CORE COMPLIANCE & LEGAL SERVICES, INC.
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Risk Management Update
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RISK – WHAT IT MEANS TO COMPLIANCE OFFICERS TODAY

The term risk has been popping up everywhere in the financial world - and not just in reference to investment risk. We've been hearing these terms over and over again but what do they really mean from a regulatory context? Some of the more common references are:

- Risk Assessment
- Risk Matrix
- Enterprise Risk Management
- Risk Management
- Investment Risk
- Risk-Based Assessments

In this month's CCLS Risk Management Update, we will explore these subject matters and discuss how each of these areas may impact compliance officers today.

A **Risk Assessment** is the evaluation of risks involved in a given situation, measured against certain standards, with a determination of an acceptable level of risk. In many situations, this involves an evaluation of the magnitude of potential loss, and the probability that the loss will occur. The methodology used for the assessment of risk generally differs from firm to firm.

For compliance officers, risk assessments generally are used to gauge the levels of risk associated with the compliance program established for the firm. A **Risk Matrix** may be used to memorialize such findings, and often serves as an effective reference to supplement discussions with senior management about potential risks identified. Each firm should tailor its risk matrix to the organization's business practices, and utilize it to describe the severity of each identified risk and the actions required to mitigate or eliminate such risk.

Enterprise Risk Management ("ERM") is the process effected by senior management to assess the firm's risk tolerance in achieving a set of objectives. Importantly, ERM provides a framework for identifying particular events or circumstances relevant to the organization's risks and opportunities, which allows the firm to determine a response strategy. By identifying and proactively addressing risks and opportunities, business enterprises protect and create value for their stakeholders, including owners, employees, customers, regulators, and society overall. ERM risks can include market risk, operational risk, strategic risk, reputational risk, liquidity risk and credit risk, among others.

Generally, compliance officers have a role in the overall ERM framework. In larger organizations, the Chief Compliance Officer ("CCO") does not typically have overall responsibility for ERM unless he or she also holds the position of Chief Risk Officer. For smaller organizations, the CCO may be asked to assist in ERM assessments due to resource considerations. Regardless of firm size, when ERM is discussed with senior management, the CCO should have a seat at the table to provide insights on compliance risks and to become aware of the current risk appetite and focuses for the organization.

Risk Management is the process by which firms *reduce* the occurrence of loss while *maximizing* its ability to capitalize upon opportunity. Good risk management is not about eliminating risk, but rather, about understanding it and addressing it proactively. Since rregulators and debt rating agencies have increased their scrutiny on the **risk management** processes of companies, compliance officers are often tasked with aligning the compliance program with the firm's risk management program. Through the use of internal controls and exception reports, compliance is able to identify, measure, assess, mitigate and monitor systemic risks throughout the organization.

Investment Risk is a way for investors to measure and manage risk before making investment decisions. These risks can include credit risk, liquidity risk, market risk, foreign risk and currency risk. For compliance officers, it is important for them to oversee that the client disclosure documents provided by the firm clearly define investment risks for existing and prospective clients and to confirm that supervisory controls are in place for ensuring that investment recommendations are aligned with client investment risk tolerances.

Risk-Based Assessments are an approach used to prioritize and analyze the probability and consequences of a given risk. This often entails:

- Defining the risks the firm is prepared to take;
- Identifying the risks to capital, reputation, earnings, strategy, and activities which can give rise to those risks, including credit risk, market risk, operational risk, and compliance risk;
- Compiling and designing methods of measuring those risks (which includes use of technology tools);
- Establishing internal controls to manage those risks; and
- Assigning responsibility to managers for managing risks, which includes keeping risks within previously agreed to levels, and monitoring the overall risk identification, measurement and control effectiveness.

Compliance officers may be asked to help develop internal controls for the enterprise to mitigate and monitor risks through policies and procedures, audit trails, internal desk manuals and supervisory programs. For compliance risks, compliance officers may assess risks by:

- Inventorying compliance obligations under securities laws and pursuant to disclosures provided to clients;
- Identifying areas of conflicts of interest and assessing how clients could be harmed;
- Matching existing compliance practices to the firm's inventory of obligations and conflicts to find potential gaps;
- Assessing the effectiveness of existing compliance functions to determine if they are effectively designed to prevent violations from occurring; and
- Ascertaining whether additional compliance procedures are warranted based on changes to the firm's business model, risk-based assessment or new regulatory requirements.

Conclusion

It is imperative for firms to implement their own risk procedures in order to proactively assess those areas within the organization that pose the highest degrees of risk. Once risks are identified, they need to be assigned a level (*e.g.,* high, medium or and low) which may help to prioritize potential focus areas for the firm. After the assessment is complete, this information should be promptly reported to senior management, who will weigh whether the identified risks may negatively impact the firm and/or its clients. Once this is determined, the assessments should be documented, with actions noted as to the steps taken to mitigate or eliminate future risks.

For compliance officers, take heed that there are risks associated with most business activities. Through effective monitoring and internal control implementation, these risks can be controlled, with outliers escalated to management quickly. For more information and ways to develop an effective compliance risk management program, please contact Core Compliance & Legal Services, Inc. at (619) 278-0020 or at info@corecls.com. Thank you.

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