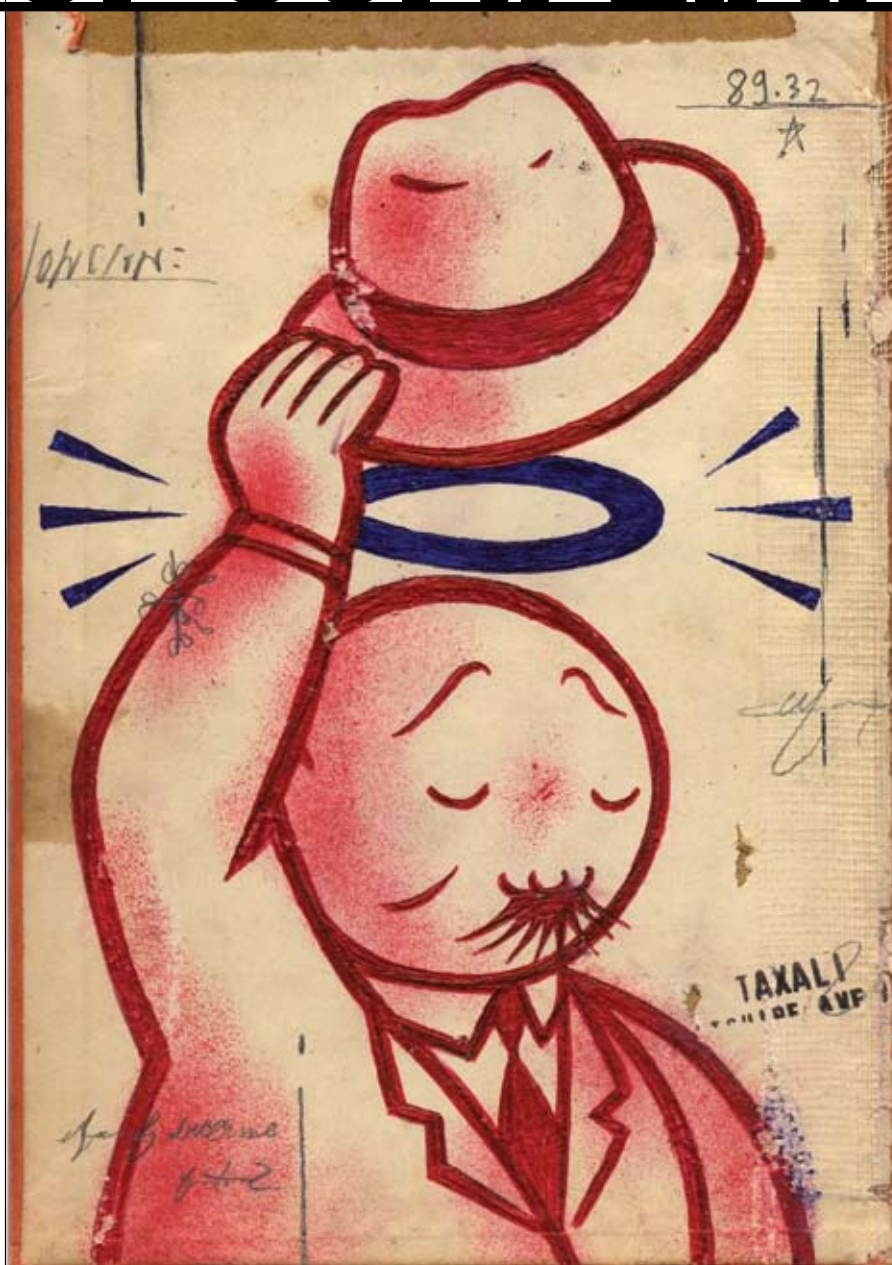


In their own words, SEC staffers reveal what's really important.

# THE CULTURE OF COMPLIANCE

By James Eccleston



**IT HASN'T TAKEN LONG FOR THE TERM "CULTURE OF COMPLIANCE"** to capture the hearts and minds of the securities regulators in this country. Born of high-profile enforcement actions such as the Enron and WorldCom accounting frauds, research analyst conflict-of-interest cases, the mutual fund late trading and market timing scandals, as well as the failure to provide "breakpoint" sales discounts, the term certainly has more panache than buzzwords like "compliance and ethics," "corrective action" and "proactive initiatives." The question is: Will the phrase ring hollow?

Not if the SEC can help it. In a series of speeches by SEC staff—most notably Lori A. Richards, director of the SEC's Office of Compliance Inspections and Examinations, and Mary Ann Gadziala, associate director of that office—the SEC has clearly been seeking to define the contours of this "culture of compliance" by providing detailed guidance to firms. Financial advisors will find it well worth the time to examine the messages Gadziala and Richards delivered to compliance audiences in recent speeches.

Gadziala, for example, pointed out that "the most important aspect of compliance at a firm is not simply how elaborate its system may be or how voluminous its written policies may be." Nor is the culture of compliance a "short-term fix to satisfy SRO rules or SEC deficiency letters following an examination." Rather, it is much more: "an overall environment that fosters ethical behavior and sensitivities to compliance with the law in all decision-making." As such,

Gadziala said, examiners will expect an “effective compliance culture” to include:

- Identification and control of compliance risks
- Implementation of effective compliance and supervisory systems
- Well resourced and effective compliance function
- Proactive compliance participation in, and oversight of, business supervisory activities
- Effective reporting and resolution of significant compliance issues, and
- Training and monitoring of employees in the performance of their duties

#### IDENTIFYING AND CONTROLLING RISKS

Gadziala made three important points about identifying and controlling compliance risks. First, while the SEC is focused on securities laws, rules and regulations, firms nonetheless must assess risk as it may arise in all other areas, such as employment and tax. And citing

Enron, they must be alert not to aid and abet violations of the law by their customers. Second, the “greater the compliance risk, the more the firm should focus on compliance in that area.” Third, once identified, the risk must be controlled, and any control gaps must be addressed and resolved. The SEC views this identification and control process as “dynamic” because it must respond constantly to changes in the law and activities at the firm.

#### COMPLIANCE PROGRAMS

While noting that there can be no “standardized” compliance program, Gadziala listed several “core” compliance functions that firms must cover:

- Identifying, measuring and assessing compliance risks
- Managing compliance risks, addressing compliance concerns, and validating corrective plans
- Working with top business management to

report on and maintain compliance

- Acting as liaison to regulators and other compliance officials
- Complying with requirements of specific statutory compliance program mandates
- Establishing and implementing compliance policies and procedures, standards and controls
- Overseeing complete and current written supervisory procedures, timely disseminating them to employees, and monitoring, surveilling, and overseeing business supervisory activities
- Detecting, preventing and managing conflicts of interests
- Training and education of firm employees, and
- Overseeing employee-related matters such as registration, licenses, regulatory filings and employee trading

Critically, to be effective, compliance functions must be “independent” from the busi-

# Create Customized Investment Policy Statements

## An On-line Application for the Professional Wealth Manager

### Be More Productive

- ▶ Provided templates can be used as is for a quick start-up, or easily changed to reflect your own style and practice.
- ▶ System centers around eight client types—different questionnaires and templates to readily serve every client circumstance.

### Be More Professional

- ▶ Make use of leading edge documents and systems.
- ▶ Attractive and professionally designed questionnaires and IPS documents.

- ▶ More consistent and thorough than a Word document.

### Be More Profitable

- ▶ Once you’ve modified the system to reflect your own practice, a “best in breed” IPS can be created by you or your staff in just minutes.
- ▶ Use of an IPS as a central part of your investment process raises clients’ trust, leading to more referrals and bigger clients.

**IPS AdvisorPro™** —  
the NEXT GENERATION in IPS creation.

*“IPS AdvisorPro™ gives me more capabilities and better document consistency.”*

*“As the Compliance Officer, IPS AdvisorPro™ offers me document control and better supervision tools.”*

*“IPS AdvisorPro™ forced me to think about my investment process... Now our IPS is truly unique.”*



From the authors of:  
**Creating an Investment Policy Statement: Guidelines & Templates**

# IPS Advisor Pro™

[www.IPSAdvisorPro.com](http://www.IPSAdvisorPro.com) ◀ LEARN MORE & VIEW THE VIDEO TOUR!

nesses of the firm. Independence covers not only reporting lines, but also: resolution of compliance concerns; compensation, bonuses and performance ratings for compliance personnel; and adequate resources, automated systems and experience

Gadziala also gave examples of the subject areas that may be included in an effective compliance program:

- Regulatory capital compliance and financial responsibility
- Suitability, switching between products, churning, fee-based accounts, margin, short-sales, unauthorized trading, parking, late allocations and misappropriation
- Trade errors and corrections
- Best execution
- Market manipulation and insider trading
- Protection of confidential customer information, privacy issues and data security
- Books and records
- Commissions, gifts or entertainment
- Information barriers and employee trading
- Business conduct rules and ethics
- Branch office reviews
- Customer complaint, client marketing, advertising and communications
- Transfer of funds and customer address changes, and
- Anti-money laundering compliance

Firms should customize this list and add any other subject matter that would be relevant to their particular business operations.

Furthermore, while senior management must be able to delegate “substantial responsibility,” Gadziala emphasized that such delegation must be “specific, in writing and clearly identify the person or persons with authority and responsibility for the function.”

#### **SUPERVISORY FUNCTION**

Perhaps the most notable feature of Gadziala’s comments is the reminder to firms that the compliance function and the supervisory function have different purposes.

“As an independent area, the compliance function is designed to perform broad-based reviews, absent conflicts that may arise from compensation or other connections to the underlying activity. The supervisory function, on the other hand, is typically business-oriented and is responsible for

day-to-day real time review of transactions and activities with the direct knowledge of the employee’s activities,” she said

#### **EMPLOYEE SUPERVISION**

This is a broad area of compliance, and according to Gadziala, aspects of it include:

- Appropriate background checks
- Monitoring registration
- Ensuring implementation of an appropriate program of heightened supervision of problem employees
- Producing written compliance for employees and assisting in creating a code of ethics
- Implementing employee training and
- Conducting employee trading reviews

CRITICALLY, TO BE EFFECTIVE, COMPLIANCE FUNCTIONS MUST BE ‘INDEPENDENT’ FROM THE BUSINESSES OF THE FIRM.

Firms also should be aware that the duty to supervise extends not only to registered employees, but also to non-registered employees who “may perform functions critical to the firm’s business or otherwise create compliance risks.”

#### **ISSUES UNDER CURRENT EXAMINATION**

The SEC’s Lori Richards recently addressed many of the same points speaking on the “process of compliance.” Additionally, the Office of Compliance and Examinations director provided insights into some of the areas on which the SEC has focused its examinations of broker/dealers. Some areas apply equally to investment advisors. In her own words these are:

■ **Insider trading and front-running:** “Whether you’re with an adviser, a broker/dealer, a hedge fund, a clearing agency or a transfer agent, include this area in your risk assessment, and in your investigation and monitoring efforts.”

■ **What are you using your clients’ money for?** “Given all of the ‘secret payments’ cases that we’ve seen, it would make sense for you to look at fund expenses and the use of advi-

sory clients’ monies, and be sure that they are appropriate, and that the money is used as intended and disclosed.” “Also,” she continued, “be particularly alert to payments to affiliates and those that may be intended to increase assets under management under the guise of something else”

■ **Seniors:** “If your firm does business with seniors, be certain that you’re doing so in a way that complies with applicable fiduciary and ethical principles—as well as suitability and disclosure standards—in recognition of their age, objectives, capacity and needs

■ **Supervision:** Examiners are very focused on whether firms of all stripes are ade-

quately supervising employees,” Richards warned,—particularly in branch offices, on trading desks, with respect to big producers, solicitors, and others.”

■ **Trading issues:** She identified as hot topics Best execution in debt and equity securities, payments for order flow, soft dollars and use of [directed] brokerage, Reg SHO (regarding short selling), and mark-ups.”

■ **Controls to prevent theft and misrepresentation:** “This includes issues such as controls over the creation and sending of account statements, and account and position valuations—and includes theft or misuse of customer information by identity thieves.”

■ **Anti Money Laundering:** Here Richards left no doubt: “We are very interested in your AML compliance programs,” she said.

Clearly, the SEC is determined to breathe meaning into the term “culture of compliance” and expects that it will be embraced by all.

**JAMES ECCLESTON** is a partner in the Chicago law firm Shaheen, Novoselsky, Staat, Filipowski & Eccleston. He also hosts [www.financialcounsel.com](http://www.financialcounsel.com).