



Conspicuous Compliance

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Made in the Shade

The title may evoke easy times from our youth, however a more challenging evocation refers to the rite of passage that just about every 14-year old is familiar with - **shadowing** - whereby newly ascendant freshman have an opportunity to get a sense for life at a local high school before official enrollment. A similar process is often used to affirmatively determine mutual interest in professional employment.

If students and job seekers can benefit from shadowing, why not the CCO? For just a few hours of time invested, the “shadowing” CCO stands to gain valuable insight into key business processes such as risk management protocol and the manner in which professionals interact with clients and other key constituents of the firm. The process is simple – sit with a professional and observe them performing their daily job responsibilities. Observe, and ask questions of course!

The benefits to the CCO are numerous:

- ✓ Witness firsthand how employees hold themselves out – and hold out the firm – to various constituents
- ✓ Observe problem-solving and related compliance resource focus
- ✓ Ascertain the degree to which employees follow compliance policy and procedures
- ✓ Pinpoint areas where the compliance program may not adequately address evolving business activities of the firm
- ✓ Identify timely topics for inclusion in future compliance training programs
- ✓ Develop and communicate procedural refinements

Employees can benefit from CCO shadowing as well:

- ✓ Refine compliance policy and procedure implementation
- ✓ Receive personal, job-specific feedback about how they can contribute to the compliance culture of the firm
- ✓ Identify emerging and exception processes for CCO consideration and risk assessment

Give shadowing a try - start with one colleague and see how it works. The “summer doldrums” - an ideal time to have it made in the shade.

SEC Chairman emphasizes 3 core principles that inspire today's regulators:

First — the protection of investors. This is something that I think about at all times. On the door to my office I have a sign that reads 'How does it help investors?' It serves as a reminder to anyone who enters that the investor is our highest priority.

That's our primary focus.

Second — ensuring markets are fair, efficient and transparent. As investor advocates, we understand the importance of stable markets and sound institutions. But, we also appreciate that truthfulness and transparency are just as important. In short, we cannot stop investors from taking risks, but we can insist that they have the relevant facts to weigh those risks.

And, third — the reduction of systemic risk. This is a topic in the U.S. that is generating significant attention as we grapple over just how best to understand and reduce the risks that can threaten our financial system as a whole."

Mary Schapiro, 6/11/09



The Doctor Is In

It was bound to happen - with the losses of the Great Recession of 2007-2009 continuing to accumulate (two more banks* went down in early July while it seems every day the SEC is alleging another Ponzi scheme**), government solutions to reinvigorate economic growth and investor confidence may attain a new level of inspiration.

Many regulatory initiatives have been floated, from mandatory registration of hedge funds to surprise exams for certain investment advisers. Here is an idea you may not have heard ...

The Bank for International Settlements ("BIS") has recommended that financial products' risk attributes be ranked for suitability and complexity in a manner similar to the pharmacological profiles of regulated drugs. The BIS is a Swiss-based organization whose mission is to foster international monetary and financial cooperation while serving as a banking counterparty for central banks.

"In a scheme analogous to the hierarchy controlling the availability of pharmaceuticals, the safest securities would, like non-prescription medicines, be available for purchase by everyone," the BIS noted in its annual report. Upstream on the risk channel would be securities available only for those with "authorization" to invest in them, while further up the risk ladder still would be securities made available in limited amounts, requiring investors to be pre-screened, not unlike drug therapy testing. Finally, there would be those securities which are deemed illegal and are not to be marketed or sold to investors of any type. Risky securities could be upgraded to less risky status only after being successfully screened and tested for multiple risk attributes.

Campy analogies to illicit pharma notwithstanding, the implications of this proposal are wide ranging and certainly not fully manifest. However, were this suitability protocol to be adopted as proposed, Compliance Officers throughout the capital markets would surely be lighting their hair on fire while simultaneously putting the ensuing conflagration out with a hammer. Customers and prospects alike may have to be vetted with government inspired risk assessment documentation to correlate investor suitability with the predetermined risk attributes of the securities resident in their portfolios. Investment grade paper, non-rated private placements, bonds, equities, commodities and so called synthetics alike would presumably be covered by new thresholds of suitability analysis.

*Actual reported number of failures is 7 banks however 6 in Illinois had one common majority owner
**Provident Royalties LLC had its assets frozen by the SEC on July 6, 2009

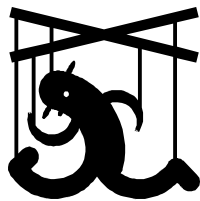
*Pearls of
Wisdom
from
Ronald Reagan*

"Government exists to protect us from each other. Where government has gone beyond its limits is in deciding to protect us from ourselves."

"Governments tend not to solve problems, only to rearrange them."

"No government ever voluntarily reduces itself in size. Government programs, once launched, never disappear. Actually, a government bureau is the nearest thing to eternal life we'll ever see on this earth!"

"The taxpayer - that's someone who works for the federal government but doesn't have to take the civil service examination."



We Done Here?

Whether the Fed or the SEC adopt the prescription recommendation remains to be seen, indeed the full magisterial sweep of the widely anticipated regulatory reform of the U.S. capital markets is not due to be revealed for several weeks, if then. Nonetheless, suitability itself is not a regulatory orphan as all regulated financial institutions have financial consumer suitability requirements that are promulgated by their functional regulator. Indeed, broker-dealers are held to the "suitability requirement" when offering investing advice to clients while the investment adviser is held to the more stringent fiduciary duty of care when providing investment management services to institutional and retail clients. Were security ownership by prescription to become a reality, client suitability policy and procedures would likely require an extensive recalibration, or at the very least new suitability protocol would be required to fully reflect the proposed vetting process.

Clients of investment advisers referred by wrap platforms would certainly represent one considerable gray area wherein the new standards would be applied. Indeed would the new standard extend to not only products but professional financial services as well, i.e., further codification of the accredited investor status? Starting to get the picture? Regardless of your political stripes there is no denying that both the current and contemplated manifestation and insinuation of governmental influence into the financial services industry is nowhere near done, for better or worse.

What can compliance professionals do in the meantime? Read on...

Do the Tighten-Up

Terrific summer of '68 song by Archie Bell & The Drells - also a recommended best practice for CCOs waiting on the re-regulation train. Take a look at your suitability protocol for all client types (institutions, retail wrap, retail direct, solicitor-generated, related accounts) and ensure that current suitability procedures are implemented and fully documented by all relationship management areas (e.g., marketing and portfolio management). If security ownership by prescription does become a compliance reality it is best to start from a position of strength relative to the efficacy and relevance of current suitability policy and procedure.

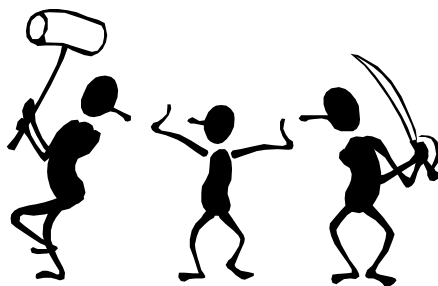
It's possible that the BIS is taking a page out of the American political playbook whereby the proposal is merely a trial balloon. Nonetheless, given the consumer complaints attendant to mortgage and even money market products (auction rate securities anyone?) it is likely that investor suitability reforms of some fashion will be forthcoming.

Fiduciary Standard

“A fiduciary standard is considered to have real teeth because it is an affirmative obligation of loyalty and care that continues through the life of the relationship between the adviser and the client, and it controls all aspects of their relationship. The SEC and the investment adviser community have historically stood for the principle that investment advisers could not completely perform their basic function — furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments — unless all conflicts of interest between the investment counsel and the client were removed.”

Speech "The Globalization of Investment Advisers — How Will Regulators Respond?"

SEC Commissioner Luis A. Aguilar, 6/23/09



Arbitration Abounds

As the ongoing deliberation regarding the distinction between the fiduciary obligations of brokers and investment advisers continues, FINRA released 2009 arbitration statistics through the month of May and they do tell a tale. Let's start with new case filings: new arbitration cases filed with FINRA against broker-dealers through May of 2009 are up 85% compared to the same period in 2008 (3,163 through 5/09 versus 1,711 through 5/08).

Consider the top 5 controversies at the center of FINRA arbitration claims served as of May, 2009 (it should be noted that each case can be coded to contain up to four compliance action items):

- 1) Breach of fiduciary duty
- 2) Misrepresentation
- 3) Negligence
- 4) Breach of Contract
- 5) Unsuitability

Will the fiduciary distinction become extinct?

Source: www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm



FINRA Wants You!

There is no shortage of speculation about the regulatory changes on the horizon. Yet, a very interesting statistic quoted by the Chairman of FINRA may hold the key to pending change:

“Consider the contrast: FINRA oversees 4,900 firms and conducts over 2,500 regular exams each year. The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of those firms—not because of lack of desire but lack of resources. Indeed, the SEC has said recently that in the fiscal years of 2009 and 2010, it projects that it will examine just 9 percent of investment advisers each year. FINRA and the SEC, by contrast, are projected to examine 55 percent of broker-dealers each year.”

There is nothing like a crisis to introduce change, and change is certainly coming to the financial services industry. No crystal ball here, just a hunch that the standards for **all** practitioners are on the rise. FINRA wants to get their hands on investment advisers. If they do, the odds of being examined more frequently than every 5-7 years are sure to rise.

Source: Speech by Rick Ketchum, Chairman & CEO, FINRA, Washington, DC; June 17, 2009

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