



## Risk Management Update November 2010

### **REGULATORY UPDATES: RECENT SPEECHES FROM THE SEC'S OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS AND FINRA**

2010 marks an unprecedented year for the world of compliance. Before the passage of the Dodd-Frank Act,<sup>1</sup> investors were demanding transparency and increased compliance controls. Regulatory examinations increased and the number of firms going to enforcement surged. In response, advisory firms implemented and enhanced efforts of risk management committees, which in many cases resulted in increased compliance staff or outsourcing to law firms or consultants. With over 100 new regulations being promulgated as a result of Dodd-Frank, firms are grasping for solutions on how to best stay on-top of these new regulations in a cost-efficient manner.

Over the last month, members of the Core Compliance & Legal Services, Inc. ("CCLS") team had an opportunity to participate in several fall compliance conferences which highlighted considerations for developing a robust compliance program in the wake of financial reform. Below are highlights from some of these events, which focuses on speeches provided by the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") and Financial Industry Regulatory Authority ("FINRA").

#### *Highlights from Speeches by Carlo Di Florio, Director of OCIE*

A former partner in Price Waterhouse Cooper's Financial Services Regulatory Practices Division, Mr. Di Florio joined the SEC as Director of OCIE in January 2010. In this capacity, Mr. Di Florio is responsible for overseeing the SEC's nationwide examination programs for investment advisers, broker-dealers, mutual funds, credit rating agencies and self-regulatory organizations, among others.<sup>2</sup>

Recent speeches by DiFlorio underscore many of the SEC's targeted areas during this "critical time of financial regulatory reform."<sup>3</sup> Notably, DiFlorio's speeches have focused on the implications of the Dodd-Frank Act, critical developments at the commission, the new Form ADV Part 2, regulation of derivatives and swaps, and new clearing agency responsibilities pertaining to risk management for member firms.

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<sup>1</sup> See: <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.

<sup>2</sup> See <http://www.sec.gov/news/press/2010/2010-1.htm>.

<sup>3</sup> *Id.*

The SEC has brought in new leadership to help tackle these problems. The new leadership has been tasked with identifying systemic risks and understanding those risks as applied to various business models and the marketplace. The Division of Enforcement is deploying attorneys in five areas, including investment management, market abuse, municipal securities, foreign corrupt practices and structured/new products. Rulemaking is focusing on investor protection, and concentrating on the areas of money market funds, credit rating agencies, say on play, pay to play, derivative and swap rules and asset back securities, among others.

Notably, OCIE is in the process of launching a *national examinations program*; no longer will examinations be from a regional perspective. This strategically risk-based program is engineered to concentrate on analyzing data, which may help to make the examination process more efficient and hone in on the highest risk issues of a firm. Areas of focus will include:

- The structure of a firm's management team and whether or not they are engaged;
- The interaction of the board, internal auditors and external consultants with compliance and senior management;
- Competency of the Chief Compliance Officer; and
- Communications between senior management, finance and compliance.

Those areas that continue to be examined include:

- Valuation: Examiners are looking at firms' policies and procedures to understand the overall valuation process, focusing on incentives to overvalue (*i.e.*, markups) and verification from external auditors;
- Conflicts of Interest: Underscored areas include best execution, favoritism of accounts (*e.g.*, side letters) on trading and expenses, best execution and due diligence;
- Portfolio management: Review of a firm's adherence to client-specific investment strategies and restrictions as well as trade allocations<sup>4</sup>;
- Performance Advertising and Calculation: Examiners are looking at what is driving performance and ensuring accuracy of calculations; and
- Asset verification and custody: Examination focus is on audit reports and the processes used for verification of accuracy up to the custodial and clearing firm level. Specifically, examiners will review firms' policies and procedures, account reconciliations and client complaints to evaluate consistency in application.

### ***State Adviser Examination Priorities***

At various industry conferences, representatives from NASAA have spoken to recent examination focuses effecting State Registrations. These areas include, but are not limited to:

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<sup>4</sup> *See In Matter of Value Line, Inc*

- Inconsistent Disclosures in Forms ADV Part 1 and II;
- Books and records that do not reflect suitability, contracts with clients;
- Regulation S-P violations; and
- Unsupported performance data

### ***B-D Regulatory Examination Priorities***

For the broker-dealer space, the OCIE Chief Counsel as well as the Senior Vice President of the Financial Industry Regulatory Agency, (“FINRA”) spoke on the SEC’s key issues of concern for B-D’s, including: the impact of the May 6, 2010 “flash-crash”, market structure concerns and exam developments.

The “flash-crash” raised many questions within the securities industry regarding liquidity of instruments. In order to mitigate and limit the occurrence of a similar “crash”, the SEC has proposed and implemented tracking devices, or “circuit breakers”, designed to prevent similar events from happening and with the hope of fostering market stability.

As addressed by the SEC panelists, the top B-D examination priorities continue to be supervision of sales, trading practices and protection of customer assets and information. Importantly, the panelists stressed the need for broker-dealers to implement and maintain viable written supervisory procedures which cover these noted areas of concern.

The panelist from FINRA also discussed B-D hot topics and FINRA’s examination priorities, focusing more on the areas of structured products, anti-money laundering, high yield and junk bonds, social networking, fraud and responsibilities of chief compliance officers.

As 2010 comes to a close with many new financial regulations in the books, 2011 promises to bring many more proposed rules to fruition. Both the SEC and State regulatory bodies have stated additional guidance will be forthcoming by the close of the year. CCLS in turn will maintain it’s commitment to staying ahead of the curve with regard compliance needs, thus providing needed guidance for firms in the year to come. For more information, please contact us at (619) 278-0020.

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