



Conspicuous Compliance

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Living and Breathing Compliance

CCOs may often **feel** like they live and breathe compliance, certainly welcome news for the SEC. But Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations ("OCIE"), expressed this sentiment a bit differently, noting that advisers must implement **compliance programs** that are "**living and breathing.**" In remarks before the 2005 Investment Adviser Compliance Best Practices Summit, she observed:

"Your compliance program cannot be static. It can't be 'done,' 'on the shelf,' or 'fixed.' An effective compliance program must continue to evolve and, to do so, the program must be able to identify, meet, and incorporate changes in your business and changes in your customers, to continue to identify conflicts of interest, to be responsive to changes in the statutory and regulatory regime... ."

How do investment advisers implement an *organic* compliance program? Short answer - practice ongoing testing of internal controls. In fact, the SEC has observed that for large and even mid-size firms, ongoing review and testing may be the **ONLY** way to ensure the efficacy and relevance of a compliance program.

Continuous and vigorous testing of the firm's compliance regimen will provide valuable insights and benefits to the firm and the CCO, including:

- (1) finding areas where policy and practice diverge;
- (2) discerning those procedures and internal controls that no longer comport to the firm's business model and have become irrelevant;
- (3) observing gaps between the firm's compliance policy and the compliance knowledge and/or implementation of the policy on the part of employees;
- (4) detecting conflicts of interest and risks previously undiscovered;
- (5) identifying compliance vulnerabilities before they become outright deficiencies;
- (6) making compliance personnel accessible; and
- (7) demonstrating to personnel that compliance is important.

Though it's true that the SEC does not **mandate** that firms review and test policies on an ongoing basis, the OCIE strongly **urges** firms to take an activist approach. For most firms, "activist" means more than once a year.

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Testing, Testing...1-2-3 (is this thing on?)

We believe the best way for broker-dealers and advisers to build a strong compliance program is by implementing risk-based compliance policies, engaging staffs thoroughly in the compliance process and vigorously testing compliance resources. In this business, nothing remains static - professional expertise, products, markets, clients, and the regulatory winds are subject to change. This evolution can render compliance tools and related controls marginally effective and even obsolete over time.

Today, financial institutions operate in a regulatory era where the assignment of legal and fiduciary responsibilities and affirmative obligation has migrated to **ALL** parties to a financial transaction. Legal doctrine (e.g., **willful blindness**) has been successfully utilized by the SEC and other regulators to prosecute firms and employees that "unknowingly" abet financial crimes such as money laundering and insider trading up and down the distribution channel. Furthermore, firms are frequently sanctioned for failure to supervise, i.e., failure to **identify, stop and prevent** activities that violate the fiduciary standards of the industry.

A 2007 investment management compliance survey* reveals startling observations about the current state of compliance testing in the industry. Although survey respondents were investment managers, the compliance findings are relevant to virtually all players in the capital markets today.

The survey observed that investment managers spanning all advisory industry metrics were applying compliance assumptions and presumptions which may jeopardize regulatory standards and highly coveted reputations. In virtually every case, a proactive evaluation/testing of a firm's business model and related proprietary compliance tools would reveal compliance vulnerabilities that require immediate attention.

**2007 Investment Management Compliance Testing Survey organized by ACA Compliance Group, IM Insight, Investment Adviser Association, and Old Mutual Asset Management. Respondents included 450 investment advisers with AUM of \$250 million - \$20 billion, with the majority of firms represented having been in the business more than five years.*

The Survey Says ...

Following are select highlights as well as HRL insights relative to the 2007 Investment Management Compliance Testing Survey:

Insider Trading

Survey Fact - 60% of respondents did not test for insider trading, presumably because most advisers did not consider insider trading a meaningful and relevant threat.

Survey Observation - 85% of respondents did not conduct an insider trading risk assessment - which of course begs the question - How do they know they are not exposed to the risk?

Characteristics of a "Living, Breathing" Compliance Program ...

(1) must be respected within the organization and have the utmost support from the top;

(2) must be well-resourced, and populated by staff with expertise;

(3) must possess an attitude of skepticism; and

(4) must continually beware of conflicts of interest.

Lori Richards
Director, SEC OCIE
February 28, 2005

IA Annual Review Report Card

“Last summer, an informal SEC staff study found that over 40 percent of advisers examined during a four-month period received a deficiency letter comment on their annual review process.”

... according to the 2007
Investment Management
Compliance Testing
Survey, 9/4/07

HRL Risk Measures – CCOs should be asking ... Who has access to confidential information? Are procedures and internal controls in place to ensure conformance with regulatory requirements and have they been tested for proper implementation? Are highly profitable client trades supported by the firm’s investment philosophy and due diligence process? Do personal trading records conform to pre-clearance and reporting standards? Are there effective, ongoing insider trading communication, training, and supervisory processes in place?

Side-by-Side Product Investing

Survey Fact - 23% of respondents engaged in side-by-side investing whereby two independent products were managed concomitantly (e.g., hedge fund managed alongside mutual fund and/or separate accounts).

Survey Observation - 29% of respondents engaged in side-by-side investing did not perform *any* compliance tests relative to this practice and *not one firm* restricted communications or information sharing between portfolio managers of the contrasting lines of business / products.

HRL Risk Measures – CCOs should identify inherent and potential side-by-side investing conflicts of interest which may compromise critical fiduciary standards; eliminate or disclose all conflicts; and institute thoughtful and creative internal controls to mitigate conflicts of interest.

Record Retention

Survey Fact - 81% of respondents retained *all* e-mail records for *all* employees while 15% of firms retained only those records required by law.

Survey Observation - E-mail review was cited as an effective insider trading testing tool well recognized by employees. Instant messaging was prohibited by 56% of respondents however, 33% of firms that permit IM (primarily for trader use only) did not retain *any* IM records.

HRL Risk Measures – CCOs should incorporate *all* communication media pursuant to the books and records retention rules and recognize that selective and/or convenient retention implies inadequate compliance and offers no regulatory protection.

Continuity Plans

Survey Fact - 93% of respondents had developed a written business continuity plan pursuant to industry standards.

Survey Observation - There was no clear consensus on plan testing protocol relative to mode or frequency. While the overwhelming majority (89.5%) had contracted for physical back-up sites and redundant communication systems, 37% of firms had not tested the physical back-up site and 49% had not yet tested their communication systems. An incredible 96% had not yet participated in an industry-wide voluntary disaster preparedness drill.

SEC View on Why Tackling Conflicts of Interest is so Vital:

“While one reason to ... [identify and address conflicts] ... of course, is to avoid a possible enforcement action, the other reason, and the one that should be most important to you ... [as compliance professionals] ... is to avoid the harm to your client relationships and reputation that may well result if these conflicts are not adequately identified and addressed – harm that will inevitably affect your bottom line.”

*Linda Thomsen,
Director, SEC Division
of Enforcement
March 22, 2007*

HRL Risk Measures - After identifying and prioritizing key operational requirements necessary to re-start your business within 24-48 hours (telecommunications, physical office space, staff transportation, client records, third party reliance, key operating systems, etc.) and articulating these requirements in a business continuity plan, firms should implement periodic dry runs to establish plan efficacy and relevance pursuant to the firm’s evolving business model. When afforded the opportunity to participate in an industry-simulated disaster, firms should take full advantage of the lessons to be learned by all parties participating in the drill.

These excerpts provide a critical lesson for investment advisers: outright compliance failure, partial compliance and marginally relevant compliance efforts are likely to be detected by thorough and frequent testing of policies, procedures, and internal controls. Effective testing and subsequent amendment may very well keep your firm out of the regulatory spotlight ... and out of trouble.

Detecting Conflicts of Interest

A conflict of interest is an incompatibility between one’s own interests, the interests of the firm, and the interests of clients.

A recent issue of ***Conspicuous Compliance*** outlined a step-by-step process for broker-dealers and investment advisers to handle conflicts of interest. The first step in such a process is identification – create an environment where conflicts of interest are always on the radar screen.

Our clients convey a level of frustration in this regard, as many feel that identifying conflicts is easier said than done. CCOs tell us that conflicts of interest are like blind spots in driving mirrors – there are certain situations you just don’t see coming and if you do, sometimes it’s too late.

How can CCOs **effectively** detect conflicts of interest? First, recognize that they cannot shoulder the compliance function alone. Conflicts of interest may be introduced by personnel and business practices at all levels of the organization. Therefore, it is sound compliance practice to get all firm personnel involved in the conflict identification process.

How? Consider the following ...

- ✓ **Situational discussion** – Posit relevant “what if” scenarios to various teams of personnel - use their responses to develop a “collective” assessment of the firm’s fiduciary awareness.
- ✓ **Case studies** – Share current industry cases of regulatory actions against firms and their staff to facilitate discussion about real scenarios, with the objective of evaluating employee mindsets and sharpening awareness of conflicts of interest.

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Limiting Conflicts of Interest in Asset Management

“Clearly stated and defined policies and procedures are helpful in the investment management process. This helps limit the types of conflicts of interest that might arise. By limiting needless ‘discretion’ and articulating to everyone in a transparent fashion -- e.g., employees within the organization, customers and regulators -- the ‘intent’ and ‘procedures’ of the firm become clearer.”

Chester Spatt, Chief Economist, Office of Economic Analysis, SEC

May 12, 2005

- ✓ **Brainstorming** – Start at the top, moving down the management chain to eventually include front line and support personnel at all firm levels. For starters, define the conflict of interest concept, including the fiduciary aspect, and solicit feedback regarding all service partners. Focus on factors like selection process, decision criteria, personal relationships, means of communication, and compensation arrangements.
- ✓ **Develop background** – At first blush this may appear to be a nefarious activity but give the idea consideration. We recommend that the CCO develop over time background on access personnel, i.e., what do their spouses or in-laws do for a living, what outside activities do they participate in, etc. Much of this background arises through compliance certification or in ongoing social settings. We, however suggest that the CCO directly reference this background information in the course of discharging compliance responsibilities. Recent criminal and civil prosecutions involving spouses and other family members of brokers and advisers underline the relevance and value of this activity.
- ✓ **Follow the money** – Investigate big revenue trades, highly profitable clients, top trading counterparties, dispersion of performance across advisory portfolios, entry and exit prices of identical portfolio holdings across product lines, client relationships marked by heavy firm entertainment, high expense business trips – any and all activities where large dollars are flowing in and out of the firm.

Lessons Learned – Trading Violations

Consider an SEC conflict of interest enforcement case currently pending. The SEC alleges that over a 5-year period, a portfolio manager employed by a prominent investment adviser concealed his personal stock trading activity (most notably trades in stocks held by the mutual funds he managed) and falsified internal reports. The enforcement action claims that during this period, the portfolio manager executed and failed to disclose approximately 3,500 trades in public company stocks and profited to the tune of \$410,000. The charges pending against the individual include violation of the firm’s ethics policy as well as the antifraud and reporting provisions of the 1940 Investment Company Act.

Firm Policies and Controls Did Not Stop the Fraud

This is a classic conflict of interest case whereby the portfolio manager breached his fiduciary duty under the 1940 Act. The compliance kicker? **The firm’s personal trading policy was robust** and included: (1) pre-clearance requirements for all portfolio manager trades, (2) prohibition of short-term trades, (3) limit of 30 securities trades in a single quarter, (4) 60-day holding period for all securities, (5) quarterly and annual personal trade reporting, (6) annual certification of code of ethics policy, and (7) attendance at annual compliance meetings.

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2006 SEC Exams

“Most of our exams find that in some way, advisers have not fully complied with some provision of the Investment Advisers Act. In 2006, we conducted over 1,300 exams of advisers. The vast majority of our examinations -- 81% -- resulted in non-public letters from us to you ... [the advisers] ... informing you of these problems and asking for corrective action. The vast majority of firms respond to our deficiency letters by making improvements in disclosures or in compliance controls to prevent the problem from reoccurring. In about 6% of our exams of advisers, we find indications of very serious violations - mostly fraud of some type - that result in a referral to the SEC's enforcement staff for further investigation.”

*Lori Richards
Director, SEC OCIE
March 23, 2007*

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What Would You Do?

The portfolio manager filed bogus reports and falsely certified his compliance with the firm's code of ethics policy. Could this firm have prevented or limited this fraudulent activity? The reality is probably not. However, this employee was conducting an average of 58 personal trades a month, so perhaps he was talking up his portfolio success to colleagues, or maybe he was placing trades from the office on company time. Hindsight always provides that coveted 20/20. The truth is that if an employee or a firm is determined to commit fraud, they will find a way to do it, regardless of how bright the regulatory line may be. Any number of policies and internal controls can be implemented to **attempt to** prevent such fraud, but circumventions remain.

The good news in this case? Thus far, the investment advisory firm who employed this errant portfolio manager has not been implicated in his crimes. Little solace for the employees of the firm who are left with a tarnished reputation and nervous clients.

Recognizing and managing conflicts of interest form the bedrock of effective compliance programs. Firms must be vigilant and minimize conflict of interest vulnerability. At the very least, don't make it easy for any employee or third party to use the firm's good name and resources for personal gain by means of breaching fiduciary duties.

HORRIGAN RESOURCES - WHO WE ARE

We have assisted clients for more than 10 years in matters pertaining to compliance and training. Our products and services include risk and fiduciary assessments, audits, compliance policy manuals and handbooks, training programs, continuing education as well as on-call compliance consulting resources.

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