



Conspicuous Compliance

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Time for a Super Tune-up

A key component of regulatory compliance policy is mandated written supervisory procedures. Regulators require broker-dealers, advisers and registered hedge funds to develop, implement and update written supervisory procedures for covered employees. Like all policy, supervisory procedures may become stale or even irrelevant in the fullness of time. This reality presents a real and potentially growing compliance risk for financial firms as the first quarter of 2009 draws to a close.

The extreme financial distress that has been visited upon financial firms during the preceding 18 months has pressured business models and business acumen alike. This environment is ripe for policy drift as revenue drivers decline and staff capabilities are marginalized. More disconcerting however is the potential for de facto change to the firm's business model as sustained market volatility persists and the attainment of alpha and revenue becomes increasingly elusive. The CCO must be vigilant for anecdotal signs of lax supervisory policy or procedural drift, for if left unattended the firm's supervisory processes will surely be marginalized.

When times are tough, one cannot have too many loyal friends - whether it is kindness and support during a grieving process, or perhaps assistance with timely and informed advice. The corollary with supervisory policy is true as well: sound supervision is something a CCO cannot have in overabundance. In the current environment, sound, relevant and well documented supervisory procedures are better than a compliance budget increase (to a point). Unfortunately, when business conditions are dramatically altered, whether due to macro conditions as now experienced or a more insular event such as a key employee defection or the merger of two entities, supervisory procedures are often the first casualty in the effort to reel in expenses.

The supervisory policy precepts highlighted on the next page date back to an SEC speech by the Director of SEC Enforcement circa December 2001 when two months after 9/11 and roughly midway through the dot.com bear market, volatility and financial distress ruled. Then, as now, trading desks and investment committees sought to do more with less in terms of resources and investment returns.

Read on for more about management of supervisory risk >>>



Supervisory Risk

Consider the following areas of supervisory risk, as affirmed by the SEC through enforcement citations:

- Ø **Business plans may outgrow the firm's supervisory policy and procedure;** the CCO must be conversant with the business model and related plan execution in order to appropriately monitor and test the supervisory procedures of the firm (Dawson-Samberg Capital Management 8/3/00).
- Ø **Market conditions may cause the business plan to migrate, knowingly or unknowingly, from the original mandate;** whether bull or bear, both genus may inspire a drift or outright abandonment of the mandated business plan upon which the supervisory procedures were originally predicated, e.g., "hot" IPO participation and related trade distribution, or mark-to-market on illiquid holdings (Heartland Group 11/27/01).
- Ø **Functional separation is the oxygen of sound supervisory procedures;** if the supervisor executes the functional activity, the related internal control is massively undermined to the point of near death. Staff cuts and reductions of compliance resources may lead to supervisory/staff function overlays that present substantial compliance risk to the enterprise (Van Kampen Advisors 9/8/99, Dreyfus Corporation 5/10/00, Western Asset Management Co. and Legg Mason Fund Adviser, Inc. 9/28/01).
- Ø **Supervisory practices know no organizational boundary;** there is no supervisory "buck stops here" either internally or externally for the regulated enterprise. The nature of a relationship will determine the underlying supervisory responsibilities, of both an implied and overt nature, e.g., advisers have a fiduciary responsibility to supervise sub-advisers regardless of the language of the contract which binds them, (Ibid).

The Essence of Risk Management

"The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome and the linkage between effect and cause is hidden from us."

Peter Bernstein, Against the Gods, 1998

Turn to the next article for tips to ensure that supervisory procedures are relevant >>>



Implementation of the Tune-up

Supervisory risk is relevant to virtually any regulated financial enterprise given the variability of macroeconomic influences and investor confidence. Following are suggestions offered by the SEC, accompanied by a few of our own “best practice” ideas:

- ü Obtain annual compliance certifications from key service providers/vendors (sub-advisers, brokers, custodians);
- ü Maintain robust communications with key third party service providers, especially those to whom key fiduciary responsibilities have been delegated;
- ü Maintain an effective supervisory culture which reflects the following:
 - ü an appropriate “tone at the top” regarding the critical importance of effective supervision;
 - ü self reporting of misconduct or poor functional execution including the origin, extent and consequences of the exception concomitant with full disclosure to appropriate management and regulatory authorities;
 - ü appropriate, timely, and documented remediation, including disciplinary measures against employees and redesign of internal controls and related testing protocol as warranted;
 - ü investment policy as directed from the investment and risk management committees consistent with client engagement agreements and ADV disclosures, e.g., option and related derivative market products may provide attractive risk reward premium in troubled times however the investment policy of the firm and suitability profiles of the client must be in alignment, while related disclosures to prospects and clients must provide a policy mandate with related internal controls and supervisory procedures.

That regulatory change is coming is a virtual certainty. Some believe that forthcoming regulatory change will be so profound and far reaching that proactive compliance risk management and mitigation initiatives are best curtailed until the new regulatory era dawns. We disagree - sound and relevant supervisory policy, especially when it is challenged by an extreme operational environment should not be a compliance hold-out, rather it should be the marquee player in a relevant compliance program.

Economic Crisis

“Most economic crises, in one way or another, have originated from abuses in the financial system, which may explain why orthodox economists have traditionally shunned their brethren in the finance departments. Stocks and bonds, for example, by their very nature, invite speculation and even corruption: No one buys them with the lofty purpose of making the allocation of the nation’s capital more efficient. People buy them in the hope of catching a ride on the road to riches.”

Peter Bernstein, Capital Ideas, 1992

Social Networks, Third Party Servers, and Blogs ... oh my!

Tweets and microblogs join the growing list of Internet communication proliferation dramatically changing the way we connect with friends, family, clients, prospects, and business partners. Social networks, third party controlled communication, and blogs are just a few examples of the creative genius flowing from the Internet giving CCOs a headache!

Social Networks

Myspace, Facebook, LinkedIn, Zoominfo, Twitter ... the list goes on. Social networking has arrived and must be reckoned with by the CCOs of the 21st century. Just to name one, Twitter is a free social messaging service for staying connected in real-time through the exchange of short, quick, frequent answers to the question: **What are you doing?** If you can't beat them, join them. Even the SEC has embraced this motto, as the SEC's Office of Investor Education is now posting regulatory enforcement updates on Twitter. See for yourself by checking out www.twitter.com/SEC_Investor_Ed.

Third Party Servers

Emailing off the reservation. It happens every day ... whether logging in to a client's institutional email box on the web, or sending web articles to clients directly from publisher email servers. The opportunities to send email to clients and third parties "off the radar screen" of the regulated firm's email servers are growing every day, and so is the associated compliance risk.

Blogs

According to 2008 SEC guidance, under certain circumstances, companies can rely on their websites and blogs to meet public disclosure requirements under Regulation FD. Regulators recognize blogs as a legitimate medium to post vital information and data. Alas, the double-edged sword - new portals to disseminate marketing, advertising, and client reports, inviting privacy breaches and hackers, among other technology threats.

Instant Messaging

Few can argue that instant messaging is not an efficient method of communication – with colleagues inside and outside the enterprise. It is ideal for quick, fluid conversations, but rather costly to capture and monitor.

What are the Risks?

All these forms of revolutionary communication present material risks to the regulated enterprise, including:

- ü Compromised reputation of employees and the firm
- ü Significant loss of productivity
- ü Privacy and confidentiality breaches and identity theft
- ü Internet threats—spyware, malware, viruses, scumware, spoofed email
- ü Discoverable content that may be inappropriate and/or illegal
- ü Damaging communication which may be misunderstood, taken out of context, or considered misrepresentation, particularly with regard to the use of slang and shorthand

Change ...

"It's not so much that we're afraid of change or so in love with the old ways, but it's that place in between that we fear It's like being between trapezes. It's Linus when his blanket is in the dryer. There's nothing to hold on to."

Marilyn Ferguson

Turn to the next page for tips in managing these Internet risks >>>

Stay Ahead of Internet Risks

According to Proofpoint, an email security firm and software vendor, one in ten companies (out of 294 respondents) has investigated unauthorized disclosure of material information *in the past year*.

The CTO of Watchfire, another web security firm opines that management is naive if they do not think blogs and other social networking venues do not materially elevate security risks to private non-public information. The most effective defense as always begins with a sound and explicit policy which governs employee use of blogs, etc., even on their own time insofar as private company information remains private regardless of when and where it is illegally or improperly disclosed.

IBM's blogging policy in this regard is quite explicit, e.g., "You must not comment on IBM's future business performance, business plans, or prospects anywhere in the world." Indeed, it is reported that the SEC monitors the blogosphere quite extensively, having recently prosecuted an individual for insider trading based upon coded blogs that a private investor issued.

How can CCOs stay ahead of the Internet communication curve, especially the increasingly ubiquitous social networking?

One simple solution is across-the-board prohibition of the use of all forms of social networking, communications through outside email servers, blogs, and instant messaging. However, such an extreme position may not be tenable or even possible, particularly for firms that recognize that these communication venues can offer employee efficiency and competitive advantage in the marketplace.

Perhaps the first place to start, then, is to foster an open and candid conversation with employees and clients as to the requirements, benefits and risks associated with the myriad of Internet portals utilized or contemplated by the stakeholders involved. The CCO cannot begin to help protect the firm unless the facts as well as associated benefits and risks are identified and evaluated.

Upon defining the playing field, the CCO should consider initiating employee training sessions emphasizing the appropriate utilization of social networking and other net capabilities on company premises and utilizing company property. The policy of the firm must then implement and test internal controls which observe the user environment and appropriately filter, review and escalate as necessary those communications deemed to be problematic. The policing of employee Internet use should contribute to an environment whereby employees are less likely to put themselves and the enterprise at risk.

What's Old is New Again!

"The dismal record of portfolio management over the past five years needs no elaboration ...

With all the research input, the sophisticated economic analysis, the jolly conferences, the attention to decision making structures, and the increased understanding of risk and reward, how could so many have failed to see that all the known parameters were bursting apart? ... None of us can avoid being haunted by the academic diagnosis."

*Peter Bernstein, 1974,
written in his
introduction to the first
issue of The Journal of
Portfolio Management*



The Regulators Speak

About Government

“It is not my intention to do away with government. It is rather to make it work -- work with us, not over us; stand by our side, not ride on our back. Government can and must provide opportunity, not smother it; foster productivity, not stifle it.”

*Ronald Reagan -
First Inaugural
Address, January 20,
1981*

On February 23, 2009, the National Society of Compliance Professionals (“NSCP”) hosted its annual dialogue with Southern regional regulators. In attendance were Kit Addleman, Regional Director, SEC Atlanta Regional Office; Dan Stefek, Director, FINRA Atlanta Regional Office; and Robert Terry, Director, Division of Securities (Georgia). A few important messages shared by the regulators follow.

(1) Don’t cut compliance! According to the NSCP, the regulators stated that in times of staff reductions and downsizing, it is not prudent to cut compliance and if a firm makes such cuts, they may be subject to enhanced regulator scrutiny.

(2) Limited scope exams are on the rise! SEC Director Addleman shared with the group the regulator’s plans to conduct more “limited scope” examinations in coming months. In these exams, regulatory examiners typically spend anywhere from ½ to a full day at the registrant to get a better understanding of the business and potential risks. The SEC noted that one such limited scope examination resulted in an enforcement referral last year involving hefty disgorgement penalties.

(3) FINRA priorities! FINRA shared a list of its current priorities which include anti-money laundering, advertising, books and records, breakpoints, business recovery, customer information protection, research analyst rules, supervisory control, variable annuities, senior investors, securities futures, mutual funds, and college savings plans. For more details about these priorities, regulatory guidance and a wide range of resources segregated by topic, CCOs should go to FINRA’s website at <http://www.finra.org/Industry/Issues/index.htm>.

Horrigan Resources, Ltd.
3000 Village Run Road
Building 103, #209
Wexford, PA 15090
(724) 934-0129 phone
(724) 934-0132 fax
brathz@horriganresources.com
www.horriganresources.com

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