



Conspicuous Compliance

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Fish Hooks in their Pockets

A colleague once described his partner's pockets as being "infested with fish hooks" when he bemoaned the latter's *reliable* inability to pick up the check at the local watering hole. One could posit that the commercial banking industry is likewise afflicted with an abundance of caution as they are loath to reach into their corporate pockets and lend funds to clients. Banks are not alone in their risk aversion as hedge funds dodge margin calls and covered call writing resumes a prominence with retail investors not seen since the bear market of 2001. **Is risk getting a bad rap (again)?** Risk management – that noble endeavor which seeks to put risk in its rightful place – is a discipline receiving significant attention due to the unprecedented freeze-up currently underway in the credit markets.

However, it is no surprise that risk management processes have long been an integral component of the SEC inspection and enforcement process. During its 2007 CCO Outreach Regional Seminars, the SEC shared several simple risk assessment questions it poses during adviser examinations:

- ❖ How does the business operate?
- ❖ Where are the risks?
- ❖ How are risks mitigated?

The SEC follows the trail of information, money, and securities from the initial contact with the firm through to the final point of interaction. This process often reveals points of vulnerability in the firm's capacity to discharge its preeminent fiduciary responsibility to put the customer's interests first. The vulnerability may be discerned as a conflict of interest, regulatory deficiency related to process or the failure to supervise, enforcement action worthy, or even criminal activity such as fraud or money laundering. This "look back" is regarded in the context of pre-existing internal controls and supervisory systems which have been implemented by the firm to identify and manage risk in a manner permitting the SEC to determine process, knowledge and intent.

How does the CCO get ahead of the risk management curve? By looking at core processes which govern asset gathering, marketing and disclosures, portfolio management, trading, data management, operations, fees, compensation, record keeping and reporting. By evaluating, elbow to elbow with line of business managers, the business and compliance risks imbedded in these processes. Then, by championing efforts to eradicate or mitigate risks through **clearly articulated disclosures and/or effective and relevant internal controls and supervisory processes.**

RISK CORNER

Empowerment Risk

The risk that managers and employees are not properly lead, do not know what to do (or how to do it) when they need to do it, exceed the boundaries of their defined authorities, do not have the resources, training and tools necessary to make effective decisions or are given incentives to do the wrong thing.

Risks related to empowerment include:

- ❖ Leadership
- ❖ Authority/limit
- ❖ Outsourcing
- ❖ Performance incentives
- ❖ Change readiness
- ❖ Communications

Source:
The Protiviti Risk Model
knowledgeleader.com



When Business Risk = Compliance Risk

The contrast between business and compliance risk is subtle and in some cases may not be different at all. **Business risks** are events and conditions which marginalize the firm's capability to successfully execute its business plan. Conversely, **compliance risk** pertains to legal or regulatory sanctions and/or the financial loss a firm may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct, and standards of good practice. Clearly when compliance risk morphs into real business risk - or when the inverse occurs, it may be too late to extricate the firm from what is likely to be a rather messy affair.

The process of identifying and managing business risk should be delegated to all employees of the firm. Everyone in the firm should be tasked with recognizing and taking appropriate action to manage business risk in its various manifestations - and there should be no doubt that it is ever present. Taking "appropriate action" may require immediate intervention or may involve escalation through the management chain of command, perhaps including the Risk Management Committee of the enterprise. It is expected that the CCO would be a vital member of such a committee.

One of the critical responsibilities of the CCO is to overlay the business risk assessment with a **compliance risk assessment** by asking these key questions:

- Have we broken any laws or regulations?
- Have we violated any codes of conduct, standards of good practice, or firm policies?
- When problems or violations do occur, are we resolving them promptly and making timely notification to appropriate parties?
- Are we misleading or misrepresenting?
- Have we harmed?
- Are we pleading ignorance when we have reason to know?
- Are we benefiting from favoritism in any way?
- Are we disclosing business practices and related conflicts of interest, both current and prospective, clearly and accurately?
- Are we profiting personally or as a firm to the detriment of others?
- Have we put the investor's interests above all others?

The CCO cannot ride solo in the pursuit of mitigating compliance risk, but should be the most vocal champion of this effort. Compliance resources must be directed to recognize the firm's business risk set and understand its dynamic relationship to the compliance risks of the enterprise.

Reputation Risk

Risk wears many colors inside the regulated enterprise. The two general risk types most closely aligned with compliance implementation are regulatory risk and reputation risk. **Regulatory risk** arises when the interaction of uncertainty and regulation changes the cost of financing the operations of a firm. Of course, failure to adequately manage regulatory risk in an investment advisory or broker-dealer enterprise can very quickly translate into reputation risk.

What is reputation risk? According to the Federal Reserve, **reputation risk** is the potential that negative publicity regarding enterprise business practices, whether ultimately proven or not, will cause a decline in the customer base, costly litigation, or revenue and profit margin contraction.

Without question, the failure to deliver the firm's products and services in a manner consistent with client expectations puts the reputation of the enterprise at substantial risk. How can the CCO help protect the reputation of the enterprise? Aside from ongoing best efforts to manage regulatory risk, the CCO must enhance the collective capability of all employees to discharge their responsibilities effectively and ethically. Here are some ideas:

- (1) Engender a management philosophy where employees are recognized as the most significant resource of the enterprise;
- (2) Champion efforts to ensure that employees are held accountable, and consistently receive direct supervision and the requisite ongoing support to perform job duties as well as maximize their potential;
- (3) Encourage the development of marketing and service programs where prospect and client communications are clear, accurate, and easily understood;
- (4) Push for standards, process, internal controls, and documentation as ongoing protocol to ensure robust operations and consistent delivery of products and services;
- (5) Anticipate problems by ensuring that all employees understand limits of authority as well as critical escalation steps vital to resolution;
- (6) Foster dialogue between the firm and key constituents - clients, vendors, affiliates, and shareholders alike - to help contribute to a transparent environment where values, standards, and expectations are clear and well communicated.

Reputation stands to be bolstered or tarnished every time the firm delivers its value proposition - when an employee interacts with a client, when the firm collaborates with a vendor to improve performance, when a solicitor tells the firm's story in a marketing setting. The reputation of the enterprise is put on the line every day.

Building and living up to the firm's reputation is the responsibility of each and every employee of the enterprise.

Reputation Risk

“People have a hard time really grappling with what reputation is, measuring it, and understanding it—and sometimes reputation is in the eye of the beholder. Everyone knows when reputation is severely damaged, but it's hard to see minor degrees of change.”

John Farrell, Head of Enterprise Risk Management Practice, KPMG



Say What?

When it comes to disclosure, SEC Chairman Christopher Cox does not mince words, "We're dead serious about plain English."

Indeed they are ... the SEC has historically and continues to implement plain English initiatives across the financial landscape, and now they have arrived on the doorstep of investment advisers. The SEC voted unanimously last month to propose rule amendments requiring investment advisers to prepare and deliver to clients a narrative brochure written in plain English. The narrative must publicly disclose - to current and prospective clients - more detailed information about the adviser's business practices, conflicts of interest, and disciplinary record.

"[This] ... proposal is a significant event for investment advisers and the investors that hire them. ... Disclosure is at the core of the fiduciary principles that govern the relationship between advisers and their clients," noted Andrew J. Donohue, Director of the SEC's Division of Investment Management. He continues, "Central to the proposal is narrative plain English disclosure to advisory clients and prospective clients that will empower them to make informed decisions when hiring advisers and to manage the advisory relationship on an ongoing basis."

The SEC's proposed amendments to Part II of Form ADV and related rules under the Investment Advisers Act of 1940 would shed light on vital advisory business practices in a manner historically not well understood by investors. What will be expected of advisers, and how will brochure presentations change? According to Lori Schock, Acting Director of the SEC Office of Investor Education and Assistance, advisers should respond to the plain English initiative in the same way that public companies have responded to similar initiatives for annual reports and executive compensation - by **presenting information clearly and concisely**.

Here are some of Schock's suggestions:

- ❖ Use short sentences and concrete, everyday words;
- ❖ Use descriptive headings and subheadings;
- ❖ Apply tabular presentations or bullet lists for complex material;
- ❖ Avoid legal jargon and highly technical terminology;
- ❖ Put information in context and use examples.

One final piece of advice -----quite often, less is more!

CLEAR DISCLOSURE

"Most importantly, when investors ... can use their time more productively and when information is presented clearly, every market participant will be able to make better decisions. ... But in order for investors to make better choices based on disclosure, they have to read it."

*SEC Chairman
Christopher Cox
October 12, 2007*

Stuck in a Moment You Can't Get Out Of

In the words of Bono, Fidelity **IS** stuck in a moment they cannot get out of, to the tune of \$8 million! Tickets to a U2 concert and other lavish gifts are the subject of the recent SEC investigation into Fidelity Investments' enforcement of its **gifts and entertainment policy**. The Commission has reviewed events surrounding 13 current and former employees charged with improperly accepting travel, entertainment, and other gifts from outside brokers in exchange for massive volumes of mutual fund trades. In a settled Order against Fidelity, the SEC charged the firm with failure to seek **best execution** for client mutual fund securities transactions.

"The broker selection process on Fidelity's equity trading desk was compromised when gifts and lavish entertainment swayed the flow of brokerage business," noted Walter Ricciardi, Deputy Director of the SEC's Division of Enforcement. "This misconduct created a serious risk of investor harm and violated Fidelity's duty of allegiance and loyalty to investors."

"This case demonstrates again the SEC's commitment to preventing **conflicts of interest** from compromising the integrity of the markets," added David P. Bergers, Regional Director of the SEC's Boston Office. "Investment advisers must insist that brokerage firms compete for mutual fund business based on their ability to deliver best execution, not based on personal considerations like event tickets."

SEC Deputy Director Ricciardi goes on to say that the compliance tone is set at the top of an organization, and when messages are conveyed that misconduct is tolerated, the compliance culture of the organization breaks down. Peter Lynch, former Fidelity portfolio manager who remains an executive at the firm today knows this all too well. He settled a civil case with the SEC, paying \$20,000 including interest, based on allegations that he directed Fidelity equity traders to obtain tickets to high profile events.

The SEC ordered Fidelity to pay stiff penalties, invoked a censure, ordered the firm to cease any further gift policy violations, and required Fidelity to hire an independent compliance consultant to conduct a comprehensive review of firm policies and procedures concerning equity trading operations, conflicts and gifts. Those who claim that the traders implicated in this case likely saved Fidelity fund investors billions of dollars in trading costs are whistling in the wind. If it looks like favoritism and smells like favoritism, then it must be viewed as favoritism regardless of who ultimately benefits. The policy implication is clear: develop and implement effective policies, then test and enforce them consistently. When it comes to the firm's Code of Ethics, no employee is exempt.

In Good Company ...

Currently, there are nearly 25,000 investment advisers registered in the U.S. About 11,000 of these advisers are U.S.-based advisers registered with the SEC with approximately \$38 trillion of assets under management.

Another 13,000 advisers are registered at the state level, while an additional 580 SEC-registered advisers are based outside the United States.

*Source: Andrew J. Donohue, Director of the SEC Division of Investment Management
3/10/08*

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