



Conspicuous Compliance

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...compliance solutions for the financial services industry

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In This Issue

Side-by-Side ... So Long? - pg 1

Risk – Go Sing it on the Mountain - pg 2

Risk – Emerging from the Trenches – pg 3

The “C” Factor – pg 4

Compliance Documentation - pg 5

CCO as Coach – pg 6

SEC ComplianceAlert – pg 7

Side-by-Side ... So Long?

The only sure forecast for 2009 is that there will be regulatory change, both in terms of rule promulgation and the functional regulatory regime. It may be interesting to speculate about how these changes will become manifest, but the truth is very few individuals outside the imminent government to be installed really know. Having said this, it would appear that the unfolding and epic fraud perpetrated by Bernard L. Madoff Investment Securities LLC continues to astound and even confound. While it is too early to affirmatively determine the ultimate outcome for the firm’s unfortunate investors, it is not too early for firms employing the side-by-side broker-dealer/investment advisory business model to reassess internal compliance metrics relating to commission and fee-based revenues, regardless of shifting regulatory winds.

Consider the following:

- **Client Disclosure** - The age old axiom of following the money is always relevant when evaluating client disclosures. Advisers must ensure that clients are fully informed as to what monies clients pay and how the adviser earns them ... discuss products and services delivered, identify key third party partners, and if appropriate, posit prospective scenarios under which fees or commissions may change. These disclosures should be made while marketing, at the time of client engagement, and periodically thereafter. Disclose and effectively manage all conflicts of interest.
- **Regulatory Disclosure** - Compliance at its very root is the ongoing effort to deliver products and services “as advertised.” Review your ADV and make certain that business practices with third party partners/affiliates accurately reflect the nature of these relationships. Disclose and effectively manage all conflicts of interest.
- **Trading/Custodial Arrangements** - Be certain that all trading and settlement activity is performed pursuant to contractual specifications and concurrent client/provider documentation. Any deviation from these practices that is deemed to be exceptional in nature should be documented, even if done so on a retroactive basis. Disclose and effectively manage all conflicts of interest.

More to come on this story!

A CCO Walk-through

A walk-through refers to the selection of a particular transaction or event and tracing (or walking) it through the processing system from the time it is first captured and input to its final disposition. The purpose of a compliance walk-through is primarily to identify specific control procedures and to confirm the implementation of these procedures in the information system, and by extension, in the compliance program. A walk-through may be executed either partially or entirely through the enterprise, depending on the extent of the evidence or knowledge required.

The CCO walk-through is recommended for vital processes and activities, particularly those that occur in high volume and/or those involving multiple exception processes. A periodic walk-through is likely to net valuable compliance insight – new risks, policy violations, training gaps, documentation vulnerabilities ... the list goes on!

Betsy Rathz, HRL

Risk - Go Sing it on the Mountain

We just can't stop talking about risk management these days – the gambit runs from trading desks blowing out VAR thresholds to the so called “liars’ loans” underwritten by lenient mortgage bankers whose paper was subsequently insinuated into the markets through the ABS process. Even regulators are deemed to have run amok in the current “crisis of our generation.” Did you know AIG allegedly inflicted the majority of collateral damage to the U.S. capital markets from an “unregulated” insurance entity? That little nugget came up in testimony before the House Agriculture Committee on December 8, and is a true testament in itself to the intertwined nature of the 21st century marketplace given the intersection between agricultural commerce and asset backed securities.

The house committee called on five qualified witnesses to testify on seminal aspects relating to the ongoing effort to develop and implement a viable counterparty clearing platform for the credit default swap market. Of course risk management was centric to the testimony which ranged from what happened during the last 16 months to what is going to happen relative to a new regulatory regimen. One witness, Gerald Corrigan (former president of the New York Fed and current Managing Director at Goldman) opined that it was time for risk managers to “move out of the trenches and up to the mountain” and thereby gain a more holistic perspective of both the current and prospective risk sets arrayed against financial firms.

We could not agree more with Mr. Corrigan. Regardless of whether one believes that the new and highly anticipated regulatory regimen should focus on the marketplace (i.e., exchanges and regulated entities) or capital market products, it is clear that financial firms were spectacularly unprepared for the tsunami of concentric systemic risk that befell the global capital markets, participants and investors these last 16 months.

Any attempted post mortem of what went wrong with the collective risk management orientation of banks, brokers, hedge funds, underwriters and advisers during the crash of 2008 will by definition assume a posture of hindsight - but even given this qualifier, there are valuable lessons that the CCO may glean in the detritus of the financial system.

Get out of the trenches and move up the mountain - at first blush it comports nicely with the tsunami metaphor however the truer inference of the statement refers to perspective. An effective and robust compliance program requires a holistic element in addition to the daily trench warfare being waged via ongoing testing, exception reporting and policy enforcement. The independence of the CCO office must be manifest in the ability to maneuver compliance resources in an optimal manner to meet new and emergent regulatory and reputational risk posed to the firm in addition to known risks currently addressed by policy and procedure. The key lies in the CCO's **capability and willingness** to look beyond known risk sets.

SEC focus areas for B-D internal control reviews:

- (1) Internal audit – complete, independent, communicated assessments that uncover deficiencies which are addressed timely;
- (2) Senior management – active involvement, sufficient resource allocation, enterprise-wide coordination;
- (3) Adequacy – sufficient resources and systems not clouded by biased compensation programs;
- (4) Market risk in trading – VAR, economic modeling, scenario analyses, stress and back testing;
- (5) Funding, liquidity, and credit risks – counterparties, valuation, guarantees, collateral, and margin;
- (6) Operational risks – segregation of duties, protection of customer funds/securities, privacy, contingency planning;
- (7) Legal and compliance risks – surveillance and monitoring systems, independence, robust and current policies;
- (8) Evolutionary – incorporate new products and activities in timely manner.

Mary Ann Gadziala of
SEC OCIE 11/28/07

Risk – Emerging from the Trenches

The practice of compliance risk management is frequently invoked in the regulatory and private sector, but what is the practical reality of compliance risk management to broker-dealers and investment advisers? The SEC answered this question in a speech given last year by Mary Ann Gadziala, Associate Director, OCIE. She stated, “Having risk management controls is a proactive sound practice to protect against significant financial losses, violations of law, and investor harm.” She goes on to say that risk management is most effective when it is (1) tailored to reflect unique firm dynamics, (2) ongoing, (3) proactive, (4) swift in problem resolution, (5) adaptable to new products and customers, (6) actively involves senior management, and (7) is guided by written policies and controls.

This guidance certainly makes sense intellectually, but the practical application of the risk management process is where the rubber hits the road and may often present an onerous challenge to the CCO. Here are a couple ideas to help firms effectively and proactively focus on the implementation of sound risk management practices and therein begin that all-important commute from the trenches to the mountain.

(1) Address risks where they live. Although the *oversight* of risk controls can be delegated to a committee, the risk itself must be managed at its source. An example – in many advisers and broker-dealers, it is common for valued professionals to retain important information rather than commit to enterprise access. The risk of course is that a veteran professional may leave the firm, exporting important knowledge with her. How best to manage this risk? Right at the source by requiring professionals to institutionalize this vital information via written procedures, peer-to-peer communication and hands-on supervision. The committee’s job is to *monitor* the documentation procedure process and to ensure that staff are appropriately trained and supervised. Risk management must live inside the business where the risk originates, not simply in the management committee meeting.

(2) Triage the risk set. It doesn’t take long to perform a risk triage with 50 entries on it, nor is this inherently negative as it helps the firm to ruminate and honestly assess real and potential problems. However, *effective* risk triage requires thoughtful and informed prioritization which means asking questions like: (1) Other than performance, are there non-systemic scenarios that could lead to significant client defections (e.g., reputation risk)? (2) What key people/data/systems can we not live without? (3) Where is our revenue concentrated and how do we manage and diversify this concentration? (4) Which clients are the most vulnerable in terms of our business model? (5) If required to demonstrate regulatory compliance in a given area, could we provide sufficient documentation of process and assessment?

So mind the trenches and continue to adroitly manage the known risk sets and as conditions permit, get up to the mountain and develop a proactive compliance regimen that ensures the CCO is heard and visible throughout the enterprise.

2008 Complaint Trends

Through September, new case filings with FINRA Dispute Resolution are up significantly over the prior year. Specifically, between January and September 2007, investors had filed 2,382 arbitration cases with FINRA Dispute Resolution. Through September 2008, FINRA Dispute Resolution had received 3,469 arbitration filings. This represents a 46% increase.

What is the outlook for next year? According to SIFMA, firms should expect to see a rise in complaints in the areas of auction rate, margin call, system access, trade cancellation, erroneous trading and account performance.

Source: "Retail Brokerage and Advisory Issues"
SIFMA Compliance & Legal Division

2008 Fall Compliance Seminar in NYC
November 11, 2008

The "C" Factor

Complaints ... no firm likes to receive them and employees certainly do not like hearing them. Yet, the current environment is ripe for complaints – now is the time to review your firm's complaint policies and remind employees of their responsibilities and proper procedure. All firms have a "C" factor; the question is what do they do with it? Here is a good place to start...

Clearly define complaints in your firm. We define a complaint as an event whereby a customer or his agent register dissatisfaction with the firm. This dissatisfaction may be directed toward the personnel of the firm or the services rendered and may not necessarily be objectively justified. What is the difference between a true complaint and a customer service problem? Generally, you have to get past the tone of the customer's voice and listen carefully to the choice of words to get to the underlying message.

Document the sequence of events. Conversation details may fade over time, which means it is vital to take notes during or immediately following the communication. Don't wait until a problem emerges; make it general practice to take good notes summarizing all key customer contact. When complaints do arise in the context of verbal conversations, pay close attention to the customer's tone and choice of words. Resist the urge to talk and defend, but rather listen and obtain clarification as necessary. Always avoid the stated position that the customer is wrong, even if the facts suggest that this is the case. Invariably this position will unnecessarily escalate the issue to a conflict which will likely require more time and possibly money to resolve.

Address complaints immediately. Despite our best efforts, customers will lodge complaints. When a customer contact reaches complaint status, employees should refrain from assigning any responsibility to the customer, a colleague, or third party. The key is to acknowledge the customer's concerns, reassure them that their concerns will be addressed, ensure that appropriate personnel are notified pursuant to firm policy, and assist accordingly in the complaint resolution. Policy should provide for appropriate escalation when customer problem resolution is "unattainable" under current circumstances. Prudent policy would require CCO notification under all complaint scenarios.

Complaints represent invitations to improve. Dissatisfaction with service execution reflects directly upon the reputation of the firm and may reach to the heart of the business model itself. For example, some target markets may be determined to be unsuitable relative to the capabilities of the firm, e. g, day traders may not comport to the brokerage service model or socially responsible accounts may not comport to the adviser service model. In this regard, complaints may uncover expectation and performance capability mismatches. If customers take the time to complain, it generally means they believe the firm will listen and respond to their concerns. Conversely, those that don't communicate complaints could be signaling their perception that the firm is unwilling or unable to address their concerns thus becoming a key reputational risk to the firm. Remind employees to resist any temptation to ignore or cover up a complaint. Embrace the "second chance" to get back on track in pursuit of meeting customer expectations and preserving business opportunities to serve and even grow customer relationships.

The “Do’s” of Documentation

Documentation means different things to different people. When it comes to compliance documentation, how much is necessary?

Here are some tips:

- ✓ Document the activity or event so that a colleague with no previous connection to the activity could understand key facts, important matters arising during the event, and the conclusions reached;
- ✓ Upon review of documentation, be sure you have answered the key questions of Who, What, When, Where, Why, and How Resolved;
- ✓ File the documentation for easy retrieval in the future – be consistent in filing methods;
- ✓ When in doubt, draft a “compliance memo to self” and place in a compliance memo file.



Compliance Documentation ... going to the dogs!

Would you advocate that your kids invest time and effort in completing their homework and then feed it to the dog?

Of course not – homework is designed to help reinforce the lessons learned in school, **and** is turned in to the teacher to ascertain whether students get the lesson and where they need help. Ultimately, homework is returned to students for future reference and test study aids. At least that’s the idea, right?

Failing to document all the things you as a Compliance Officer do each day to ensure that your compliance program is effective is akin to feeding homework to the dog. Regulators universally opine that the lack of documented compliance activity will generally be interpreted to mean there is no compliance activity. And **that** will cost you – in lengthy deficiency letters, enforcement actions, disgorgements, and more frequent visits by your friendly regulator.

Compliance Officers can implement simple solutions to keep the regulators satisfied. Here are just a few:

- ✚ Any time you look at a report, document, or file, **leave your fingerprints** by way of initials and date – whether you are the CCO, CIO, COO, President (or all of the above), get credit for monitoring the business processes of the firm;
- ✚ When holding meetings that speak directly to a compliance policy or vital operational process, consistently assign a “reporter” to take notes for retention in a **Minutes File**;
- ✚ Encourage senior managers who may forget to “report” important activities or events to **make notes on their daily planners** which can be reviewed, scanned, or at least made available for future access;
- ✚ Consider an **electronic message board** on your firm’s intranet site for posting important compliance messages, such as policy amendment notifications, compliance alerts, filing deadlines, etc.;
- ✚ **Use the electronic trade “note” feature** to document important market or transaction factors that impact trade execution, allocation, or any aspect of trade policy in order to justify actions as necessary;
- ✚ **Maintain a policy exception file** showing the audit trail of approvals for circumstances that warrant diversion from stated policy. Exceptions will occur; ensure that you can prove CCO knowledge and management of exceptions with a fully annotated exception file.

We find that regulated firms are generally doing the right things when it comes to compliance matters, but they often fail to dot the “i’s” and cross the “T’s” by disregarding the audit trail of their diligence. Don’t let your compliance documentation go to the dogs!

What do Barbara Streisand and Tiger Woods have in common?

“In addition to being at the top of their respective fields, Streisand in music and Woods in golf, they both work with a coach.”

“Why would someone at the top of their chosen profession need a coach?”

“The answer is quite simple. They realize, as do top performers in every field, the value of having someone on the sidelines watching their every move and making sure they're on track. They know that, while they are doing what they do, it's important to have someone watching their every step and providing feedback to help them be their best.”

Excerpted from an article authored by business coach Jim Donovan



CCO as Coach

Chances are you have a childhood memory that involves a coach. What do you remember about the coach? An encouraging word, a secret tactic to test your opponent, or perhaps correction of bad form in your technique. And of course, perhaps the occasional remark about a mistake or perceived lack of effort. In any event, the coach most likely shared some insight or advice that you probably needed to hear at that particular moment. Why? Because a coach's job is to help us see something about our performance or our situation that we simply cannot – or will not - see for ourselves. A coach has a perspective that we, in whatever capacity, may not have.

And so it goes with the CCO! One of the perks of being a CCO is the opportunity to share insight with your colleagues that they are unable to see for themselves. A new rule, risky transaction, gap in the process, spotty audit trail ... you name it, you as the CCO – and you alone – are in a position to be the compliance coach. You have a unique obligation to ‘watch the backs’ of your colleagues in the trenches as they execute the business plan of your firm.

So seize coaching moments when they surface – long before they become policy exceptions, deficiency reports, compliance violations, audit trails, or formal records ripe for regulatory scrutiny. Offer them a different approach that will help preserve their reputation and that of the firm's. Let them know that you rely on them to develop and preserve a culture of compliance. If you can help them see the benefit of good compliance, they are likely to take your coaching advice and make **your** job easier and the firm better protected.

One more thing – **the golden rule of coaching** is to first offer positive feedback about the employee's performance in terms of compliance awareness. This helps assure them that you recognize their contribution, and generally puts them in a better frame of mind to hear what else you have to say. Then educate and offer ideas for areas of improvement and finish by emphasizing how they and the firm will benefit from adjusting their perspective.

circa 1944

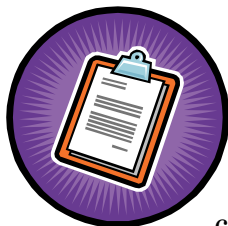
A SPEECH DEFENDING THE INTERPRETIVE POWERS OF THE SEC:

"We do not deem it advisable to lay down any hard and fast rule. Were we to do so, a certain class of gentlemen ... 'they toil not neither do they spin' ... would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises."

*Edward H. Cashion
Counsel to the
Corporation Finance
Division of the SEC*

*Excerpt from speech
before the National
Association of State
Securities
Commissioners
St. Louis, Missouri*

December 13, 1944



SEC ComplianceAlert

In July, the SEC issued its latest ComplianceAlert letter to Chief Compliance Officers, outlining common deficiencies and weaknesses found by examiners during recent compliance examinations of investment advisers, mutual funds, broker-dealers, and transfer agents. Through this medium, the SEC offers regulated firms useful guidance to support their quest to remain compliant with federal securities laws and rules.

In the July release, the SEC provided guidance on four critical topics: (1) personal trading by advisory staff; (2) proxy voting and use of proxy voting services; (3) valuation and liquidity issues in high yield municipal bond funds; and (4) soft dollar practices of investment advisers. Below we excerpt two of the most interesting ComplianceAlert observations:

(1) "Adviser's code of ethics was not followed. The adviser and/or its employees engaged in practices that deviated from the adviser's written code of ethics (*e.g.*, trades were not pre-cleared, pre-clearance forms did not contain information required to be provided by the employees, the adviser did not receive duplicate confirmations, and trades were placed in securities that are on the adviser's "do not trade" list). Examiners also commented when they believe an adviser had weak control procedures regarding oversight of supervised investment personnel (*i.e.*, portfolio managers, traders, and analysts), such as when these personnel disclosed sensitive portfolio and trading information to advisory personnel at other advisory firms, which were managing the supervised personnel's money in hedge funds or separate accounts."

HRL - What to do: Remind all personnel that disclosure of the firm's proprietary investment activity – of a current and contemplated nature – is a violation of Code of Ethics' insider trading policies and will subject them to disciplinary sanctions which include termination of employment. No employee may be immune or "above" the Code, even the President or CIO.

(2) "Advisers did not document their assessment of proxy service providers. Some firms had not documented their review of the proxy service providers used; therefore, examiners could not assess whether the adviser had established and implemented measures reasonably designed to identify and address proxy voting firms' conflicts of interest. Examiners also could not confirm claims of proxy service provider independence."

HRL - What to do: Paper your proxy records with evidence of due diligence efforts initiated in the selection of the proxy voting service provider. Include written communication – certification is recommended - from the provider attesting to their policies related to independence and conflicts of interest.

See the full text of ComplianceAlert on the SEC website at the following address-
<http://www.sec.gov/about/offices/ocie/complialerto708.htm>



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