

Horrigan Resources, Ltd.

Regulatory Bulletin

February 2010

As your 2010 compliance program review kicks into high gear, don't miss these important new rules, compliance dates and policy considerations

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Dates to Remember

<i>Compliance Date - January 1, 2010</i>	<i>Regulation S-AM - Affiliate Marketing</i>
<i>Compliance Date – March 12, 2010</i>	<i>Custody Rule Amendment</i>
<i>Compliance Date - June 1, 2010</i>	<i>Red Flags Rule – Identity Theft</i>

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Regulation S-AM

Regulation S-AM became effective January 1, 2010. This SEC Rule limits the extent to which certain financial institutions can provide consumer information to affiliates for marketing purposes. Under Regulation S-AM, a covered person is prohibited from using eligibility information that it receives from an affiliate to make a marketing solicitation unless: (1) the potential marketing use of that information has been clearly, conspicuously, and concisely disclosed to the consumer; (2) the consumer has been provided a reasonable opportunity and a simple method to opt out of receiving the marketing solicitations; and (3) the consumer has not opted out.

Here are the highlights of the Rule:

- ∇ Applies to brokers, dealers, investment companies, registered investment advisers, and registered transfer agents;
- ∇ Limits sharing of “eligibility data” about consumers between affiliates for the purpose of initiating marketing solicitations (eligibility data is information used to identify the consumer as a marketing target, e.g., net worth);
- ∇ Requires consumer to be granted an opt out option before using eligibility information to initiate a marketing solicitation;
- ∇ Opt out notices can be included with existing notice requirements, e.g., privacy notice.

Regulation S-AM specifies the parameters of compliant opt out methodologies, including details about the:

- ∇ Scope and duration of the opt out
- ∇ Contents of the opt out notice
- ∇ Definition of reasonable opportunity to opt out
- ∇ Definition of reasonable and simple method of opting out
- ∇ Delivery of opt out notices
- ∇ Renewal of opt out elections

The SEC offers a compliance guide for regulated entities to assess the new Rule and its relevance to their business model. Go to the following link to access the guide and model forms: <http://www.sec.gov/divisions/marketreg/tmcompliance/34-60423-secg.htm>

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Custody Rule Amendment

Recent amendments to SEC Custody Rule 206(4)-2 become effective March 12, 2010. The amendments are intended to provide additional safeguards when a registered adviser has custody of client funds or securities by requiring the adviser, among other things:

- ∇ to undergo an annual surprise examination by an independent public accountant to verify client assets;
- ∇ to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and
- ∇ unless client assets are maintained by an independent custodian (*i.e.*, a custodian that is not the adviser itself or a related person), to obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB).

There are a number of other important elements of the amended Rule worthy of consideration:

- ∇ **Account Statement Legends:** In addition to the current requirement that advisers notify their clients promptly upon opening a custodial account on their behalf, additional requirements are now imposed with regard to account statement legends:
 - Advisers that elect to send their own account statements to clients must include a legend in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser; and
 - Advisers that send their own account statements to clients, in any subsequent statements they deliver to clients after the initial notice, must urge clients to compare the adviser's statements with the account statements they receive from the custodian.
- ∇ **Reasonable Belief that Clients Receive Custodial Statements:** The amended Rule requires that an adviser's reasonable belief that the qualified custodian sends account statements directly to clients must be formed by the adviser after "due inquiry." The Rule amendment clarifies the SEC's expectations about due inquiry, which will likely impact most advisers' compliance testing protocol.

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Custody Rule Amendment (cont'd)

- ▽ **Internal Controls Required for Advisers Who Deduct Fees:** Advisers who are deemed to have custody solely because they deduct fees from client accounts, though not subject to a surprise examination, must implement policies, procedures, and controls to ensure that fee calculations and deductions are accurate. SEC release commentary offers suggested protocol.
- ▽ **Pooled Investment Vehicle Audit:** Certain advisers are deemed to have custody only insofar as their capacity as general partner of a limited partnership, managing member of a limited liability company or trustee of a trust gives them legal ownership of or access to client funds or securities. In this case, advisers must obtain an audit of the pool and deliver the audited financial statements to pool investors within 120 days of the pool's fiscal year-end. The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB.
- ▽ **Commission Reporting:** Rule amendments impose certain reporting requirements upon independent public accountants performing surprise examinations if material discrepancies are uncovered.
- ▽ **Custody by Adviser and Related Person:** When an adviser or its related person serves as a qualified custodian for advisory client funds or securities, the adviser must obtain, or receive from its related person, at least annually, a written report which includes an opinion from a PCAOB registered independent public accountant with respect to the adviser's or related person's controls relating to custody of client assets. Specific reporting requirements apply with regard to such written reports.
- ▽ **Amendments to ADV Form Part 1A:** Registered advisers must report to the SEC more detailed information about their custody practices in their registration form, specifically items 7 and 9.

Clients are urged to go to the SEC website for a complete summary of the Custody Rule amendment and release commentary: <http://sec.gov/rules/final/2009/ia-2968.pdf>

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Red Flags Rule

The Red Flags Rule (FTC 16 CFR 681), an amendment to the Fair and Accurate Credit Transactions Act of 2003, is effective June 1, 2010. The Rule attempts to close the loop on identity theft by making it harder for criminals to use a stolen identity.

The Red Flags Rule requires financial institutions and creditors maintaining “transaction accounts” to take a risk-based view of operations and identify where and how a thief could be using someone else’s identity to steal from the institution. The Rule requires firms to identify the full range of indicators that might represent a tip off to possible identity theft, implement appropriate predictive and detective controls, and react appropriately according to the level of risk identified.

Here are some highlights of the Rule:

- ∇ Creditors are defined as any business that allows a customer to defer payment;
- ∇ Transaction account is defined as an account for household/personal use that permits third party payments by check, wire, etc.;
- ∇ Each organization is responsible for generating its own list of Red Flags, and subsequently designing a program to identify and mitigate associated identity theft risks;
- ∇ Policy may be incorporated into Anti-Money Laundering and Customer Identification Program policies and procedures;
- ∇ Program must be regularly reviewed and approved by the Board of Directors;
- ∇ Personnel must receive adequate training;
- ∇ See also Massachusetts Office of Consumer Affairs and Business Regulation which requires a comprehensive “personal information protection program.”

The first step for CCOs is to ascertain the relevance of this Rule to the enterprise business model. Start by asking a few questions: (a) Has your institution been victimized by identity fraud in the past? (b) What types of identity fraud is your institution vulnerable to? (c) What types of controls are necessary to achieve compliance? (d) What are the costs of compliance? (e) What are the costs and risks associated with non-compliance? (f) What reasonable steps can be taken to minimize the threat of identity theft and ensure compliance with the Red Flags Rule?

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Privacy – New Model Notice

Eight federal regulatory agencies, including the SEC, have published final amendments to their rules that implement the privacy provisions of Subtitle A of Title V of the Gramm-Leach-Bliley Act (“GLB Act”) which require financial institutions to provide initial and annual privacy notices to their customers. Pursuant to Section 728 of the Financial Services Regulatory Relief Act of 2006, the regulators have adopted a model privacy form that financial institutions may rely on as a safe harbor to provide disclosures under the rules. The intent of the amendments is to make it easier for consumers to understand how financial institutions collect and share information about them.

The full release of the amendment can be found by accessing the following link:
http://www.ftc.gov/privacy/privacyinitiatives/PrivacyModelForm_Rule.pdf

For a copy of the Model Privacy Notice Form with Opt Out, go to the following link:
<http://ftc.gov/privacy/privacyinitiatives/PrivacyModelForm.pdf>

For a copy of the Model Privacy Form – No Opt Out, go to the following link:
http://ftc.gov/privacy/privacyinitiatives/PrivacyModelForm_NoOptOut.pdf

Compliance Policy Considerations

In light of recent developments on the regulatory front, regulated entities are strongly encouraged to review compliance programs with a view toward adding new or revised policies, procedures, and internal controls in the following areas:

∇ **Red Flags – Deter Identify Theft**

- Ascertain relevance of new rule to your business
- Identify Red Flags in your business
- Develop and communicate internal controls which mitigate the risks

∇ **Political Contributions**

- Political contributions are coming under more regulatory scrutiny
- Pay to Play rule proposal initiated in 2009
- Some form of regulation is anticipated sometime in 2010
- CCOs should initiate an analysis of how the enterprise and its employees may impact the business through political contributions and formulate preliminary policies and procedures to match the risks

∇ **Risk Assessment Process**

- Fully develop an enterprise business and compliance risk assessment process
- Formalize the process through written policies, procedures and controls

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Compliance Policy Considerations (cont'd)

▽ Regulation S-AM Affiliate Marketing

- Ascertain relevance of new rule to your business
- Collaborate with affiliates, as necessary, to develop policies
- Communicate new policies and requirements to all involved in marketing

▽ Social media

- Identify various methods of social media utilized by the enterprise and its employees
- Develop policies and controls which reasonably mitigate the risk of misuse of social media
- Communicate new policies and requirements to all covered personnel
- For guidance, see FINRA Regulatory Notice 10-06 issued in January, 2010 (<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120779.pdf>)

▽ Contingency Plan Test

- The February winter weather event no doubt stretched the resources of many financial service firms
- Many firms initiated their contingency plans to ensure continuous client service
- Use this weather event to document this test of your Contingency Plan, to at least partially satisfy regulatory requirements to test the plan each year
- Make amendments as necessary based on lessons learned from the event

▽ Custody

- Ascertain relevance of new rule amendments to your business
- In particular, establish the following:
 - Does my firm or an affiliate maintain custody over client assets?
 - Does my firm deliver customer statements to clients?
 - Does my firm deduct fees directly from client accounts?
 - Is my firm a general partner to a pooled investment?
 - Do any of our employees serve as the executor, conservator or trustee for an estate, conservatorship or personal trust?

▽ Privacy

- Review the model privacy notices for potential use
- Draft the new notice for your business
- Ensure that all personnel are familiar with the notice changes and use only the revised documents accordingly

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