



# Conspicuous Compliance

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## Hold the Sauce, Please!

The SEC is proposing to require a narrative ADV Part 2 for registered investment advisers. The amendment is expected to be implemented this year as part of the Commission's Plain English initiative introduced in 2007. The new ADV brochure, describing the adviser's services, fees, business practices, and conflicts of interest, is intended to provide clear and unambiguous disclosures which are (1) more likely to be read, and (2) more easily understood by clients and the investing public.

The 10,800+ investment advisers registered with the Commission serve nearly 20 million investors. Every investment adviser will have to retool the ADV Form Part 2 to comply with the new rule. The current ADV includes most of the topics expected to be required in the new brochure and will assist in the transition to the narrative disclosure. **It is not so much what you say, but how you say it that will require the attention of CCOs.** The key is to be clear, frank ... and hold the sauce!

We believe a good place to start is by considering how you talk in conversation with prospects and clients about the issues most relevant to your professional services. Think about what you say, and then write it down in a conversational tone. Here are some questions to get started ...

- ✚ What has been newsworthy about your firm in the past 2 years?
- ✚ What services do you offer clients? Are there any vital client qualifications or hurdles for each service?
- ✚ What 3rd parties does your firm rely upon? Do you work directly with any affiliate companies? If so, how do you benefit by doing so?
- ✚ Describe your firm's investment philosophy, typical account turnover and types of securities/instruments used in portfolios.
- ✚ What types of clients do you serve and what is the % client mix?
- ✚ How much will a client pay for your services ("all in"), and are all clients treated "equally" when it comes to fees and discounts?
- ✚ What should clients expect in terms of performance and the risk associated with achieving such performance.
- ✚ Who runs the firm? How do portfolio and client assignments work? How personalized are client services?
- ✚ How often do you review portfolios and what can clients expect to receive in terms of asset reports and market communications?
- ✚ How much say do clients have about portfolio construction and other customized service deliverables?
- ✚ Talk about material disciplinary histories of the firm and personnel that clients should know before they do business with your firm.

## **SEC: Privacy Breaches On the Rise -**

**“In the last two years, we have seen a significant increase in information security breaches involving institutions we regulate. Perhaps most disturbing is the increase in incidents involving the takeover of online brokerage accounts, including the use of the accounts by foreign nationals as part of “pump-and-dump” schemes. The financial services sector also is a popular target for online targeted attacks, and “phishing” attacks in which fraudsters set up an Internet site designed to mimic a legitimate site and induce random Internet users to disclose personal information. In other recent incidents, registered representatives of broker-dealers disposed of information and records about clients or prospective clients in accessible areas, from which journalists were able to remove them.”**

*Source: Excerpt of SEC proposed rule amendment release re: Regulation S-P March 13, 2008*

## **Another Privacy Brick in the Wall**

Consumer privacy is once again pinging the regulatory radar as Regulation S-P is soon to be amended by the SEC to beef up consumer protection. The massive identity thefts that have plagued the public and private sectors in recent years will now come home to roost for investment advisors, broker-dealers, and investment companies. The SEC is striving to achieve, across the financial services sector, a closer alignment with existing consumer privacy rules and guidelines issued by the Federal Trade Commission, the federal agency that first promulgated consumer privacy protection protocol with the Fair Credit Reporting Act of 1971, amended in 2003 with the Fair and Accurate Credit Transactions Act.

New amendments will require advisors, brokers-dealers and investment companies to adopt more substantial policies to safeguard and appropriately dispose of confidential client information, as well as establish and test standards for data breaches. New policy and procedure enactments will have to address administrative, technical and physical safeguards to be deployed in the protection of consumer records and confidential information, and include staff training, service provider coordination, and internal controls to manage anticipated threats.

Data breaches occur when unauthorized access on any scale is experienced by the firm. The amendment will require firms experiencing a breach to promptly inform affected consumers “if misuse of sensitive personal information has occurred or is reasonably possible.” To the extent that misuse is deemed to have occurred, the firm will be required to notify the SEC if “an individual identified with the information has suffered substantial harm or inconvenience or an unauthorized person has intentionally obtained access to or used sensitive personal information.”

It’s not all bad however as the SEC seeks to reduce the ‘blackout period’ in effect between notice and consent periods during the account transfer process. The amendment proposes language relaxing client opt-out and notification requirements that registered representatives must observe in exporting certain client information when moving on to a new firm.

Currently, registered representatives changing firms must obtain an express or implied customer consent to disclose client information to an unaffiliated third party. Failure to obtain customer consent led to SEC-initiated administrative proceedings in 2007 against a regional brokerage firm. The proposed amendment will likely invoke an exception which permits ‘migratory’ brokers and other financial professionals to take client names, mailing/ email addresses, telephone numbers as well as a “general description of the types of accounts held by the customers” with them upon departure. The only catch – the rep must provide the firm with a list of the information retained under the exception no later than his/her separation date from the firm.

What the Commission giveth in terms of reducing compliance hassles with account transfers, it taketh away in terms of the additional written consumer privacy policy and procedure. Expect further guidance about the newly amended Regulation S-P in coming months.

## RISK CORNER

### *Knowledge Capital Risk*

The risk that processes for capturing and institutionalizing learning across the organization are either nonexistent or ineffective.

The **costs** of knowledge capital risk to your organization, especially in the client and compliance arenas, include:

- ❖ Slow response time relative to client inquiry/complaint
- ❖ Clients who are dissatisfied, or who pull their business from the firm
- ❖ Repeated errors or compliance policy violations
- ❖ Slow professional competence development
- ❖ Hard dollars lost correcting trade-related and other errors
- ❖ Constraints on growth

*Source:  
The Protiviti Risk Model  
knowledgeleader.com*



## No Rest for Regulators

Will the decades-old distinction between commercial banks and investment banks come to an inglorious end in 2008? Surely, a burning question you ask yourself each day! Many observers opine that the Fed will be truly cornered when the September deadline for extending the IB discount window (the newly created borrowing facility open to investment banks) comes due. The special facility put in place to effectively deal with capital market liquidity concerns will be difficult to roll back, particularly considering the ongoing hemorrhaging of investment bank capital due to the parade of

asset write offs.

A renewal of the facility would almost certainly usher in a new regulatory era for investment banks. Clearly if tax dollars are used to backstop unregulated financial entities on an open-ended basis, lawmakers and agency bureaucrats will feel obliged to introduce a new investment banking regulatory regimen.

What are the odds of the feds dialing up new investment banking regulations? We think fairly high. The credit market freeze-up, while not as acute today as it was at the onset of the crisis, is still a significant problem. The TED Spread and other risk/liquidity metrics reflect improvement, yet still embed a huge risk premium that fogs the price discovery and risk transference capabilities of the capital markets. Congress will likely assess the risk/reward tradeoff to favor a comprehensive regulatory regime to more effectively address the 21<sup>st</sup> century U.S. capital markets model. A new regulatory hierarchy will not only target investment banks as covered entities and provide new funding facilities of last resort, but may very well auger structural changes that would impact current broker-dealer and investment advisory CCOs.

Here is our short list of potential regulatory pitfalls coming in 2009 - bear in mind that we submit the following with a tank full of caveat-emptor and without discrimination to any prospective denizens of Capital Hill.

1. Been there done that! ... investment banks say hello to CCO.
2. Are we there yet? ... hedge funds finally get a functional regulator. Will it be the SEC?
3. What's old is new again! ... resurgence of the "middle office" risk management controls in a more institutionalized form.
4. What gear are we in? ... leverage and the concomitant impact on the balance sheet will usher in more scrutiny and transparency.

Stay tuned!

## The Life of a CCO – It's Always Something

"We like to think of our work as an even-keeled course that is only occasionally interrupted by a crisis of major proportions. We really don't like crises - we sometimes become cranky, distracted and disheveled - sort of like, well, Roseanne Roseannadanna."

" ... the reality is that our work is probably better described as a series of crises that are occasionally interrupted by a calm patch, which more often than not is the eye of the storm. This is particularly true for compliance. In a compliance department, the workload is often set at maximum flow. It's full catastrophe engagement with thorny compliance issues most all the time. If it's not one thing, it's another thing, but it's always something. And that, I submit, is exactly as it should be."

*Source: excerpt of speech by Linda Chatman Thomsen, Director, SEC Division of Enforcement Washington, D.C. June 4, 2008*



## **CCO Dinged for Failure to Implement Policy**

***Following is an excerpt of a speech delivered on June 4, 2008 by Linda Chatman Thomsen, Director of the SEC Division of Enforcement. In it, she highlights a broker-dealer CCO penalized for not properly implementing his firm's insider trading policies.***

" ... On the compliance front, I want to talk about one of those rare instances in which the Commission has sued an individual compliance officer. The matter involved the compliance program of ... [a] ... captive broker-dealer for a Los Angeles-based investment bank. In a settled civil injunctive action against ... [the firm,] ... the Commission alleged that the firm failed to enforce procedures on its books that sought to prevent the misuse of inside information. Along with the Commission's action against the firm, the Commission also filed a settled administrative action against ... [the] ... Chief Financial and Compliance Officer ... censuring him and fining him \$25,000 for his aiding and abetting ... [the firm's]... violations."

"As many of you know, Section 15(f) of the Exchange Act requires broker-dealers to establish, maintain and enforce policies and procedures designed to prevent the misuse of material nonpublic information. And ... [the firm] ... had those policies and procedures. In fact ... [the firm] ... had written insider trading policies, both freestanding and as part of its employee handbook, and a separate acknowledgement form in which an employee certified he had received those policies. It had forms requiring employees to disclose securities transactions and outside business activities. And it updated its policies to add a restricted securities list, and to require employees to release to the firm duplicate statements from their securities trading accounts."

"But there is a 'but.' As imposing as these procedures were on paper, something was missing: the human element, the hand that collected the signed acknowledgement paper, the eye that met the employee's gaze and saw that he understood and accepted the responsibilities enumerated in that paper. And without that person ensuring that those policies were a living, breathing trust between employer and employee, well, the law was not being upheld. As I said a moment ago, it's not enough to have policies and programs on the books. They have to be *bona fide*, working programs whose dictates are honored. You as compliance professionals provide the human element that brings compliance policies to life and ensures that they are enforced. So basic, so simple, yet, so important. And this applies not merely to insider trading but to all the policies you enforce."

**Horrigan Resources, Ltd.  
10592 Perry Highway, #209  
Wexford, PA 15090  
(724) 934-0129 phone  
(724) 934-0132 fax  
[www.horriganresources.com](http://www.horriganresources.com)**

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