



## Legal Risk Management Tip October 2008

### **LORI RICHARDS KEYNOTE ADDRESS – WHAT TO DO AS COMPLIANCE PROFESSIONALS**

On October 21, 2008, Lori Richards, Director of the Office of Compliance Inspections and Examinations (“OCIE”) of the Securities and Exchange Commission (“SEC”) was the keynote speaker at the National Society of Compliance Professionals’ (“NSCP”) National Meeting. The theme of this year’s address focused on risk management and the role of a compliance professional particularly during this market environment.

Compliance professionals have long understood the importance of their role: to educate, guide and insist on adherence to the securities laws. The compliance function is essential and must be adequately resourced. As Ms. Richards stated, to cut legal, compliance and IT resources is short-sighted and ill-advised.<sup>1</sup>

Emphasizing the need to enhance compliance efforts, Ms. Richards provided the following guidance.

#### **Top 10 List - What To Do as a Compliance Professional**

1. Remind employees of fiduciary obligations (for investment advisory firms) and just, fair and equitable rules of trade (for broker-dealer firms).
2. Pay attention to compliance obligations and be mindful of the underlying tenets of the securities laws to tell the truth and treat investors fairly and honestly, always putting their interests first.
3. Provide full disclosures to investors. Describe investment risks fully. Check Form ADV, marketing materials, prospectuses and any other disclosure documents for adequacy of representations made to investors, with particular focus on how the firm represents its participation in money market funds, SIPC coverage and performance numbers. Ms. Richards reminded advisers that the Form ADV is the “constitution of the firm” and must match the business’ model.
4. Consider the following areas within your compliance program (which are current SEC examination focuses).
  - a. *Portfolio Management* – monitor trading patterns. Detect if trading is occurring more aggressively and whether the portfolio manager is trying to catch-up on performance fees or whether there is non-compliance with investment guidelines.
  - b. *Financial Controls* – for broker-dealers, look at net-cap requirements and internal controls for monitoring funds in and out of client accounts.

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<sup>1</sup> Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm’n, Keynote Address at the National Society of Compliance Professionals National Meeting: Compliance Through Crisis—Focus Areas for SEC Examiners and Compliance Professionals (Oct. 21, 2008) available at <http://www.sec.gov/news/speech/2008/spch102108lar.htm>.

- c. *Valuation* – test to make sure the firm has strong policies and procedures for valuation processes, particularly for illiquid and difficult to price securities. Consider the firm’s ability to price and do an analysis as to its reasonableness. Be alert to “accommodation quotes” that do not reflect the price at which the security could be sold. Verify quotes with pricing services and determine whether pricing is based on a model or the broker’s willingness to transact the security at a certain price. [Risk Management Tip: Regularly go back and check the price against the market’s fair value and follow-up on any detected gaps.]
  - d. *Sale of Structured Products* – look at lower-risk investment products and review for marketing accuracy and disclosures pertaining to liquidity and safety. Conversely, consider the sale and marketing of high risk, aggressive products and consider the suitability of such products for your investors.
  - e. *Controls at Acquired Firms* – consider the existing controls of the acquired firm and ensure that processes do not fall through the cracks.
5. During times of financial strain, look at your employees for indications of fraud and financial distress by using a system of compliance checks and balances. Consider theft, loss or misuse abuses. Review prime brokerage arrangements and use of a qualified custodian. Check that customer account numbers are protected.
  6. Be sure that the investments being offered or recommended are suitable for the investor. The SEC will continue to focus on sales to seniors, variable annuity sales, niche ETFs, 1330 funds and structured products.
  7. Protect insider information. Identify the firm’s sources of insider information, analyze the strength of established Chinese Walls and test the adequacy of the firm’s policies and procedures.
  8. Survey for and investigate undisclosed payments. Look at revenue-sharing arrangements, fund networking arrangements and other collected fees to see whether or not they have been disclosed to investors. Check with accounting to see if there have been any fictitious bill entries or kick-backs to third-party service providers.
  9. Review the adequacy of your Anti-Money Laundering Program. Consider whether the fund’s or broker-dealer’s policies and procedures are strong enough to detect and deter money laundering. See if there are regular tests which are conducted to determine effectiveness and if practices match the firm’s policies and procedures.
  10. Regardless of the firm type, corporate governance is essential. For broker-dealers, look at supervisory practices at the largest branch offices. Test supervisory policies and procedures to determine whether the branch audit system is effective, particularly in detecting unsuitable trades. For advisers, consider the controls over traders, and particularly their involvement in the valuation process. Also, look for abuses in investment guideline violations. For investment companies, think about whether the mutual fund’s board of directors has implemented valuation policies and procedures and if the firm has an adequate disciplinary process. Consider abuses in transferring accounts.

Ms. Richards reminded industry compliance professionals of their role – to assure investor protection and the integrity of the marketplace. At this time, it is imperative to remind CEO’s of the firm’s obligations to investors and the adage that good compliance is good business.

For more information on this report, please visit <http://www.sec.gov/news/speech.shtml#staff> or contact us at (619) 298-2880.

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