

Online training can reinforce key COI concepts and standards. Pairing the communication of your COI policy and training with a disclosure request can maximize impact and results—it's best to ask employees to disclose potentially risky relationships when company expectations and requirements are most clear and top of mind.

### Watch Your Tone

Using the right language in your COI and disclosure policies is crucial. It's critical not to scare or threaten employees, which may decrease their willingness to report a relationship or their candor in doing so. While the term "conflict of interest" may seem like a cause for concern, reporting a relationship is not a bad thing or something that will necessarily result in punishment. That message should be clearly communicated to your employees.

## Disclosure Channels

To ensure a fair and consistent approach to COI management, a defined disclosure process should be implemented and regularly communicated throughout the company. Though a dedicated disclosure management solution is best, other options for collecting



COI reports can include a telephone hotline or company proxy. However, bear in mind that relying on e-mails, paper forms, or an intermediary can be prone to errors and difficult to update as relationships change. Deploying an online portal that is directly accessible by all employees will help you better manage COIs.

Whichever method you choose to collect disclosures, it's best to provide a standard form. This ensures that all the necessary and critical information about the relationship is collected and that extraneous or irrelevant details don't distract reviewers. Providing a uniform disclosure form also ensures that you collect the same data every time, making it easier to make fair and consistent decisions.

*Make it clear that employees should update their disclosures whenever there's a change in the relationship or their role in the business, as this can affect the likelihood or impact of the risk. Your disclosure process should make it easy for employees to update pre-existing COI reports. Regardless of changes, disclosures should be revisited yearly to ensure they remain accurate.*

Make it clear that employees should update their disclosures whenever there's a change in the relationship or their role in the business, as this can affect the likelihood or impact of the risk. Your disclosure process should make it easy for employees to update pre-existing COI reports. Regardless of changes, disclosures should be revisited yearly to ensure they remain accurate.

While your policy may encourage employees to self-report their relationships, you also want a mechanism in place for other employees to report a potentially unknown and risky conflict. This is best done through a separate reporting channel, such as a compliance hotline, to ensure proper routing and prioritization. A compliance hotline option often allows the third party to report anonymously, which may encourage the reporting of high-risk conflicts that another employee is trying to hide.

## Technology

Conflict of interest disclosures used to be collected and stored in files that made it difficult to update; continuously monitor known conflicts; understand complex, multiparty relationships; and ultimately address any risk posed by the relationship. As

compliance solutions mature, better disclosure management options have developed. These new platforms are a flexible, reliable, and auditable way to reconcile disclosures, allow employees to update reported relationships, communicate with the reporting party, document COI decisions, and establish and track provisions related to relationship approvals. Some solutions have also made it possible to understand how documented conflicts affect your larger risks and incidents, as well as provide insight into how well your COI initiatives and controls work.

From an employee's perspective, electronic disclosure forms make it easy to disclose and update their relationships, especially if the technology walks them through the process. Customizable solutions allow organizations to include prompts and clarifications on what information should be entered and serve up specific questions based on the information previously provided. It also keeps disclosure records in one centralized platform, making it easier to review, modify, report on, and audit entries in the future.

A comprehensive solution should provide the ability to communicate directly with the reporting party. You can quickly request clarification, answer questions, provide written stipulations to avoid a conflict, and require the employee's attestation to these conditions. Direct communication speeds up the review process and logs all exchanges in an auditable, defensible manner.

## Audits

Policies and training around conflicts of interest and a robust disclosure management system are important features of COI management, but they cannot be relied upon alone. A company should also leverage audits, which are a good way to ensure that special provisions for accommodating conflicts are being followed, that reported relationships are up-to-date and accurate, that ramifications for conflict of interest policy violations are being uniformly enforced, and that the disclosure process is achieving the kinds of results the organization desires.

Audits should also evaluate oversight processes to protect against the potential for easy, undetected conflicts—such as a single employee being responsible for collecting bids, choosing a vendor, and signing subsequent work orders. Keeping a careful eye on work relationships can help companies identify risk areas for exploiting conflicts of interest, even if a conflict has not yet arisen.

## Tips for Success

While every company contends with conflicts of interest, not many organizations have taken an active role in addressing this risk beyond putting basic policies in place. As more organizations





adopt proactive COI risk management strategies, it's important to keep a few critical factors in mind when developing your own strategy and initiatives.

#### Applied to Everyone

One of the keys to managing conflicts of interest is consistency. Policies, procedures, and responses should be applied consistently to all employees, including board members and executives. In fact, COI risk is frequently more pervasive for senior leaders and directors, making it even more important that your program reaches all levels of the organization.

#### Take Away the Fear

Many companies ask their employees to submit disclosures via the general compliance hotline or online form. These channels can seem intimidating and complex to employees, decreasing the likelihood and candor of disclosures. Disclosure management can and should be separated to provide a simple, non-threatening reporting channel that encourages employees to be upfront about the nature of their relationships so that they can be properly documented and addressed. It's also important to use inviting, non-threatening language in your policies, training, and communications when explaining or soliciting disclosures. Remember, in most cases nothing wrong has been done—the potential is simply there.

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#### Ensure Adequate Resources and Oversight

Whether you rely on the chief compliance officer or a review committee, have a designated party that's responsible for reviewing and responding to conflict of interest disclosures. All employees should be aware of who this person(s) is, how the process works, and how to report issues or seek clarification. As with all compliance initiatives, it is important that the oversight party is

given proper autonomy to handle these activities without pressure or interference.

#### Keep It Up

Relationships are fluid by nature. Personal relationships grow, end or otherwise change and most employees no longer stay with the same company for 30 years. Your approach to COI management should take these facts into account. Choose a solution that makes it easy for employees to update their disclosures and that reminds them to regularly revisit the information for accuracy.

#### Address Specific Need

Relationships and conflicts of interest are largely driven by culture. For instance, some cultures have strong tribal ties while others have different relationships with extended family. Make sure your policies, procedures, and controls account for the specific influences of your location or the cultural affiliation of your workforce.

## Conclusion

It's unavoidable that your company will encounter employee relationships that have the potential to lead to a real or perceived conflict of interest. Identifying and addressing relationships that may pose a risk can enhance the likelihood that business is conducted on the value of the services each party provides, not on personal relationships, financial incentives, or self-interests.

Like all parts of a successful compliance program, this is an ongoing effort, but one that is well worth the time and resources. Well-crafted policies, training, and disclosure platforms help defend your company from misconduct, reduce risk, enhance business objectives, and meet government expectations. Ultimately, companies should work to foster a culture of transparency and fairness that ensures the long-term financial and reputational health of the organization—being aware of relationships and mitigating the potential for conflicts of interest are important steps along that path. ■

*Part of an integrated suite of compliance software, Convercent's Disclosure Manager helps compliance professionals to understand employee relationships that may impair objectivity and prevent and address potential conflicts of interest. Learn more at [Convercent.com](http://Convercent.com) or by calling 1-866-403-2713.*



# Getting Ahead of COI Through Disclosure

By Aarti Maharaj

**M**anaging conflict-of-interest issues can be a herculean task. Yes, you can get reprimanded or even sued for a COI, so the threat is very much real—but enforcing policies against conflicts of interest is difficult for companies to do.

The formal definition, according to the Securities and Exchange Commission, is that a COI exists when a person or a company “has an incentive to serve one interest at the expense of another interest or obligation.” Navigating through those sticky situations poses a series of challenges, from both a compliance and an ethics perspective.

JPMorgan Chase, for example, has always been under heavy scrutiny by regulators. Last year the banking giant’s executives were questioned about whether the company pushed private-banking clients to its own investment products instead of third-party options. The inquiries by regulators prompted JPMorgan to change its disclosures to private-banking clients, to identify and reflect the differences between its own products and those of third parties.

**“Conflicts of interest are material facts that investment advisers, as fiduciaries, must disclose to their clients.”**

Julie Riewe, Co-Chief, Asset Management Unit,  
Division of Enforcement, SEC

That is not the first time JPMorgan faced criticism for putting its own interests before those of its clients. In a 2011 arbitration case, JPMorgan paid \$384 million to American Century Investments for violating an acquisition agreement, after the company was penalized for favoring its own funds at the expense of American Century’s. Executives were informed that the sale of JPMorgan Asset Management products was “more beneficial to their careers than the sales and promotion of ACI or other managers’ products,” the arbitrators said in their filing.

Conflict-of-interest issues can take many forms. News reports have been abuzz with shoddy recruiting practices by major financial institutions. Earlier this year, HSBC came under fire when reports revealed that a senior HSBC banker sweetened a bid through offering a “favor” for a client’s son. The senior banker discussed in a chat room with colleagues that he helped his client’s son land an internship on Wall Street. While the bid fell through, a regulatory lawyer noted that the bank did not violate any conflict-of-interest laws, although it did violate clauses in HSBC’s

code of ethics that forbid such discussions. HSBC placed the banker under investigation, and the person now faces the possibility of termination.

JPMorgan’s infamous “Sons and Daughters” program has been the center of attention for its alleged hiring of Chinese officials’ children to secure better deals in China. U.S. authorities investigated JPMorgan when the bank hired the son of China’s commerce minister, despite the child being one of the worst candidates, according to the bank’s recruiters. The *Wall Street Journal* reported that Gao Jue, son of Minister Gao Hucheng, managed to keep his job at JPMorgan amid major job cuts. Many of the company’s employees were outraged at Jue’s poor performance and wondered how the minister’s son avoided getting axed after “accidentally” sending a sexually explicit e-mail to a human resources employee. Hucheng, in return, promised to “go extra miles” for the multinational bank if Jue was spared.

The list of other financial institutions wrapped up in alleged COI issues goes on. UBS was in the limelight last year after two of its high-ranking employees were suspended amid questionable hiring decisions. The Swiss bank hired Joyce Wei, the daughter of the chairman of a top Chinese chemical company, prior to securing its role as one of the lead banks in the company’s \$654 million IPO.

## SEC Eyes COI in 2015

**I**n a recent speech, “Conflicts, Conflicts Everywhere,” the SEC’s Julie Riewe, leader of the Asset Management Unit in the Division of Enforcement, emphasized that conflicts of interest “are material facts that investment advisers, as fiduciaries, must disclose to their clients.” In the wake of recent scandals that have gripped the financial industry, Riewe said that the agency would focus a significant amount of time and resources around conflict-of-interest cases.

For many years, the agency has been calling on corporations to build COI principles into their cultures. In 2012, Carlo di Florio, then-director of the SEC’s Office of Compliance Inspections and Examinations, said in a speech that ethics can be difficult to navigate because most companies fail to create an environment where ethics percolates from top to bottom. “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 (everybody else is doing it), or just personal weaknesses—vanity, self-delusion, or poor judgment,” di Florio said at the time.

He suggested that the best antidote lies in building and maintaining a robust ethics program; one that can be coupled with a “strong internalized sense of ethics by everyone in an organization, manifested in their ability—especially executives, business managers, compliance officers, and lawyers—to think independently, rigorously, and objectively.”

He also recommended that COI policies should be embedded into a company's overall risk governance structure, since the business unit is seen as the first line of defense for managing and overseeing conflict-of-interest cases. If designed well, a robust ethics program can help employees recognize when a situation places one's own interest before the interest of the organization.

Lisa Beth Lentini, vice president for global compliance at Carlson Wagonlit Travel, a travel management company that operates in more than 150 countries, wholly agrees

with that concept. "Ethics can have a major impact on employees by encouraging open and honest discussion," Lentini says.



Lentini

In 2015, the SEC plans to revisit this subject starting with COI disclosures in the banking sector. "An adviser's failure to disclose conflicts of interest subjects it to [a] possible enforcement action," Riewe said. While the SEC has chased many enforcement cases in the past year, Riewe promised that more actions are "in the pipeline" for 2015.

ment cases in the past year, Riewe promised that more actions are "in the pipeline" for 2015.

#### Dialogue Matters

Amid the scandals that have tarnished some of the world's largest firms, most compliance officers are looking for best practices to inoculate their organization against COI trouble.

Lentini suggests that tying a COI policy to a company's values can serve as one approach, since that technique can help drive a transparent culture. At the same time, educating and having ongoing dialogues with employees about their legal and ethical obligations to the company is vital. Whether disclosure seems relevant at the time or not, admitting possible personal interests and obligations at the outset of any relationship is a best practice.

**"Bad things happen in dark corners, and it's good practice to be very transparent and disclose more when necessary."**

Lisa Beth Lentini, Vice President for Global Compliance, Carlson Wagonlit Travel

"Bad things happen in dark corners, and it's good practice to be very transparent and disclose more when necessary," Lentini says. In turn, this will promote "an open conversation about conflicts, allowing issues to be addressed before spiraling out of control." ■

#### CONFLICTS, CONFLICTS EVERYWHERE

Below is an excerpt from a speech by Julie Riewe, co-chief of the SEC Enforcement Division's Asset Management Unit, on COI:

To fulfill their obligations as fiduciaries, and to avoid enforcement action, advisers must identify, and then address—through elimination or disclosure—those conflicts. There are many ways to do that, but among others, and at a very high level: Take a step back and rigorously and objectively evaluate your firm—its personnel, its business, its various fee structures, and its affiliates. Is the firm a dually registered investment adviser and broker-dealer, or does the adviser have an affiliated broker-dealer? If so, the firm will have inherent conflict risks if it engages in principal transactions or trades through its brokerage arm or an affiliated broker-dealer. Does the firm manage clients side-by-side? If so, and if the firm's clients are funds, do they engage in inter-fund lending or investing? Does the firm receive compensation from any third parties for recommending investments or using certain service providers? Does it engage in proprietary trading or investing? If so, has the firm disclosed its potential biases and that its investment advice could be tainted by compensation received from any third parties or from proprietary investing?

For each conflict identified, as a threshold matter, can the conflict be eliminated? If not, why not? If the adviser cannot, or chooses not to, eliminate the conflict, has the firm mitigated the conflict and disclosed it? Is there someone—a person, a few individuals, a committee—at the firm responsible for evaluating and deciding how to address conflicts? Is that person or individuals or committee sufficiently objective? Is the process used to evaluate and address conflicts designed to be objective and consistent? Does the firm have policies and procedures in place to identify new conflicts and monitor and continually re-evaluate ongoing conflicts? As to mitigation, are the firm's policies and procedures reasonably designed to address the conflicts the firm has identified, and are they properly implemented?

As to written disclosure, has the firm reviewed all of the relevant disclosure documents ... to ensure that all conflicts are disclosed, and disclosed in a manner that allows clients or investors to understand the conflict, its magnitude, and the particular risk it presents? Does the firm review those documents regularly to ensure that new or emerging conflicts are disclosed in a timely way? Further to disclosure, is the adviser keeping the chief compliance officer and boards of directors (if any) informed about conflicts of interests, particularly the adviser's analysis and decisions on whether to eliminate or mitigate a conflict? Only through complete and timely disclosure can advisers, as fiduciaries, discharge their obligation to put their clients' and investors' interests ahead of their own.

Source: SEC.

# Internal Audit's Role in Scrutinizing Related Parties

By Jose Tabuena  
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Companies have become aware that related-party transactions can raise conflicts of interest concerns, creating the appearance that decisions are made on considerations other than the best interests of the organization and its shareholders. Typically, directors prefer to avoid entering into related-party transactions, but there may be situations where a board recognizes that such a transaction may be in the best interests of the company—including, but not limited to, circumstances where it may obtain products or services on terms that are not readily available from alternative sources.



**Jose  
Tabuena**  
Columnist

Given the recent history of related-party transactions that resulted in significant financial reporting fraud, it should come as no surprise that the Public Company Accounting Oversight Board adopted Auditing Standard No. 18, *Related Parties*, to address the audit procedures to be used when evaluating these relationships. Heightened scrutiny of related-party transactions isn't unprecedented, and at the PCAOB meeting to adopt the new rules participants cited examples involving Enron, Dynegy, Adelphi Communications, and Tyco, plus a string of more recent episodes where unusual transactions were entered into just to dress up the books.

Notably, a recent academic study that was published in an issue of *The Accounting Review* concluded that lax oversight can result when ties with the board and C-suite are too cozy. The authors of the study, "Will Disclosure of Friendship Ties between Directors and CEOs Yield Perverse Effects?" were surprised that so many directors reported they'd be willing to put the company at risk to ensure a bonus for their CEO "friend." Although the experiment comprised an artificial role-play environment, the results confirm the PCAOB perspective that auditors should take a more active role in finding out what kinds of relationships their boards and executives have. In addition to related-party transactions, the new auditing standard and amendments further address a company's financial relationships and transactions with executive officers, and significant unusual transactions.

Under the new related-party standard, external auditors must:

- » Perform specific procedures to obtain an understand-

ing of a company's relationships and transactions with related parties.

- » Perform more in-depth procedures in response to the risk of material mis-statement associated with these relationships and transactions.
- » Communicate with the audit committee to obtain information specifically regarding related-party transactions during the auditor's risk assessment.
- » Communicate the auditor's evaluation of the company's identification of, accounting for, and disclosure of related-party relationships and transactions to the audit committee.

Under the new standard, companies can expect a more rigorous examination of these transactions and a demand for increased communication with their audit committee. Although the new standard and amendments are directed at external auditors, Securities and Exchange Commission-reporting companies and their internal auditors should consider the extent to which their audit committee agendas should be updated to take into account the new communication and process requirements.

## A Type of Conflict of Interest

For purposes of the new standards, auditors will look to the definition of "related party" under applicable SEC requirements. However, internal auditors should quickly be alerted to the fact that related-party transactions are merely a subset of conflict-of-interest situations that should already be addressed by the company on a regular basis.

Related-party transactions are also not confined to public companies subject to PCAOB auditing standards. Non-profits have their own requirements for identifying related parties and their transactions with them. Private companies should also be alert to the risks posed by these transactions and conflicts of interest.

While the term "conflict of interest" can have a negative connotation, only some of the many different types of conflicts may actually be harmful. How an organization manages conflicts of interests, including related-party transactions, and ensures open and honest deliberation, can affect all aspects of its culture and operations. An essential understanding for boards is not to try to avoid all possible related-party transactions and conflict-of-interest situations, which is not practicable, but to develop and follow a process for handling them effectively.

Another notable finding from *The Accounting Review* study is that simply disclosing a conflict or friendship does



not eliminate its potential to create problems. The experiment found that when social relations were disclosed, instead of tightening oversight, counter-intuitively directors went easier on their CEO pal. This, and other studies, seems to suggest that disclosing a relationship or conflict can be treated as a license to put their interests ahead of the company's, perhaps with the belief their duty was met by the disclosure. This provides even more reason to rigorously test the accuracy and completeness of relationships and transactions in these critical areas.

### Internal Audit's Role

**T**he new standard requires outside auditors to perform basic procedures to better identify red flags, understand the business purpose behind transactions, and communicate more frequently with audit committees. Internal audit can support application of the standard by monitoring conflict-of-interest policies and assessing their effectiveness. Companies should also review code-of-conduct provisions and internal policies addressing conflicts of interest, considering how these coordinate with a board-level policy for approving related-party transactions.

Most organizations have conflict-of-interest policies that oblige the disclosure of conflicts when they arise, require certification that the employee has read the policy and has either reported or isn't aware of any violations to the policy. Typically, companies use an annual questionnaire that asks the employee to supply information and respond to detailed questions about common scenarios that may give rise to a conflict.

Generally, internal auditors should examine processes around related parties, significant unusual transactions, and executive financial relationships. The PCAOB makes clear that the evaluation "involves more than assessing the process used by the company."

A particular challenge is the often invisible nature of conflicts of interest. Most agree that companies and employees should avoid situations that even give the appearance of one, but if you don't *see* the conflict, or believe it won't impair your objectivity, you probably won't avoid or disclose it. We can be a poor judge of our own biases and generally aren't predisposed to divulge a possible conflict situation. Auditing conflicts of interest can be a challenge because of difficulty in detecting and establishing a negative: How do you identify a conflict of interest that was not reported?

The new audit standard suggests procedures to identify and evaluate related-party transactions. The PCAOB rec-

ommends auditors take into account types of information gathered during the audit (such as close review of stockholder meeting minutes) that can identify related parties. The new standard includes examples and sources of information that could point to related parties and other conflicts that might exist.

A technique for internal audit to consider is random and targeted reviews of travel and entertainment expenses, especially in high-volume areas and high-risk departments. These may uncover suspicious spending that indicates a possible conflict. Expense reports can also suggest potential conflicts of interest. Surveying vendors and suppliers can reveal situations where a disgruntled contractor or prospective seller believes a competitor has been unfairly favored. Continual monitoring can help identify red flags and highlight risk areas for more focused review.

There are tools available to the internal auditor to support the company's management of related-party transactions and conflicts of interest. More frequently, I see the use of analytic technology emerging as a tool to detect potential conflicts of interests. A data match can be performed between employee and vendor data files to identify relationships that suggest possible conflicts and control weaknesses. The matching would look for employees and vendors with the same address, tax ID number, or bank account.

The best approach to managing related-party transactions and conflicts of interest will vary by organization. But all companies share the fundamental need for disinterested decision making.

An organization that fails to prevent and manage conflicts of interests risks public embarrassment and legal liability. A company is better served by having policies and guidelines that are well understood by leadership and the workforce. Fortunately, there are processes and techniques to detect and monitor for potential conflicts and to help ensure such issues are appropriately addressed. ■

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# Defense Dept. Pursues COI at Contractors

New rules mean big decisions on buying and selling business units

By Jaclyn Jaeger

**T**he Department of Defense is taking a much harder look at potential organizational conflicts of interest at its largest contractors.

In 2010, the DoD issued final rules that provide uniform guidance and tighten existing requirements on organizational conflicts of interest. And while the final rules are less comprehensive than the ones proposed, they are causing some contractors to make big changes to comply with them.

The rules implement a provision in the 2009 Weapons Systems Acquisition Reform Act, which required the DoD to crack down on such conflicts. The Federal Acquisition Regulation subpart 9.5, and years of decisional law from the Government Accountability Office and the Court of Federal Claims, categorizes organizational conflicts of interest into three basic types: unequal access to information, biased ground rules, and impaired objectivity.

For example, a conflict of interest could occur when a firm has access to non-public government information that would give it a leg up in competing for future government business. Another potential conflict of interest could occur if a company wins a contract to build a weapon, while one of its affiliates gains a separate government contract to test the weapon.

Peter Eyre, a counsel in the government contracts group of law firm Crowell & Moring, says the rule is causing a lot of consternation among defense contractors. He says potential organizational conflicts of interest are “driving decisions not only about specific programs and contracts, but also about buying and selling entire business units. This is a big, big deal,” he says.

Some of the largest defense contractors, for instance, already have divested business units that they said posed potential conflicts of interest. In June 2010, two months after the DoD issued its draft rules, Lockheed divested most of its Enterprise Integration Group and Pacific Architects and Engineers, two units within its Information Systems and Global Services business. Northrop Grumman also agreed to sell its advisory services unit, TASC, to avoid the conflict of interest it created.

However, the final rules depart significantly from the draft version issued in April 2010. Unlike the proposed rule, which was much more comprehensive and would have applied to virtually all defense contracts, the final rule applies

only to major defense acquisition programs.

Major defense acquisition programs are defined as those programs with total expenditures for research, development, testing, and evaluation that exceed \$300 million (in 1990 dollars), or programs with a total procurement cost that exceeds \$1.8 billion (in 1990 dollars). The DoD reasoned that extending coverage to include all defense contracts could have delayed the release of the final rules and would have created unnecessary confusion.

Government industry groups largely cheered that decision. Stan Soloway, CEO of the Professional Services Council, the national trade association of the government pro-

“While the final rule has these overarching policy guidelines for the contracting officers to follow, it still doesn’t give the contracting officers any more definitive guidance in identifying potential OCIs.”

—Nicole Owren-Wiest, Partner, Wiley Rein

fessional and technical services industry, said the final rule provides “much needed clarity and focus.” He also praised the DoD for not applying a “one size fits all” approach to all defense procurements, as the proposed rule would have done.

Yet some watchdog groups are unhappy with the change. The Project on Government Oversight, an independent non-profit that investigates and exposes corruption and other misconduct, said it wished the proposed rule had been “clarified and strengthened and applied to all DoD acquisitions,” said Scott Amey, general counsel for POGO.

## Guidance Wanted

**T**he general consensus, though, is that contracting officers still need more guidance around conflicts of interest. “While the final rule has these overarching policy guidelines for the contracting officers to follow, it still doesn’t give the contracting officers any more definitive guidance in identifying potential OCIs or coming up with potential ways to resolve them,” says Nicole Owren-Wiest, a partner at law firm Wiley Rein.

“Also missing are clearly defined penalties for violating conflict-of-interest regulations, including termination of a contract, fines, withholding of payments, and suspension or debarment,” said Amey. “A lack of a remedy clause will hamper the DoD’s ability to hold contractors accountable for failing to disclose an actual or apparent OCI.”

While the final rule does not state the penalties for failing to disclose or mitigate organizational conflicts of interest, Eyre notes that the consequences can range from the loss of a contract to allegations that a contractor has violated the False Claims Act.

The rule also contains some additional changes to address conflicts of interest. It provides that a contractor, or its affiliates, who perform Systems Engineering and Technical Assistance (SETA) functions cannot then participate as a prime contractor or major sub-contractor in the development or production of a weapon system under the major defense acquisition program, unless they submit a conflict of interest mitigation plan that's been approved by the government.

On a practical level, this means contracting officers must now insert this new language in any solicitations for SETA awards going forward. Likewise, if government contractors want to request an exception to the prohibition, they must then submit an Organizational Conflict of Interest Mitigation Plan with the offer.

"For contractors who qualify, it can't just be a paper plan that gets approved and implemented," says Owren-Wiest. "They're going to have to make sure to have robust compliance policies and procedures to ensure they are complying with their mitigation plan. Otherwise, they're jeopardizing their or their affiliates' ability to compete on the production contract."

The final rules also eliminate the DoD's "preferred method" of using mitigation—such as institutional firewalls or delegating certain tasks to a sub-contractor—to resolve conflicts of interest. The department decided that such a strategy could have had unintentionally encouraged contracting officers to make resolution decisions without considering all the facts and information.

Instead, the DoD encourages agencies to obtain advice on major defense acquisition programs from sources that are "objective and unbiased." Furthermore, the DoD said, "contracting officers generally should seek to resolve organizational conflicts of interest in a manner that will promote competition and preserve DoD access to the expertise and experience of qualified contractors."

According to Owren-Wiest, if there's a way to potentially mitigate or otherwise resolve an issue then that should be the goal, rather than disqualifying an offer.

Thomas Papson, a partner in the law firm of McKenna Long & Aldridge, says he expects the Federal Acquisition Regulation Council to soon issue its own organizational conflict-of-interest modifications. "I'm guessing in a few months, the proposed FAR rule will be issued and everybody can have at it again on those broader issues." ■

## PROPOSED RULE AMENDMENTS

What follows is an excerpt from the Department of Defense's "Discussion and Analysis" regarding changes that were made to the proposed rule on the Defense Federal Acquisition Regulation Supplement (DFARS):

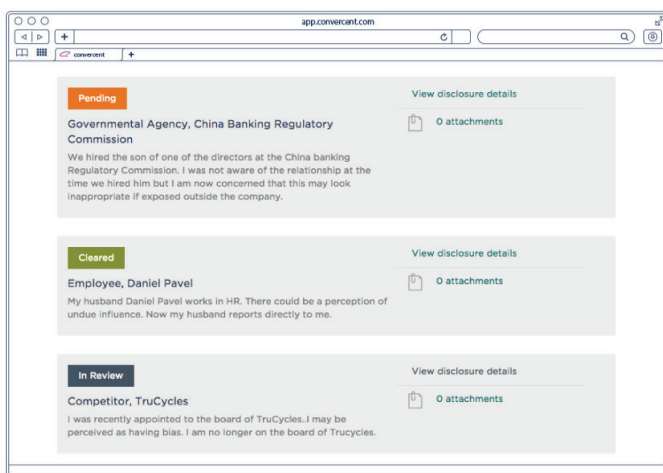
The DoD received comments from 21 respondents in response to the proposed rule. Some respondents expressed general support for the rulemaking. Others expressed concern that the rule did not achieve the overall objectives of section 207, either because the proposed coverage was too stringent or not sufficiently strong. Based on public comments, changes were made to the proposed rule, including the following:

- » Removing from the DFARS final rule the proposed changes that would have provided general regulatory coverage on OCIs to temporarily replace that in FAR subpart 9.5.
- » Locating the core of the final rule in subpart 209.5 and 252.209.
- » Making clear that this final rule takes precedence over FAR subpart 9.5, to the extent that there are inconsistencies.
- » Adding to the policy an explanation of the basic goals to promote competition and preserve DoD access to the expertise of qualified contractors.
- » Tightening the exception for "domain experience and expertise" to require a head of the contracting activity determination that DoD needs access to the domain experience and expertise of the apparently successful offeror; and that, based on the agreed-to resolution strategy, the apparently successful offeror will be able to provide objective and unbiased advice.
- » Refining the definition of "major subcontractor" to include upper and lower limits on application of the percentage factor test for determining if the value of the subcontract in relation to the prime contract warrants classifying the subcontract as major; specifically:
  - A sub-contract less than the cost or pricing data threshold would not be considered a major subcontract; and
  - A sub-contract equal to or exceeding \$50 million would automatically be considered a major subcontract.
- » Addressing pre-MDAP as well as MDAP programs.

Source: Department of Defense DFARS Ruling (Dec. 29, 2010).



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