

# NSCP CURRENTS

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## The World of Compliance of 2008 is Dead: John Walsh's Remarks at the 2009 NSCP National Meeting

by John H. Walsh

*The following is a transcript of the Keynote Address delivered at the 22nd annual National Membership Meeting of the National Society of Compliance Professionals.*

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Good morning. It is a pleasure to be here. The views I am about to express are my own, and not necessarily those of the Commission, the Commissioners, or my colleagues on the staff. I have attended the NSCP National Meeting for many years. Over those years I have watched it grow from a relatively small gathering to the huge group we see here today. In fact, I am told that you moved the meeting to Philadelphia because none of the hotels in Washington, D.C., have a hall big enough to hold you. That speaks volumes about the work of NSCP, the energy of Joan Hinchman, and the dedication of the compliance professionals here today. I am very proud to be part of this gathering.

More than once over the years, in

preparation for this annual meeting, I have reflected back on where we had been in the last year and where we were going in the next. What happened? What lessons have we learned? How would compliance change in the coming year? As I stand here today, I can tell you, over the last year, we have seen events, learned lessons, and now foresee looming changes in compliance, on an order beyond anything in my prior experience.

We need not review the events of the last year. We all lived through them. I am certain the memory remains fresh. Indeed, some of the events, such as those associated with money market funds or fraudulent schemes, will be remembered for a very, very long time. Future students will study them in textbooks and discuss them in seminars. I have seen this in my own family. I have a daughter in college and a son in high school, and they have asked me, in recent months, as they prepared for some class or other, why is it bad to "break-a-buck?" Or, who was this terrible "Mr. Ponzi?" Some day, perhaps, amnesia may set in. But if it does, it will be our job, compliance's job, to remember, and to remind the forgetful.

Instead of reviewing recent events, let us focus on the lessons to be learned from them. At the threshold, the most important lesson, and the most fundamental, is that compliance has changed forever. To put it bluntly, the

world of compliance of 2008 is dead. It is ancient history. We cannot go back. Moreover, based on the events of the last year, why would anyone want to go back?

As you know, I practice compliance in the public sector, with the Commission's examination program. I can assure you, the examination program is changing, and it will continue to change. We have watched with interest as our colleagues in the Division of Enforcement, under the leadership of a new Director, have gone through a top-to-bottom self-assessment, and have embarked on a massive rethinking and restructuring of their program. When Chairman Schapiro appoints a permanent Director for the Office of Compliance Inspections and Examinations ("OCIE") – I serve as Acting Director – we anticipate conducting a similar review for the examination program. We look forward to this review.

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**JOHN WALSH***(Continued from page 1)*

In the meanwhile, we have been laying the groundwork for this coming review by thinking vigorously and skeptically about our program and identifying areas where immediate improvement is possible. To help us we have the benefit of a very detailed report by our Inspector General on the problems we encountered in certain past examinations. Based on what the Inspector General saw in those examinations he has provided us with a number of recommendations that will enhance our program, and we are moving forward to implement them. We have also engaged in extensive self evaluation. Different teams in headquarters and regional offices have participated in focus groups or roundtable-type discussions and considered how we need to change.

Finally, as Acting Director I have asked individuals to serve as national leads – as national change agents – on designated issues. I have tapped line-managers from headquarters and the regional offices. In some cases they are working full time studying, questioning, formulating ideas, and vetting proposed changes. I have also given them deadlines. By a date certain, the analysis must be completed, the decisions made, and the change agent must be ready to train examiners on the new methods they will follow in the specific designated area.

Today, I would like to discuss five specific areas where the examination program is changing, based on the lessons we have learned. These are not simple check-the-box kinds of changes. Rather, they will fundamentally alter how we operate. All are works-in-progress.

First lesson: we need more expertise. This is one of the most important lessons we have learned. Examiners must have sufficient expertise to keep up with the businesses they oversee. How have we been addressing this?

Sweep examinations will play an important role. In a sweep review we build a special team, reach out around

the agency for the expertise we need, prepare a customized plan, circulate our plan through the other offices and divisions within the Commission, consult with the Commission itself, perform a series of examinations with the same team (thus providing the team with a defined learning process), and then report back inside the agency. We have found this type of ad hoc targeted expertise to be very effective. We expect to deploy it in support of other SEC offices' and divisions' initiatives to enhance their own specialization.

We have also created a new type of examiner position called a "Senior Specialized Examiner." Currently, we have only a small number of these positions available, but we anticipate leveraging their expertise around the program. These are individuals with significant expertise trading options, running an equity-trading desk, or rating the credit-worthiness of asset backed securities, and so on. Finally, we are enhancing our training: with targeted internal programs, collaboration with other regulators, and more extensive use of external certification programs. For example, more than a third of all examiners are currently studying for the Certified Fraud Examiner credential. We are also considering other certification programs.

How will you see these changes? Let me give you an example. During an examination the team leader tells you: "As you know, tomorrow we will interview your trading desk. We will be joined by a colleague from Washington – or New York – who will lead the interviews." That colleague, when he or she arrives, will turn out to be a very experienced individual who once ran a trading desk much like yours. That is the kind of expertise we hope to acquire.

Second lesson: we need to organize ourselves to make sure the right expertise is deployed to each problem. This has been a particularly important lesson for OCIE. For historical reasons our program has been divided into two parts: one for broker-dealers and the other for investment advisers. This is a legacy of the program's origins in two different divisions, and has

been preserved for various reasons. Unfortunately, this legacy, and the poor communications it caused, played a role in certain failed examinations. How have we been addressing this?

This is an area where I have put a change agent to work. I have asked a highly regarded Assistant Director from a regional office to take the national lead on this topic. He has been working full time asking: how do we examine firms that are registered as both a broker-dealer and an investment adviser; how do we examine firms that have affiliates with another registration status; and most challenging of all, how do we examine firms that have only a single registration status, but are engaging in activities that require the deployment of expertise that is not possessed by the examination team? The change agent is interviewing staff, reviewing reports, and he will join certain examination teams to observe their collaboration in the field.

Chairman Schapiro has told us that she wants the agency to work with a new "Culture of Collaboration." I view this area, bringing expertise together from across the examination program, and from other offices and divisions, as a case study of her policy. Our ultimate goal is not just to get examiners to talk with each other, but to create and instill a Culture of Collaboration throughout our work.

In addition, in the meanwhile, we have been taking specific steps to enhance this collaborative approach. We are establishing periodic review procedures for all examinations, in which a primary agenda item will be whether the examination team needs help with additional expertise. We have conducted several cross-training programs, in which examiners and examination managers are learning about each other's areas of expertise. Finally, we are building ad hoc teams to address specific compliance issues that touch multiple areas of expertise. For example, we have formed a cross-disciplinary working group to review firms that use algorithms in their trading.

How will you see these changes? Let me give you an example. An

examination team gives you a request for records, and you discover that the team wants to see documents from several affiliates: broker-dealers, investment advisers, and perhaps other types of registrants as well. As you study the request you realize that the examiners are tracking transactions, or business relationships, or conflicts of interest, or compliance controls through the many sub-units of your organization. When they arrive on site, you realize that they are taking a holistic view of your organization and its business practices. That is the kind of silo-free oversight we hope to achieve.

Third lesson: we must reach out to third parties to verify what we have been told. The days when we could conduct verification on the premises of a single firm – looking at correspondence on letterhead, requesting manually signed documents, or downloading through a firm's computers – are behind us. Modern verification requires us to reach out directly to counterparties, custodians, and clients. How are we addressing this? In 2009 we established an aggressive program of third party verification. If you have been examined within the last several months, I am certain you have had first hand experience with this program. In particular, we have focused on third party verification of assets. To do this we have confirmed down, to the client, to learn what they think they have, and we have confirmed up, to the custodian, to find out what is really there.

We are currently reviewing our experiences, refining our procedures, and working to make sure we are contacting the right third parties to verify the right information. I have change agents at work in this area as well. We expect to complete our internal review and finalize our new procedures soon. I have emphasized within the examination program, and I will emphasize to you, that we must use third party verification routinely, and effectively, if we are to regain the trust and confidence of those we serve. How will you see these changes? You will see third party verification at work when we reach out to your counterparties,

custodians, or clients, to have a conversation about you. Sometimes it may only be a conference call. Of course, we will arrange the call by letter so the other parties will know it is really the SEC on the phone. Other times we may test a small sample of information – orders, trades, or assets. Yet other times we may engage in extensive testing designed to validate significant amount of information. This is the new reality. You should make sure that your counterparties, custodians, and clients understand that your regulator may want to talk with them.

Fourth lesson: we cannot allow examiners to be intimidated. I have been very disturbed to learn how law-breakers, people running serious frauds, tried to intimidate SEC examiners. The fraudsters claimed to have special influence, or special access, and they threatened examiners, screamed at them, and tried to direct or silence their inquiries.

How are we addressing this? We have established an internal Exam Hotline for examiners who believe they are being intimidated. Our goal is to make sure they can quickly reach senior officials in Washington, when necessary. The new internal Exam Hotline is set up exactly like the external Exam Hotline that has been available to the regulated community for some years.

I have also asked two senior Associate Directors to serve as national leads in developing a new culture of

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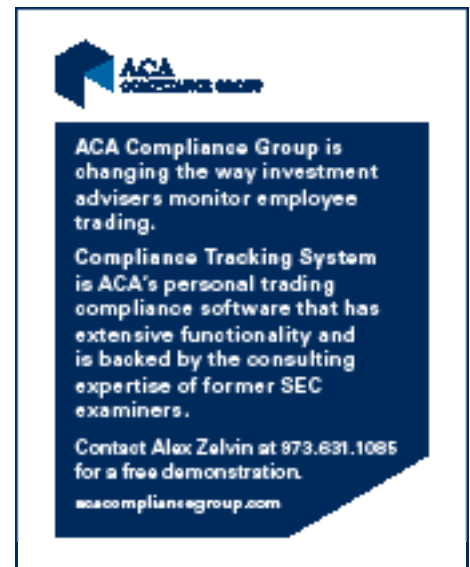
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support for examiners. We must make sure both that examiners have our support, and that they know they have our support. At the same time, the firms that we are examining should feel free to ask questions, or to speak with the examiners' supervisor, or even to call the external Exam Hotline, if they feel that is appropriate. We welcome questions, we welcome having a dialogue, including with supervisors, if you believe that is appropriate. But we will not tolerate threats.

How will you see this? Hopefully you will not. I hope no one here would ever tell an examiner you can get her fired, or that she should be careful, because you know her boss's boss. Indeed, most compliance professionals that I have spoken with about this issue have expressed shock and disbelief that anyone would attempt such a thing. I agree. In fact, this conduct is so unacceptable and abnormal that you can expect examiners to view it as a red flag suggesting that there are substantive problems at the firm. Trying to cover up violations with intimidation will not work.

Fifth lesson: we need to regularly review our policies and procedures to make sure we are keeping them current and up-to-date. This is something compliance professionals learned a while ago. Over the last few years, conducting Annual Compliance Reviews has become a settled element in the professional practice of compliance. I have always thought it was a great idea for you. Now I think it is a great idea for us. How are we addressing this?

We are embarking on an initiative to conduct Annual Reviews within the examination program. This was among the Inspector General's recommendations. We anticipate that we will review our policies and procedures, conduct forensic tests on how they are working, and otherwise consider whether our program is addressing the risks we have identified. I am certain this sounds very familiar to you all. In addition, as you may recall, when the Commission adopted the compliance

rules for funds and advisers, it gave you approximately two years to conduct your first annual review (counting the rule's delayed effectiveness and the time after effectiveness to conduct the review). Many compliance professionals told me that the extra time to get ready, the first time around, was very helpful. Not surprisingly, even though we will begin working on this immediately, we anticipate requiring the same length of time in-house.

How will you see this? Actually, you will see it very soon. We expect to post a new position in the examination program to take the lead in this effort. It will be posted as a Senior Specialized Examiner (one of the new senior positions I mentioned before), and also as a Senior Attorney (the double posting will permit both attorneys and nonattorneys to apply). We hope an experienced compliance professional who has conducted annual reviews of large and complex organizations will come to the SEC to help us conduct our own. I must admit, having spent a lot of time over the last few years observing your efforts in this regard, I am pleased to see this idea come full circle. Up to this point I have focused on how the examination program is changing. It is. But the events of the last year have had an impact on the practice of compliance everywhere. I hope all of you have been looking at recent events, and asking the same questions: What lessons can we learn? How do we need to change our programs in response? All of us need to reflect upon these questions. I would like to suggest that in your reflections, or perhaps in your Annual Review, you give some thought to the lessons we have learned, to ask if they might be applicable to you:

First, we all should enhance our expertise. Every compliance office should be asking: do we have enough expertise to keep up with the business side? For example, if you have a trading desk: Do the compliance professionals who work with the desk understand it? Can they test its activity to ensure that it complies with the firm's policies and procedures, or with a strategy's stated goals? If you use an algorithm to trade,

do you have anyone with the expertise to oversee it? These are questions for all of us.

Second, we all should break down the silos that divide us. Many compliance offices are divided into the same kinds of silos we have had in the examination program. The business side escaped its silos a long time ago. Have you kept up? We all need a Culture of Collaboration to make sure specialized groups are working together.

Third, we all should focus on obtaining verifiable and verified information. Do you, as a compliance professional, reach out to the third parties that do business with your firm: counterparties, custodians, and clients? Stated broadly: how can you trust the information you use in your compliance processes? We are asking the question of ourselves, and you can expect us to ask it of you.

Fourth, we all should protect compliance professionals from intimidation. Are there employees at your firm who use intimidation to attempt to escape compliance oversight? Do not let them get away with it. You may want to mention their names the next time you meet with the CEO, or the Independent Directors – or even – the next time you meet with me. As professionals, we cannot tolerate this.

Fifth, we all should focus on conducting top quality Annual Reviews. Here, you have a head start, since you have been doing them for several years. Let me just say that I am pleased to join those who practice – as well as preach – the benefits of an Annual Review.

This has been an extraordinary year. Compliance will never be the same. But if we learn our lessons, if we give compliance more expertise, if we develop a true Culture of Collaboration across different areas of specialization, if we make sure we have verifiable and verified data, if we protect compliance professionals from intimidation, and if we conduct effective annual reviews, we will all emerge wiser, and the practice of compliance will emerge better, from the experience.

Thank you.

# Enterprise-Wide Risk Management for Advisers and Brokers

*by Richard D. Marshall*

Risk management has become an important theme for advisers and brokers. The SEC's standard inspection request letter for advisers prominently features questions about risk assessments.<sup>1</sup> The CFA Institute has recently required its members to conduct risk assessments.<sup>2</sup> In 1999, the SEC, NASD, and NYSE issued a joint statement urging broker-dealers to conduct risk assessments.<sup>3</sup> Finally, in a recent speech, the head of FINRA reminded broker-dealers of the importance of conducting risk assessments.<sup>4</sup>

## What Is a Risk Assessment?

Although detailed guidance has been published about how to conduct a risk assessment, two key elements are critical to the process: issue spotting and resource allocation. Issue spotting involves the identification of all possible events that could pose risks. This process involves a creative and intensive review of a registrant's business to identify all possible events that could give rise to positive and negative events. The challenge in this exercise, of course, is identifying the unknown, unforeseen risks. The guidance set forth below may help with this process, but no method is perfect.

Resource allocation is the second basic step in any risk assessment and involves a two step process: assessing the probability that a risk will occur and then assessing the magnitude of the risk if it does occur. Thus, for example, a flu epidemic may be somewhat likely to occur but may not be viewed as likely to materially damage a business if it does occur. The process of assessing probability and magnitude permits a firm to allocate its resources so that appropriate resources are assigned to each risk. Risks that are viewed as unlikely to occur and unlikely to cause significant damage if they do

occur would receive less resources for their mitigation. In contrast, risks that are likely to occur and likely to cause significant damage to a firm if they do occur should receive far more resources devoted to their mitigation.

## SEC Guidance for Advisers on Conducting a Risk Assessment

The SEC has published a "Risk Inventory Guide" on its web site. [http://www.sec.gov/info/cco/red\\_flag\\_legend\\_2007.pdf](http://www.sec.gov/info/cco/red_flag_legend_2007.pdf) The Guide lists twelve categories of risks for an investment adviser. According to the SEC, "[a]s a CCO responsible for your firm's compliance, you should determine what risks are present and how they might affect your firm and its operations, assess whether the controls in place to manage or mitigate these risks are adequate, and make or recommend modifications to the compliance policies and procedures as necessary." The twelve categories of risk are set forth below:

### a. **Marketing/Performance:**

- Inaccurate performance calculations
- Overstated performance
- Guarantees of profit
- Unsubstantiated claims
- Misrepresentation of services offered
- Use of unapproved marketing materials
- Misrepresentation about advisory firm and principals.

### b. **Form ADV/Disclosures:**

- Failure to provide Form ADV
- Inaccurate, omitted, or unclear disclosures
- Out of date disclosures
- Misrepresentation of services offered
- Failure to disclose potential conflicts of interest
- Inaccurate account statements
- Overstating account value

### c. **Invoices/Fees:**

- Non-"research" products obtained without disclosure
- Incorrect fee calculation
- Use of inflated asset values
- Direct debit of fees from custodial account
- Prohibited fees

### d. **IPO Offerings:**

- Directing trades to brokers that provide IPO offerings
- Placement of IPO allocations in adviser's proprietary or

employees' personal accounts

e. **Soft Dollars/Kickbacks:** ▪ Research and/or sources of research outside safe harbor ▪ Inadequate due diligence on research product ▪ Broker does not pay research source directly ▪ Inaccurate or misleading research obtained ▪ Research obtained is not current ▪ Mixed-use items not appropriately allocated

f. **Compensation:** ▪ Incentive-based compensation leads to inappropriate recommendations or investments

### g. **Objectives/Restrictions:**

- Objectives not kept current
- Objectives miscommunicated or not clearly understood
- Adviser influences client to accept higher risk than desired
- Failure to reconcile information communicated to portfolio manager and strategy implemented
- Restrictions not monitored

### h. **Trade Ticket:**

- Preferential trade allocation
- Side by side management conflicts
- Investments outside client objectives or restrictions
- Failure to include required information on trade ticket
- Inappropriate allocation on partial fills

i. **Trade Execution:** ▪ Failure to seek to obtain best execution ▪ Favoring brokers based on research or referrals received ▪ Post-trade allocation instructions ▪ Principal or cross trades without required disclosure/consent ▪ Errors/corrections not identified and resolved in client's best interest

j. **Non-public Information:** ▪ Non public information obtained during analysis phase ▪ Use of non-public information for personal gain/loss avoidance ▪ Use of client trading to manipulate price of publicly traded stock

### k. **Personal and Proprietary Trading Account:**

- Portfolio manager utilizes knowledge of upcoming trades for gain/loss avoidance in personal account
- Trader uses knowledge of market and current or upcoming trades to manipulate prices or for gain/loss avoidance

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**RISK MANAGEMENT***(Continued from page 5)*

**I. Money/Securities to/from Broker/Custodian:** • Funds or securities sent to the adviser or employees instead of the custodian • Theft  
SEC Guidance on Risk Assessments for Broker-Dealers

In a speech on Nov. 28, 2007, “Risk Management for Broker-Dealers, Mary Ann Gadziala, associate director in OCIE, stated the following with respect to risk management at broker-dealers: “Perhaps the most timely and relevant publication on risk management principles from the perspective of the SEC, which is specifically related to legal and reputational risks associated with complex structured finance activities, is the “Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities” (Interagency Statement). This statement was issued on January 5, 2007, by the SEC and the bank regulatory agencies. . . . The Interagency Statement is generally principles based. It describes some of the internal controls and risk management procedures that may assist financial institutions with the identification, review and approval of complex structured finance transactions (CSFTs) that may pose heightened levels of legal or reputational risk to a firm. These policies and procedures should, among other things, be designed to allow the institution to identify elevated risk CSFTs during its transaction and new product approval processes. They should provide for elevated risk CSFTs to be reviewed by appropriate levels of control and management personnel at the institutions, including personnel from control areas that are independent of the business line(s) involved in the transaction. They should provide for the maintenance of appropriate documentation in connection with these processes. In addition, firms should have appropriate training for firm personnel involved with CSFTs, and procedures should provide for periodic reviews and audits of CSFT activities to verify and monitor that procedures and controls are being effectively implemented.”

Ms. Gadziala identified the

following areas that OCIE reviews in its inspections of risk management systems at broker-dealers:

- Internal audit, to ensure that comprehensive and independent assessments get to management and the board, and that deficiencies are addressed in a timely manner; the review also assists us in scoping our examinations;
- Senior management, to look for establishment of overall policies and active involvement in the oversight of risk parameters and controls — areas of particular focus for senior management also may include ensuring that firms have sufficient resources for risk management and protecting against the so-called “silo effect” where risk management is not integrated into a common framework; enterprise risk management is the new watchword for comprehensive and effective risk management systems;
- Adequacy of resources and systems used for risk management; and compensation or other incentives that may adversely impact independence;
- Market risk in trading activities and firm inventory, including VAR (value at risk), economic models, scenario analyses, stress testing, and back testing; we follow trades from the trading desk through the entire risk management system; for firms that have chosen to implement Appendix E for capital changes, we would also be looking specifically for controls to ensure compliance with the requirements of Appendix E; to the extent a firm did not engage in principal trading activities or hold firm inventory, this area may not be a significant area of review during a risk management examination;
- Funding, liquidity and credit risks, including counterparty credit risk across all products and businesses, credit limits, pricing models, valuation, guarantees, collateral, margin, and settlement and legal risks — the recent events in the subprime market and impact generally of those events on the capital markets demonstrate the importance of strong and evolving credit controls; for retail firms, the focus would likely be on collateral and margin, as well as

counterparty credit risk, as appropriate;

- Operational risks, including: segregation of duties; checks and balances; protection of customer funds and securities; controls to prevent identity thefts, phishing attacks, and inappropriate release of sensitive customer information; operating systems; management information systems; management reporting; front and back office operations; security; and contingency planning and disaster recovery — in this last area, the devastating results of 9/11, major hurricane damage, and the California fires are only a few recent examples of why business continuity risk management is so critical;
  - Legal and compliance controls, including surveillance and monitoring systems and procedures, reports to senior management, and independence — unlike “supervision” by the business area, “compliance” is an independent oversight function; for firms that are more oriented toward retail rather than wholesale operations, controls related to sales practices — highlighted, for example, by rules precipitated by the Guttadauria case, are key elements of risk controls;<sup>6</sup> recent reports have indicated that some firm personnel are not confident that policies and procedures are current and complete and therefore do not bother to read or follow them — having comprehensive and up-to-date procedures is critical and this should help ensure they are read and followed;
  - And finally, we look to see that new products and activities are assimilated into the risk management system in a timely and appropriate manner — the Enron-related problems with general concerns about CSFTs are just one example that highlights the need for integrating new products in risk management control systems.
- Guidance from the Investment Adviser Association on Conducting a Risk Assessment

In January 2006, the Investment Adviser Association (“IAA”) published guidance on how an investment adviser should perform a risk assessment. <http://www.investmentadviser.org/eweb/>

dynamicpage.aspx?webcode=PubDoc-RiskAssesment. This guidance offers the following definition of a risk assessment: "A risk assessment involves identifying and prioritizing issues, conflicts and other matters regarding a firm's operations that may create risk to the interests of the firm and/or its clients. This process requires a firm to consider carefully its vulnerabilities. The assessment should also include a review of the processes surrounding identified risk areas (e.g., policies, procedures and business practices) in order to identify and eliminate or mitigate any gaps or weakness in these processes."

The IAA guidance identifies the following types of risks: "The advisory business involves many types of risks that may potentially harm the interests of a firm and its clients. Advisers may group risk into broad categories such as operational, strategic, financial, compliance, and reputation. Some risks may fall into more than one category. Operational risk arises from the potential that inadequate information systems, operations systems, transaction processing, systems development, *etc.*, will result in unforeseen losses. Strategic risk arises from inadequate current and prospective business decisions or responsiveness that might harm a firm's financial condition or create conflicts among a firm's clients. For example, this category may include risks associated with an adviser's (i) affiliations with broker-dealers or other businesses, (ii) lines of business such as managing mutual funds along side hedge funds, or (iii) non-U.S. business activities. Financial risk is the risk that a firm may be unable to meet its financial obligations. This category may include risks associated with (i) counterparty creditworthiness, (ii) firm leveraging, or (iii) cash flow management and revenue cycles. Compliance risk arises from the possibility that a breach of internal policies or procedures, laws, rules, regulations or ethical standards may impact negatively or disrupt firm operations or condition. For example, insider trading or failure to segregate duties or properly supervise employees may lead to regulatory enforcement

actions, litigation, breached contracts, *etc.* Finally, reputation risk arises from the potential that inappropriate employee or management actions or inactions may cause the press or public to form a negative opinion of the firm and/or its products and services."

The following questionnaire appears in the IAA guidance:

#### **Firm Affiliations**

- What are the firm's business affiliations?
- What explicit/implicit arrangements does the firm have with these entities? Does the firm use services or products of affiliates? Have arrangements, if any, been disclosed? Should the arrangements be discontinued? Could the firm have received the same or better services from an alternative firm at a better rate or fee?
- Review any related party transactions (e.g., loans). Any conflicts and/or risks to client?

#### **Business Lines**

- What are the firm's business lines (e.g., mutual funds, hedge funds, ERISA accounts, pooled funds, private accounts) and any associated conflicts (e.g., side by side management of hedge fund and mutual fund)?
- What are the major sources of revenue and savings for the firm? Are there any conflicts or risks associated with these arrangements (pay to play, kickbacks, favoritism, fraud, *etc.*)? Any special incentives or payments for use or sale of products or services?

#### **Business Continuity**

- Does the firm have a business continuity plan?
- Has the plan been tested? Does the plan have any weaknesses?
- Are systems and technology functioning adequately to meet business needs? Are systems and technology tested?
- Have there been any systems outages?
- Is there adequate systems backup?
- Is there sufficient processing capability for transaction volume?

#### **Firm Viability and Personnel**

- Does the firm have adequate cash flow to meet debt obligations?
- If key personnel were incapacitated, could the firm continue to operate

properly? Is there back-up for key positions and adequate cross training provided to other individuals?

- Do employees have enough resources?
- Is the firm adequately staffed?
- Does the firm conduct background checks on employees?
- Has the firm experienced significant turnover?
- Does the firm treat any employee with more freedom/leniency than other employees, whereby the employee would have less difficulty circumventing firm policies, procedures and operations in furtherance of his or her own interest or gain?
- Does the firm employ a portfolio manager(s) with stellar performance or reputation? Would assets under management decrease if this portfolio manager left the firm? If so, does the firm grant this portfolio manager special treatment or monitor the manager infrequently?

#### **Corporate Governance**

- Is the firm's board structure (if any) appropriate?
- Are the firm's reporting relationships appropriate?
- Is the process for making material decisions regarding firm operations appropriate?
- Is information flow adequate (e.g., if an employee used a creative accounting scheme, would senior management discover it)?

#### **Strategic Direction**

- If the firm is changing strategic direction, are the firm's resources, employees and skills adequate to implement the strategy?
- Have there been frequent changes to strategic direction?

#### **Investment Products**

- Identify the types of products about which the firm provides advice. Any conflicts of interest or risks associated with these types of products that should be disclosed and/or eliminated?

#### **Service Providers**

- Are all service providers necessary and appropriate (e.g., is the firm using an affiliated custodian when it could use a more appropriate custodian)?
- How are service provider activities

**RISK MANAGEMENT***(Continued from page 7)*

monitored? Are services provided in accordance with the contract? Are there any inspections of the service providers' facilities, operations and compliance programs?

- Is the firm being compensated for using a specific service provider?

**Third Party Payments**

- Any compensation from third parties? Any related conflicts?

**Gifts/Entertainment**

- Does the firm have a gift and entertainment policy?
- Does the firm require reporting/monitoring of gifts and entertainment?
- How large and frequent are the gifts? Are the gifts so large/generous that they create the appearance that the gifts are swaying the decision making of employees (e.g., portfolio manager and trading desk)?
- Does the receipt of gifts or entertainment indicate that the firm is favoring a certain service provider?

**Political Contributions**

- Does the firm or individual employees make political contributions?
- Is there a firm policy regarding political contributions by the firm and individual employees?
- Are decision makers being pressured to make political contributions in order to "pay to play?"
- Is the firm receiving business from entities controlled by persons who have received contributions from the firm?

**Privacy**

- How does the firm protect customer information (physical, technical safeguards)?
- Does the firm have a privacy policy?
- Is the policy disclosed to clients?
- Is there a strong emphasis on data integrity and security, including client account record keeping, passwords used, passwords changed frequently, virus software used, virus software updated at time of new releases, and firewalls in place if data is accessed through the Internet?
- What is the protocol when customer information is procured without permission from the firm or inadvertently disclosed against firm

policy?

- Is consumer report information being disposed of properly?

**Trading**

- Are trading accounts monitored? If so, are there any corresponding conflicts (e.g., a person with authority to trade on behalf of the accounts is also the person reviewing the overall account activity)?
- Is best execution periodically and systematically monitored?
- Is fair value pricing of illiquid securities employed?
- Any trading with affiliates?
- Is cross trading and principal/agent trading monitored?
- Any soft dollar arrangements? Are they in compliance with the Section 28(e) safe harbor and adequately disclosed to clients?
- Does the firm use client brokerage to obtain anything that benefits the firm, whether or not it may also benefit clients and whether or not the benefit to the adviser fits within the soft dollar safe harbor?
- Does the firm play multiple roles in a transaction?
- Are trade error correction policies and procedures clear?
- Evaluate trade error rate, do errors seem to be occurring frequently or with the same personnel?

- Are clients who are referred to the firm from a brokerage firm informed of corresponding conflicts (e.g., execution of client trades through referring broker or possible higher commission rate)?
- Are all clients that direct brokerage informed of the associated risks?
- Are IPOs and other limited securities allocated equitably among clients?
- Are trade executions placed equitably?

**Portfolio Management**

- Is there an investment committee in place? Should there be?
- Is there a process for vetting new instruments before placement into a client account (e.g., credit swaps, collateralized debt obligations)?
- Any *quid pro quo* arrangements for assets?
- Any preferential treatment of clients? Does the investment process favor some clients over others?
- Are clients' portfolios consistent with

clients' guidelines, mandates, investment objectives, disclosures and regulatory restrictions? Any style drift?

- Is there accounting, booking, or reporting to achieve other interests?
- Any waivers of transfer limits, redemption fees or trading windows?

**Hedge Funds**

- Does the firm provide credit to a hedge fund or take an equity position in it, or provide execution or prime brokerage services while recommending that hedge fund to their customers?

**Pricing/Valuation**

- Are the firm's valuation policies/methodologies adequate?
- How are thinly traded securities or private placements valued?
- Does the firm perform price variance analyses?
- Is there a process to monitor the valuation of investments?
- Is performance valued accurately?

**Fees**

- Are client holdings valued appropriately and back tested?
- Are client fees computed accurately? Could they be based on inaccurate computation of client assets?
- Do different fee structures for different clients pose any conflicts of interest?

**Custody**

- Does the firm have custody of client funds and/or securities, or could it gain access to client assets? How does the firm ensure that clients' account activity is accurately reported to the client?

**Marketing**

- How is advertising/marketing information approved?
- Is there coordination between the marketing staff and legal and compliance departments? How does the firm ensure that marketing and selling practices are in accordance with regulatory requirements?
- How are assets under management calculated? Does this coincide with marketing representations and Form ADV?
- How are performance numbers and composites calculated? How are they used in marketing materials and what disclosure accompanies the numbers? GIPS compliant?
- Does the firm enlist a solicitor(s)? If

so, is the arrangement formalized with a contract? Is the arrangement disclosed? If applicable, is the solicitor providing Form ADV and the solicitor's written disclosure document? Does the firm review the solicitor's separate written disclosure document for completeness and accuracy? Does the firm have a process for ensuring that the solicitor's written disclosure document is current?

#### **Proxy Voting**

- Any conflicts regarding proxy voting? If the firm had any such conflict, was it disclosed to clients prior to voting proxies?

#### **Pension Consultants**

- Are firm managers compensating the pension consultant for its referral to the adviser of a pension fund account? Is this arrangement disclosed?
- Does the firm have a process for seeking to review any disclosures made by a pension consultant to a pension fund account regarding the adviser?
- Are firm managers directing pension fund brokerage to a certain broker-dealer with which the pension consultant (who referred the pension fund account to the firm) has an arrangement or relationship?

#### **Form ADV**

- Are all material conflicts of interest disclosed?
- Are there any material inadequacies/omissions in the disclosure?
- Is the disclosure easily understood by clients?
- Is Form ADV disclosure consistent with marketing representations, client contracts, and offering materials?

#### **Regulatory Environment/Best Practices**

- Who or what department is responsible for keeping abreast of changes in the regulatory environment and how does the firm respond to these changes?
- Who or what department is responsible for monitoring industry best practices and how does the firm respond to these practices?

#### **Unethical Behavior/Fraud**

- Are there ways for senior management and other firm employees to commit fraud or engage in unethical behavior (e.g., front running, self-dealing, asset misappropriation, money laundering,

unfair investment allocation, incorrect management fee calculation, market manipulation, etc.)?

- How frequently is staff trained on compliance/ethics?

#### **Insider Trading**

- Are the firm's policies and procedures adequate to detect and prevent insider trading?
- Do the firm's employees understand the meaning of "insider trading" and the firm's related policies and procedures?
- Is any one employee (e.g., star portfolio manager) treated with more freedom/leniency, whereby detection of insider trading by the firm would be made difficult?

#### **Client Complaints**

- Any complaints from customers or potential customers?

#### **Record-Keeping**

- Does the firm keep records in compliance with the Advisers Act?
- Does the firm have a system for ensuring record retention?
- What is the firm's e-mail retention policy?
- Does the firm review emails on a periodic basis to determine if employees (including senior employees and officers) are acting legally and ethically?

#### **Anti-Money Laundering**

- Does the firm have an anti-money laundering policy?
- Does the firm review the anti-money laundering policy of its service providers?

The IAA guidance also presents a sample risk management matrix, with the following column headings:

#### **Business Area**

#### **Responsible Person(s)**

#### **Reporting Frequency to CCO**

#### **Identified Risk**

#### **Inherent Risk Level**

#### **Corresponding Policies/Procedures**

#### **Control Factors**

#### **Firm Priority**

#### **Next Steps**

#### **Additional or Revised Disclosure Needed**

#### **Resolution**

#### Managed Funds Association Guidance on Conducting a Risk Assessment

The Managed Funds Association has published Sound Practices for Hedge

Fund Managers (2009). Appendix III, Supplemental Information on Risk Monitoring Practices for Hedge Fund Managers, presents a detailed summary of risk monitoring practices at hedge funds.

The Appendix identifies four types of risks, all of which relate to the management of the portfolio: "market risk, credit risk, liquidity risk, and operational risk."

#### Market Risk

A critical concept in risk measurement is Value at Risk or VAR. "VAR measures the maximum change in the value of the portfolio that would be expected at a specified confidence level over a specified holding period. For example, if the 95% confidence level one-day VAR for a portfolio is \$500,000, one would expect to gain or lose more than \$500,000 in only five of every 100 trading days on average." Three methods are used to calculate VAR:

"Variance/Covariance. Under this method, which is probably the most widely used VAR methodology, the program draws volatility (variance) and correlation (covariance) information from data histories, for each position in the portfolio, and calculates the volatility estimate under the assumption that the returns for the overall portfolio will assume a normal distribution. It is the least process intensive and perhaps the easiest of the VAR methodologies;" "Historical Volatility. Under this approach, the VAR portfolio actually is repriced each day over the data history, a daily trading P/L calculation is derived and ranked in ascending order. The risk estimate is then set at the level consistent with the confidence interval selected for the analysis. Historical volatility is very process intensive, but is considered by many to be the most effective form of VAR;" and "Monte Carlo Simulation. Under the Monte Carlo approach, the portfolio is repriced across large numbers of random observations that are consistent with the volatility history of the underlying instruments. Like historical VAR, these observations are

**RISK MANAGEMENT***(Continued from page 9)*

then ranked in ascending order, and the risk estimate is set at a level consistent with the applicable confidence interval. Historical Monte Carlo VAR is typically only used for very complex portfolios, featuring abundant nonlinearities.”

**Stress Testing and Back Testing**

Stress tests permit the Hedge Fund Manager to see what will happen to the VAR number if the actual values of market factors (*i.e.*, prices, rates, volatilities, *etc.*) differ from the values used as inputs in the base-case VAR calculation. Among the potential changes in market conditions that should be considered in stress testing are:

- Changes in prices;
- Changes in interest rate term structures; and
- Changes in correlations between prices.

By comparing actual changes in the value of the portfolio to the changes generated by the VAR calculation, the Hedge Fund Manager can gain insight into whether the VAR model is accurately measuring a Hedge Fund's risk.

**The Sharpe Ratio**

As defined in the Managed Funds Association Sound Practices guide, “[t]he Sharpe Ratio is widely used to measure a portfolio's risk-adjusted performance over a specific period. The numerator of the Sharpe Ratio is a measure of portfolio return during the period; the denominator is a measure of the risk incurred in achieving the return. (For example, over the past decade the Sharpe Ratio for the S&P 500 has been approximately 1.2.) Investors prefer higher Sharpe Ratios, since a higher Sharpe Ratio indicates that the portfolio earned superior returns relative to the level of risk incurred. There are a number of ways in which return and risk could be calculated. Below is the Sharpe Ratio for an arbitrary portfolio—designated as Portfolio *j*—calculated using the most common conventions for measuring return and risk. The numerator is the return earned on the portfolio (*R<sub>j</sub>*) in excess of the risk-free rate of return (*R<sub>f</sub>*) (*i.e.*, the interest rate

earned on risk-free securities such as U.S. Treasury securities) over the same period. The denominator—the risk incurred—is measured as the standard deviation of the portfolio's daily return: (Sharpe Ratio)  $j = \frac{R_j - R_f}{\sigma}$

**Liquidity Risk**

The Managed Funds Association identifies three types of liquidity risks:

“Equity or NAV. Generally, a larger Hedge Fund will require greater levels of liquidity. However, a Hedge Fund's need for liquidity during periods of market stress is determined not only by the size of the portfolio, but also by the characteristics of the assets it holds (in addition to a Hedge Fund's need to fund redemptions). Consequently, Hedge Fund Managers need to have measures of potential liquidity that reflect the riskiness of the portfolio;”

“Worst Historical Drawdown.

This indicator provides a measure of risk and of the amount of liquidity the Hedge Fund has required in the past. This measure is, however, a backward-looking measure of risk and may not be indicative of the Hedge Fund's current exposure; and”

“VAR. As aforementioned, VAR is currently the most widely used prospective measure of market risk. Consequently, tracking the ratio of Cash or Cash + Borrowing capacity to VAR provides the Hedge Fund Manager with an indication of whether the Hedge Fund's liquidity relative to its need for liquidity is rising or falling.”

**Leverage Risk**

The Managed Funds Association identifies several ways to measure leverage risk:

“Gross Balance Sheet Assets to Equity: On-Balance-Sheet Assets/Equity. This straightforward measure is easily calculated from published financial statements; however, it fails to incorporate two important elements of a Hedge Fund's effective leverage:”

“• The risk-reducing effect of on-balance-sheet hedges is not recognized. Adding a hedge to the balance sheet increases assets and thereby increases this leverage measure, even though the transaction may substantially offset the

risk of another asset;” and

“• The full notional amount of derivative instruments is not required to be recorded on the balance sheet. To the extent the full notional amount is not recorded, this measure may understate the Hedge Fund's true economic risk.”

“• Net Balance Sheet Assets to Equity: (On-Balance-Sheet Assets-Matched Book Assets)/Equity. While this measure requires more detailed information about the positions in a Hedge Fund's portfolio, it does provide a partial solution to the shortcomings of the Gross Balance Sheet Assets to equity measure by including offsets and direct hedges as reflected in matched book assets. However, important elements of the Hedge Fund's effective leverage are still not incorporated.”

“• This measure does not reflect portfolio correlation or less direct hedges that fall outside the definition of matched book assets; and”

“• This measure does not incorporate off-balance-sheet instruments.”

“Volatility in Value of Portfolio/Equity. This is a measure of actual performance volatility over a given horizon relative to equity. While useful, it is subject to criticism. Since it is a retrospective measure, it is less useful if the composition of the portfolio changes or if future market conditions are not like historical conditions. Moreover, it does not isolate the effect of financing on the risk of the Hedge Fund since it includes financed assets; “

“VAR/Equity. This measure gives a picture of the Hedge Fund's capacity to absorb “typical” market movements. The criticism of such a measure is that it does not reflect the risk of the Hedge Fund's portfolio in extreme markets; and”

“Scenario-Derived Market Risk Measure/Equity. To assess the impact of extreme events, the leverage measure could be calculated using a market risk measure derived from analysis of extreme event scenarios (or stress tests). This measure gives senior management information about the Hedge Fund's ability to absorb extreme market events.”

**Counterparty Risk**

The Managed Funds Association offers the following techniques to manage counterparty risks:

“Current replacement cost. The amount the Hedge Fund would lose if its counterparty were to become insolvent immediately and the Hedge Fund Manager had to replace the contract in the market”

“Potential exposure. A probabilistic assessment of the additional exposure that could result if the counterparty does not default immediately but instead defaults at some date in the future. Potential exposure is particularly applicable to derivatives transactions where exposure is reciprocal and likely to change substantially before the contract expires;”

“The probability of loss. The likelihood of a default by the counterparty over the relevant time horizon. This is a function of the counterparty’s current credit quality, the length of the transaction, and possibly the nature of the transaction itself; and”

“Risk mitigation and documentation. The extent to which collateral, netting provisions, or other credit enhancement reduces the magnitude of the exposure to a counterparty. Hedge Fund Managers can greatly reduce their credit exposure to counterparties by negotiating bilateral netting and collateral provisions in their documentation and establishing document management processes to ensure transactions are documented consistently and in a timely manner.”

#### Criticism of Modern Risk Management Tools

Several criticisms have been offered of modern risk measurement tools, which are alleged to have worked poorly in the period leading to the financial crisis. The following criticisms appear in *The Turner Review* (March 2009).

##### 1. “Short observation periods.

Measures of VAR were often estimated using relatively short periods of observation e.g. 12 months. As a result they introduced significant procyclicality, with periods of low observed risk driving down measures of future prospective risk, and thus influencing capital commitment

decisions which were for a time self-fulfilling. At very least much longer time periods of observations need to be used.”

##### 2. “Non-normal distributions.

However, even if much longer time periods (e.g. ten years) had been used, it is likely that estimates would have failed to identify the scale of risks being taken. Price movements during the crisis have often been of a size whose probability was calculated by models (even using longer term inputs) to be almost infinitesimally small. This suggests that the models systematically underestimated the chances of small probability high impact events. Models frequently assume that the full distribution of possible events, from which the observed price movements are assumed to be a random sample, is normal in shape. But there is no clearly robust justification for this assumption and it is possible that financial market movements are inherently characterized by fat-tail distributions. This implies that any use of VAR models needs to be buttressed by the application of stress test techniques which consider the impact of extreme movements beyond those which the model suggests are at all probable. Deciding just how stressed the stress test should be, is however inherently difficult, and not clearly susceptible to any mathematical determination.”

##### 3. “Systemic versus idiosyncratic risk.

One explanation of fat-tail distributions may lie in the importance of systemic versus idiosyncratic risk i.e. the presence of ‘network externalities.’ The models used implicitly assume that the actions of the individual firm, reacting to market price movements, are both sufficiently small in scale as not themselves to affect the market equilibria, and independent of the actions of other firms. But this is a deeply misleading assumption if it is possible that developments in markets will induce similar and simultaneous behaviour by numerous players. If this is the case, which it certainly was in the financial crisis, VAR measures of risk may not only fail adequately to warn of rising risk, but may convey

the message that risk is low and falling at the precise time when systemic risk is high and rising. According to VAR measures, risk was low in spring 2007: in fact the system was fraught with huge systemic risk. This suggests that stress tests may need (i) to be defined as much by regulators in the light of macro-prudential concerns, as by firms in the light of idiosyncratic concerns; and (ii) to consider the impact of second order effects i.e. the impact on one bank of another bank’s likely reaction to the common systemic stress.”

##### 4. “Non-independence of future events; distinguishing risk and uncertainty.

More fundamentally, however, it is important to realize that the assumption that past distribution patterns carry robust inferences for the probability of future patterns is methodologically insecure. It involves applying to the world of social and economic relationships a technique drawn from the world of physics, in which a random sample of a definitively existing universe of possible events is used to determine the probability characteristics which govern future random samples. But it is unclear whether this analogy is valid when applied to economic and social relationships, or whether instead, we need to recognise that we are dealing not with mathematically modellable risk, but with inherent ‘Knightian’ uncertainty. This would further reinforce the need for a macro-prudential approach to regulation. But it would also suggest that no system of regulation could ever guard against all risks/uncertainties, and that there may be extreme circumstances in which the backup of risk socialization (e.g. of the sort of government intervention now being put in place) is the optimal and the only defence against system failure.”

1. The SEC’s Core Initial Information Examiners Request of Investment Advisers” includes the following:

“On-going Risk Identification and Assessment Inventory of compliance risks that forms the basis for policies and procedures and notations regarding changes made to the

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inventory. Documents mapping the inventory of risks to written policies and procedures. Written guidance provided to employees regarding compliance risk assessment process and procedures to mitigate and manage compliance risks.”

2. On November 11, 2008, the CFA Institute proposed adding a new provision to its Asset Manager Code of Professional Conduct: “Establish a risk management process that identifies, monitors, and analyzes the risk position of Manager portfolios, including the sources, nature and degree of risk exposure for both individual securities and the total portfolio.” Appendix A to this proposal stated that a risk management program at an adviser should address the following:

“A sound risk management process will consider a number of different risks, including:”  
*“Leverage.* The value of complex financial instruments can change rapidly under certain market conditions and these changes can be exacerbated by leverage. Managers should track both risk-based leverage and financial statement-based leverage in assessing risk exposure.”

*“Liquidity.* Managers should evaluate the stability of liquidity sources and establish a contingency plan for sustaining adequate funding in circumstances such as withdrawal of funds by investors and shifting collateral requirements. A trigger event can cause a dramatic increase in collateral requirements affecting multiple Credit Default Swap(CDS) positions resulting in a significant liquidity crunch. Managers should take into consideration interdependencies of collateral and credit enhancement provisions when analyzing liquidity risk.”

*“Counterparties.* Managers should continually monitor and analyze the creditworthiness of trading counterparties by seeking information that will allow Managers to make accurate risk assessments. Establishing sustainable credit terms with counterparties, including prudent margin arrangements, is a critical factor in minimizing risk during volatile periods. Managers should review the contractual ability of counterparties to terminate or otherwise alter trading relationships or margin/collateral requirements under certain conditions.”

3. On July 29, 1999, the SEC, NYSE and NASD issued a Joint Statement on Broker Dealer Risk Management Practices:

1. “Risk management is the identification, management, measurement and oversight

of various business risks and is part of a firm’s internal control structure. These risks typically arise in such areas as proprietary trading, credit, liquidity and new products. The elements of a comprehensive risk management system are highly dependent on the nature of the broker-dealer’s business and its structure.”

2. “The task force has concluded that senior management must play a significant role in the adoption and maintenance of a comprehensive system of internal controls and risk management practices. This role should include the recognition of risk management as an essential part of the business process, management’s willingness to fund the necessary elements of a risk management system, including personnel and information technology costs, and recognition that risk management is a dynamic function that must be modified and improved as a firm’s business changes and improved processes and procedures become available.”

3. “Some firms failed to adequately monitor trading risk due to poor supervisory structures, the inconsistent use of data, and employment of inappropriate risk measurement tools. For example, one inspection noted a broker-dealer that had assigned the head of the fixed income trading desk to oversee all trading risk management functions, including the risk monitoring of fixed income trading. Several broker-dealers were found to have failed to monitor the consistency of information contained in the firm’s trade processing, financial reporting and risk management systems, resulting in the omission of certain accounts and activity from the risk monitoring function. Additionally, certain broker-dealers utilized risk measures, such as notional values, that were not commensurate with the complexity of products traded. The inspections also identified numerous weaknesses in the manner by which broker-dealers manage credit risk. Numerous broker-dealers conducted trading with counterparties for whom no credit limit had been established, and in some cases credit reviews of approved counterparties were not completed within prescribed time frames. Further, many of these reviews were not adequately documented. Reports used to monitor credit exposure were frequently inaccurate. For instance, many of the reports failed to capture fully the entire population of trades within each category of trading activity and failed to aggregate total credit exposures across all product lines on a system wide basis. Additionally, computerized system limitations yielded credit reports identifying false violations of credit guidelines due to an

inability to recognize collateral or the failure to adjust credit lines. Other credit reports calculated exposure in a contradictory manner to what was intended, such as by treating credit exposure from the overcollateralization of repurchase agreements as reduction in risk. The inspections also identified instances where broker-dealers maintained understaffed and inexperienced internal audit departments. Also, many of these internal audit departments failed to include key revenue producing and functional areas, such as trading risk management and credit risk management, in the internal audit plans. Occasionally, internal audit failed to follow up on its findings, which contributed to the deficiencies which were identified remaining unremedied.”

4. In a March 23, 2009 speech, Richard Ketchum, the CEO of FINRA, noted the following: “scenario analyses need to be performed by independent risk managers that are not in love with the positions or the strategies. Second, scenarios must always evaluate cross-asset contagion risk. Third, the firm must react immediately when there are dramatic market and economic changes to reevaluate the exposures and maximum potential losses, with a careful appreciation of funding implications resulting from holding company exposures and careful concern as to how customers are being advised. And finally, this must be a task that is not delegated by the CEO and senior management of the broker-dealer no matter what the press of other business. Beyond each of these points, compliance must be an active participant in this process. The artificial border between risk management and compliance must end. No, you can’t run the numbers, but your instincts and natural concerns regarding impacts on your customers are critical to effective risk management oversight.”

## Privacy Best Practices and Updates on Regulation S-P

by Michelle L. Jacko

Regulation S-P was adopted by the SEC in accordance with Title V of the Gramm-Leach-Bliley Act (the “GLB Act”).<sup>1</sup> The GLB Act requires the SEC and other federal agencies to adopt rules relating to notice requirements and restrictions on a financial institution’s ability to disclose nonpublic personal information about its consumers.<sup>2</sup> The two primary rules under Regulation S-P are Rule 10 (the Disclosure Rule) and Rule 30 (the Safeguard Rule). Rule 10 limits the information about customers that may be disclosed by a financial institution to any non-affiliated third party unless the financial institution complies with the notice and opt out provisions of Regulation S-P and the customer has not opted out of the disclosure.<sup>3</sup> Rule 30 requires every broker, dealer, and investment company, and every SEC-registered investment adviser to “adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.”<sup>4</sup> Such safeguarding policies and procedures must be reasonably designed to: ensure that consumer records and information are kept secure and confidential; protect against anticipated threats or hazards to the security of such consumer records and information; and protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience.<sup>5</sup>

### Changes to Privacy Rules

Recently, the SEC has been considering amendments to Regulation S-P that will impact both of these rules, and consequently will affect the way firms manage nonpublic personal information about their customers. Although the proposed substantive revisions to Regulation S-P proposed in 2008 have not yet been adopted,<sup>6</sup> on November 16, 2009, the SEC, together

with several other regulatory agencies, released the final version of a model privacy form that firms may rely on as a safe harbor to the notice, disclosure, and opt-out requirements of Subtitle A of Title V of the GLB Act.<sup>7</sup>

### New Model Privacy Form

Section 503 of the GLB Act requires each financial institution to provide a notice of its privacy policies and practices to customers describing the financial institution’s policies with respect to disclosing nonpublic personal information about a consumer to both affiliated and nonaffiliated third parties and must provide a reasonable opportunity to opt-out of certain disclosures to nonaffiliated third parties.<sup>8</sup> Under Regulation S-P, institutions regulated by the SEC are required to deliver, at the time a customer relationship is formed and annually thereafter, a clear and conspicuous notice that accurately reflects the firm’s privacy policies and practices, and informs consumers of their right to opt-out of certain disclosures.<sup>9</sup> However, the notice provisions did not set forth any specific format or standardized wording for the required notices, resulting in notices that varied among financial institutions depending on their practices, many of which were long and not easily understood.<sup>10</sup>

The model forms are designed to meet the requirements of the GLB Act and are intended to be easier for consumers to understand. The new form can be used by financial institutions regulated by the SEC to satisfy their privacy notice obligations under the Investment Advisers Act of 1940 and Regulation S-P.

Importantly, the new model privacy form is designed to make it easier for consumers to more readily understand how financial institutions collect and share information about its consumers. To accomplish this, two versions of the model privacy notice form are provided for firms to use: one contains opt-out language, while the other does not. In either case, the model form is comprised of two pages, and may be printed on two sides of a single piece of paper. Page

one includes background information, a disclosure table, and opt-out information, while page two provides additional explanatory information that is necessary to ensure all disclosure requirements of the GLB Act are met.<sup>11</sup>

Significantly, use of the model form is not required, but rather serves as a safe harbor that reflects the view of the regulators as to how content and form of privacy notices should be presented.<sup>12</sup> Some other important features of the model form noted in the adopting release include: a standardized format that allows consumers to compare information sharing practices of multiple financial institutions; utilization of a checklist approach that alerts consumers to when they can or cannot opt-out; a clear and conspicuous statement at the top of the form that discloses that the privacy notice is required by federal law; and a prohibition against including extraneous marketing-type information.<sup>13</sup>

If a financial institution elects to use the model form, it must determine whether or not its information-sharing practices require the use of the opt-out language. Accordingly, financial institutions should determine whether switching to the model form is the best format to use for its privacy notice and if so, which version of the model form is the best fit for their business model. If there is any uncertainty as to which model form to use, firms should seek the advice of legal counsel.

### Other Proposed Amendments

On March 4, 2008, the SEC proposed changes to Regulation S-P, which addressed (in part) enhanced notification requirements for alleged Regulation S-P breaches and included a new exception to the notice and opt-out requirements to allow limited information sharing when representatives move from one firm to another.<sup>14</sup> These changes were not addressed in the most recent release, however, which was limited to a discussion of the final model privacy form. It therefore remains to be seen what effect any amendments to the substance of Regulation S-P will have

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on the use and applicability of the model form.

**Recent SEC Enforcement Actions**

In recent years, there has been an increase in SEC enforcement actions related to Regulation S-P. The following list represents some of the most noteworthy cases involving Regulation S-P, both historically and as of late. Because the SEC has not yet adopted its proposed revisions to Regulation S-P, we are left with analyzing trends of recent enforcement actions in order to understand the SEC's interpretation of Regulation S-P. A basic understanding of the facts surrounding the following administrative proceedings may help in the development of safeguards for your firm to consider.

• **Next Financial Group, Inc.** – Registered representatives were found to have aided and abetted the firm in violating Regulation S-P by taking clients' personal information when leaving the firm and not disclosing to customers that non-public personal information was being shared with nonaffiliated third parties.<sup>15</sup>

• **LPL Financial Corporation** – LPL was found to have (1) violated Rule 30 of Regulation S-P (the Safeguard Rule) by failing to have adequate safeguards in its online trading platform which resulted in a security breach; and (2) failed to have a customer information policy that adequately protected customer records and information.<sup>16</sup>

• **Commonwealth Equity Services** – Commonwealth was found to have violated Regulation S-P by its lack of security measures to protect nonpublic personal information about their customers. Specifically, customer information was left vulnerable to unauthorized access because Commonwealth only recommended—but did not require—that its registered representatives have anti-virus software on their computers.<sup>17</sup>

• **Merriman Curhan Ford** – The firm was held liable for the conduct of its associated persons in disseminating confidential customer information to nonaffiliated parties.<sup>18</sup>

• **SEC v. Sydney Mondschein** – The firm was found to be liable for its registered representative's activities in violation of Regulation S-P by failing to disclose to customers that he intended to sell,

and did sell, their confidential personal information to insurance agents.<sup>19</sup>

**Privacy Best Practices**

In order to help ensure your firm is in compliance with Regulation S-P, consider the following best practices.

**Remember your Duty of Loyalty and Fiduciary Responsibilities to Consumers.** The SEC can determine that a firm's failure to protect their clients' confidential information is a breach of their fiduciary duties under the Investment Advisers Act of 1940 as well as Regulation S-P.

**1. Always Provide a Privacy Notice to New Clients and Annually Thereafter.**

The Privacy Notice required by Regulation S-P must adequately describe the firm's privacy policies and the circumstances under which the firm shares of nonpublic personal information with nonaffiliated third parties. The notice must be given to clients at the commencement of the client relationship and on an annual basis thereafter.

**2. Make Certain the Privacy Policy Includes "No Phishing" Language.** Include procedures to confirm the identity of any individual requesting clients' confidential information.

**3. Documentation.** Always keep a record of your efforts to upholding your privacy policy and include internal testing results as well as other compliance related work.

**4. Require Non-Disclosure Agreements for Third-Party Service Providers.** If a third party could potentially have access to clients' confidential information, a Non Disclosure Agreement should be required.

**5. Adhere to the Technological Requirements of the Privacy Policy.**

An IT consultant or an in-house IT administrator can design and test major components of your privacy procedures to ensure the security and reliability of the firm's safeguarding and disposal process.

**6. Hold Annual Trainings on your Privacy Policy.** Have each employee sign a statement indicating their participation in privacy training sessions and acknowledging that they have read and understand the firm's privacy policy, emphasizing the importance of keeping clients' confidential information secure.

If the 2008 proposed amendments, the series of SEC enforcement actions, and the release of the model privacy form are any indication of the regulatory attention given to protecting consumer information, there is no better time

than now to review your firm's privacy policies. With the end of the year fast approaching, be sure to give adequate consideration to your firm's privacy practices and keep abreast of SEC developments, as further amendments are likely to come sooner than later.

1. Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 34-42974, Advisers Act Release No. IA-1883, Investment Company Act Release No. IC-24543, 65 Fed. Reg. 40334 (June 29, 2000).
2. 15 U.S.C. 6803(a).
3. 17 C.F.R. § 248.10.
4. *Id.* § 248.30.
5. *Id.*
6. See Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information, Exchange Act Release No. 34-57427; Investment Company Act Release No. IC-28178; Advisers Act Release No. IA-2712, 73 Fed. Reg. 13,692 (proposed Mar. 13, 2008) [hereinafter Proposing Release].
7. Final Model Privacy Form under the Gramm-Leach-Bliley Act, Exchange Act Release No. 34-61003, Advisers Act Release No. IA-2950, Investment Company Act Release No. IC 28-997, 74 Fed. Reg. 62,890 (Dec. 1, 2009), available at <http://www.sec.gov/rules/final/2009/34-61003fr.pdf> [hereinafter Final Model Privacy Form].
8. See 15 U.S.C. 6803.
9. See 17 C.F.R. Part 248A.
10. Final Model Privacy Form, *supra* note 7 at 62,892.
11. *Id.* at 62,891-92.
12. *Id.* at 62,907.
13. *Id.* at 62,891-92.
14. Proposing Release, *supra* note 6 at 13,693-94.
15. Next Financial Group, Inc., SEC File No. 3-12738 (June 18, 2008), <http://www.sec.gov/litigation/aljdec/2008/id349jtk.pdf>.
16. LPL Financial Corp., SEC File No. 3-13181 (Sept. 11, 2008), <http://www.sec.gov/litigation/admin/2008/34-58515.pdf>.
17. Commonwealth Equity Services, LLP, SEC File No. 3-13631 (Sept. 29, 2009), <http://www.sec.gov/litigation/admin/2009/34-60733.pdf>.
18. Merriman Curhan Ford & Company, SEC File No. 3-13681 (Nov. 10, 2009), <http://www.sec.gov/litigation/admin/2009/34-60976.pdf>.
19. Sec. & Exch. Comm'n v. Mondschein, Civil Action No. C-07-6178 SI (N.D. Cal., Dec. 6, 2007). See also <http://www.sec.gov/litigation/litreleases/2007/lr20386.htm>

# NEW MEMBERS

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Chapel Hill, NC

**Wendy Coticchia**

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LIMITED MEMBERSHIP, EXP 7/1/2010  
Norcross, GA

## Canadian Order Protection Rule Finalized

*by Torstein Braaten*

On Friday, November 13, 2009 the Canadian Securities Administrators (“CSA”) and the Investment Industry Regulatory Organization of Canada (“IIROC”) published their final Order Protection Rules National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules<sup>1</sup> (formerly known as the trade through rules). These rules are substantially similar to Reg NMS and will finally provide the regulatory framework for multiple markets in Canada. Canadian Securities Industry has been waiting over four years to get to this point of clarity. The foundation for the Order Protection Rule is that it “requires each marketplace to establish, maintain and ensure compliance with written policies and procedures that are reasonably designed to prevent trade-throughs on that marketplace.” This is a material shift from requiring the brokers to comply with the Best Price Obligation<sup>2</sup> as set out in the IIROC Universal Market Integrity Rules (“UMIR”)<sup>3</sup>. The Order Protection Rule also levels the playing field by ensuring that all participants in the Canadian capital Markets are covered by moving the obligation to the Marketplaces and adding an anti-avoidance provision. The anti-avoidance provision was included to ensure that participants did not intentionally avoid protected orders in Canada by sending block trades and intentional crosses off-shore (such as sending crosses in interlisted stocks to the US). IIROC will administer and monitor the anti-avoidance provision (Rules Notice 09-0328<sup>4</sup>). The Order Protection Rule has some key differences to Reg NMS. First, the rule protects the full depth-of-book; second it does not establish any fee cap other than requiring fees to be justified by the Marketplace to the CSA and be

less than one trading increment; third there is an Anti-avoidance provision; fourth there are limited exemptions and; fifth the Canadian version of the Inter Sweep Order (“ISO”) is designed to provide more flexibility and is called a “Directed-Action Order” (“DAO”) to ensure that it is not confused with its American counterpart.

### **Time-line**

The amendments for the Order Protection Rule come into force January 28, 2010. The first stage of the Order Protection Rule will not include the most significant provision of moving the obligation to the Marketplaces as they need time to formulate their plans for handling the obligation and they will need to develop and implement the policies and procedures which is expected to be heavily reliant on technology and interconnectivity between the Marketplaces. The Marketplaces will have to be fully implemented, tested and integrated by February 1, 2011. If a new Marketplace is launched or if one of the existing Marketplaces does not meet the February 1, 2011 deadline they may simply not achieve or lose their status as a protected market. The most significant change that is anticipated on January 28, 2010 is the introduction of a ban on intentionally locking markets. For the past 12 months, there has been a ground swell of concern in Canada regarding the impact of High Frequency Traders that have been accused of locking markets in an effort to help capture more rebates. ITG Canada Corp. did a study on locked and crossed markets<sup>5</sup> and found that they were evident in Canadian Markets, but not as prevalent as first thought. The study identified a persistence of locked markets for just under 8% of market quotes. When the prohibition in place starts in February 2010, the general view is that this number will decrease. However, it is possible that unintentional locking will persist as many believe that many

dealers still have a way to go to be fully compliant with the Order Protection Rules and connecting to all protected markets directly or indirectly with a jitney relationship. Regarding the Marketplaces being ready for taking on the Order Protection rule obligation, most of them have marketed their own order routers that should already provide reasonable compliance with the rule. These Marketplace routers have yet to receive the same interest and adoption as the vendor based or in-house developed routers.

### **2009 Trade-Through Implementation Committee**

Over the Spring and Summer of 2009, the CSA asked a Committee of Marketplaces, Vendors, Dealers and Regulators to discuss the draft amendments and recommend changes and wording for five topics that were still open for discussion. The five topics were: full depth-of-book vs. top-of-book obligation, marketplace fees for trading or routing, language for the anti-avoidance rule, exceptions to the Order Protection Rule, and how dealers could take back the responsibility with a special order type. Once all of the recommendations were prepared, it was clear that it was very difficult to get a consensus among the participants... other than for the anti-avoidance rule and the order marker (which was finally called the Directed-Action Order (“DAO”).

### **Next Steps**

The Trade-Through Implementation Committee continues to meet on a regular basis to monitor the status of Marketplaces in their plans to meet the February 2011 deadline. The Committee has also taken on some more immediate challenges regarding interconnectivity between marketplaces, the practical application of the system issues exemption<sup>6</sup> (self-help in Reg NMS) and the rules, best practices and barriers to the use of jitney orders for Dealers that are not members, users, or subscribers

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*Torstein Braaten is Director of Compliance at ITG Canada Corp. He also serves on NSCP's Board of Directors and NSCP's Canadian Committee.*

of a Marketplace that displays the best bid or offer.

### Conclusion

Even though Canada has a regulatory framework for Order Protection obligations in the industry, the full implementation is over a year away. The Dealers in Canada (which include the Global Dealers that have Canadian affiliates) must continue to comply with the Best Price obligations until February 2011. This means that they must connect to all markets or have alternatives available to them so that they can access all better priced orders. This goal is expected to assist the Dealers in achieving their Best Execution obligations. The Dealers are also on notice that they need to consider Dark Pools and Dark orders when the visible markets are not providing sufficient liquidity at a price point for orders in hand. It is also clear from several public statements that IIROC is not waiting for February 2011 until they enforce the Best Price obligation. They have openly stated that they have a number of enforcement actions working their way through the system. These enforcement actions will focus on circumstances where Dealers were trading through better priced orders when they were not connected to all protected markets. The Order Protection rule is long overdue; however, it does provide a solution that was needed for the efficient operation of multiple markets in Canada. The Regulators can now focus on enforcing Best Execution rules, developing a regulatory framework for Dark Pools and Dark order types, Commission Arrangements (soft-dollars), High Frequency Trading and modernizing their Direct Market and Sponsored Access Rules.

### (a) Key Aspects of the Order Protection Rule

#### (i) Marketplace Obligation

The Order Protection Rule requires each marketplace to establish, maintain and ensure compliance with written policies and procedures that are reasonably designed to prevent trade-throughs on that marketplace. Marketplaces are required to regularly

review and monitor the effectiveness of their policies and procedures and act promptly to remedy any identified deficiencies. Marketplaces may choose to implement the obligation in various ways including, for example, voluntarily establishing direct linkages to other marketplaces, rejecting orders, re-pricing orders, or designing specific trade execution algorithms. A marketplace is required to provide its policies and procedures, and any amendments thereto, to the securities regulatory authority and its regulation services provider 45 days prior to implementation.

#### (ii) Protected Orders

Order protection only applies to a protected order which is an order to buy or sell an exchange-traded security, other than an option, that is displayed on a marketplace that provides automated functionality and about which information is required to be provided to an information processor or information vendor. The CSA do not consider special terms orders that are not immediately executable or that trade in a special terms book, such as all-or-none, minimum fill, or cash or delayed delivery, to be orders that are protected.

#### (iii) Visible Orders

The Order Protection Rule only applies to orders or parts of orders that are visible. For an order to be protected, it must be displayed by a marketplace and information about it must be provided to an information processor or information vendor. Hidden orders or those parts of iceberg orders that are not visible are not protected under the Order Protection Rule. Currently, the non-visible or "dark" portions of orders can be avoided in a transparent order book through the use of the "bypass"<sup>77</sup> marker introduced by IIROC in 2008 and implemented in 2009.

#### (iv) Full Depth-of-book

The Order Protection Rule will maintain the existing standard in the UMIR Best Price Rule and apply to all visible orders and visible parts of orders entered into the book. The CSA believes that the policy objectives of investor confidence in the fairness and integrity

of the market are more effectively accomplished through full depth protection instead of the alternative top-of-book protection which has recently attract a fair amount of support from the Dealer community.

#### (v) Anti-Avoidance

We have included an anti-avoidance provision that prohibits a person or company from routing orders to foreign marketplaces for the sole purpose of avoiding the order protection regime in Canada. This provision is limited to large, pre-arranged trades and IIROC has publishing details in their Rules Notice 09-0328 dated November 13, 2009 on their website [www.iiroc.ca](http://www.iiroc.ca).

### (b) "Permitted" Trade-throughs

(i) Failure, Malfunction or Material Delay of Systems or Equipment or its Ability to Disseminate Marketplace Data (Systems Issues Exception of Self-help in Reg NMS)

(ii) Directed-Action Order (Inter market sweep order in the Reg NMS) The CSA included an exception that informs a marketplace that if it receives a specific order type, it can immediately carry out the action specified by the sender without delay or regard to any other better-priced orders displayed by another marketplace.

(iii) Changing Markets Exception (flickering quotes)

(iv) Non-Standard Orders: A non-standard order refers to an order for the purchase or sale of a security that is subject to non-standard terms or conditions relating to settlement that have not been set by the marketplace

(v) Calculated-Price Order

- call market orders;
- opening orders;
- closing orders;
- volume-weighted average price orders and;
- basis orders (price is based on a related index derivative transaction)

(vi) Closing-Price Order (special trading session or after hours session): The CSA included an exception for an order entered on a marketplace for the purchase or sale of an exchange-traded security that executes at the established

**ORDER PROTECTION RULE***(Continued from page 17)*

closing price on that marketplace for that trading day for that security.

(vii) Crossed Market exception: The CSA made an exception available to orders that clean-up a crossed market, if entered intentionally or unintentionally.

**(c) Fair Access to Marketplaces**

Provisions require marketplaces to provide fair access to all of their services relating to order entry, trading, execution, routing and data.

**(d) Trading Fee Limitation**

The CSA have decided to maintain taking a principles-based approach and not set a specific trading fee cap. Set out below is a three pronged approach:

i) Proposed Provision: The Order Protection Rule prohibits a marketplace from imposing a term for the execution of an order that has the effect of discriminating between orders that are routed to that marketplace and orders that are entered on that marketplace.

ii) Current Requirements: require marketplaces to not unreasonably prohibit, condition or limit access to services offered by it, which includes factors such as:

- the value of the security traded,
- the amount of the fee charged relative to the value of the security traded,
- the amount of fees charged on other marketplaces, and
- with respect to market data fees, the amount of market data fees charged relative to the market share of the marketplace.

iii) Letter to Marketplaces: The CSA will be asking all marketplaces to explain and justify their current fees and fee models and will review for approval any changes made to their fees going forward.

**(e) Locked and Crossed Markets**

According to the CSA, the practice of intentionally locking or crossing the market may detract from market efficiency, lead to a perception of a lack of market integrity, and may create investor confusion. The Order Protection Rule prohibits a marketplace participant from intentionally locking or crossing a market by entering a

protected order to buy a security at the same price or higher than the best protected offer or entering a protected order to sell a security at the same price or lower than the best protected bid.

The CSA recognize that locked or crossed markets may occur unintentionally. An unintentional lock or cross could occur in the following circumstances:

- as a result of latency issues when a marketplace participant has routed multiple DAOs to a variety of marketplaces;
- when one of the marketplaces displaying an order that is involved in the lock or cross experienced a failure, malfunction or material delay of its systems, equipment or ability to disseminate marketplace data;
- when the order locking or crossing the market was entered when the market was already crossed; and
- when an order that is posted after all displayed liquidity has been executed against and a reserve order generated a new visible bid above the displayed offer, or a new offer below the displayed bid.

1. [http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule\\_20091113\\_21-101\\_new-noa-21-101and23-101.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20091113_21-101_new-noa-21-101and23-101.pdf)

2. UMIR 5.2 Best Price Obligation

(1) A Participant shall make reasonable efforts at the time of the execution of an order to ensure that:

(a) in the case of an offer, the order is executed at the best bid price; and

(b) in the case of a bid, the order is executed at the best ask price.

3. <http://www.iiroc.ca/English/ComplianceSurveillance/RuleBook/Pages/UMIR.aspx>

4. <http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=01241A15F3FE491ABD7CCE8F1CD40204&Language=en>

The Proposed Amendments would not impose the obligation to consider better-priced orders on a marketplace when a Participant executes a trade on behalf of:

- a non-Canadian account; or
- a Canadian account that is denominated in a foreign currency.

The Proposed Amendments would also limit the types of orders to which the obligation

would apply. The obligation to consider better-priced orders on a marketplace would only apply when a Participant was executing on a foreign organized regulated market an order that meets one of the following four conditions:

- is part of an intentional cross;
- is part of a pre-arranged trade;
- is for more than 50 standard trading units; or
- has a value of \$250,000 or more.

5. High Frequency Trading in Canada. What Does the Data Show? Alison Crosthwait, CFA, ITG Canada Corp. September 2009

6. Failure, Malfunction or Material Delay of Systems or Equipment or its Ability to Disseminate Marketplace Data

7. The bypass marker signals to the marketplace that the order routed to the marketplace should not execute against any hidden liquidity.

# The State of the Compliance Profession

*by Richard D. Marshall*

This entire conference is devoted to presentations about the regulators and the law. This one speech addresses a different topic, and one that should be of great interest to this audience – the state of the compliance profession. This is the one opportunity to talk about each of you, both your achievements and the challenges you face.

In brief summary, the state of the compliance profession reminds me of the introduction to Charles Dickens *A Tale of Two Cities*: “It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way.” In other words, the state of the compliance profession is in some ways good, in some ways bad, and in some ways uncertain.

## The Good

How is the state of the profession good? There are three important recent achievements of the compliance profession, of which all of you should be justly proud. First, the compliance profession has weathered the worst financial crisis since the Great Depression and has come through with flying colors. Trillions of dollars have been lost, major firms have either failed or been bailed out by the government, and tremendous dislocations have swept across the financial landscape. In spite of this, virtually none of these problems have been laid at the feet of the compliance profession. In fact, just the opposite is the case – the compliance profession is widely recognized as having prevented massive stresses and dislocations from leading to fraud.

This leads me to the second great achievement of the compliance profession – the widespread recognition of its achievements by regulators and legislators. There is no talk of weakening or eliminating compliance. Instead, the government is a committed ally and supporter of the profession.

A third achievement of the compliance profession, and a corollary to the first two achievements, is the greater recognition the profession has received from the investing public. This recognition has, in turn, caused business leaders to more fully recognize the value of compliance to the overall health of their businesses. For example, it is now common for a prospective client to examine the adequacy of a firm’s compliance program as part of the due diligence process. Because the clients have elevated the importance of compliance in their decision-making, the stature of the entire compliance profession has been elevated.

## The Bad

What, then, is the bad news? An important piece of bad news flows directly from the financial crisis, the fact that the financial service industry has been shrinking and is expected to shrink even more in the future. For example, assets managed by money managers declined by almost 25 percent last year. A report in the United Kingdom, the Turner Review, notes that over the last twenty years, the financial sector has grown more quickly than most other sectors and that this is not a sustainable trend. The implication of this observation is that the financial sector needs to shrink to align itself better with the overall economy.

As the financial sector shrinks, resources become more scarce for the participants in that sector. Revenue declines, which means that expenses must also decline to minimize reductions in profits. This means that compliance professionals will face ever declining budgets to perform

their essential role. Tough economic decisions have to be made in this resource constrained environment. Compliance professionals are more often called upon to be efficiency experts and budget wizards in this difficult environment.

Other challenges create business opportunities, but also greater burdens, for compliance professionals. These are technological innovation, globalization of markets and marketing, and continuous innovation by the wizards of Wall Street. While each of these challenges can create new and exciting opportunities for financial services firms, they create immediate and difficult challenges for compliance professionals.

Let us speak first of technological innovation. Every year, new methods of communicating are introduced, new systems for storing and analyzing data emerge, and new ways to automate previously manual functions are introduced. It was only a decade ago that email was viewed as an innovation and firms struggled with the challenges of email retention and surveillance. Those challenges continue, but to the mix have been added twitter, facebook, linkedin, and other computer tools. Email is now sent and received from Blackberries, cell phones, and other portable devices and facsimiles can be sent and received from the same devices. The general trend has been for data transmission and storage to become ever easier and cheaper. The problem this poses is that as more data is created and retained, it becomes more difficult to monitor this ever growing body of data. Two decades ago a firm might accumulate a few thousand paper records in a year. A decade ago, this had grown to a million emails; today, it may have grown to ten million messages. Coupled with this growth in data have been improvements in computerized analytic tools to study this data. These

**THE STATE OF COMPLIANCE***(Continued from page 19)*

new analytic tools, however, are often hard to understand and difficult to use. Increasingly, compliance professionals are expected to develop expertise in information technology. It is also common for inadequate resources to be devoted to the compliance burdens created by new technologies and the mountains of new data they generate.

Globalization poses similar burdens on compliance professionals. No more than a decade ago, many firms operated in only one country. All of their investments and trading occurred in that one country, all of their clients were there, and all of their offices were located in the same country. In this more simple world, one country's laws and regulations were all that a compliance professional needed to master. Today, this simple, one nation model has become the exception. Now, many compliance professionals need to study the laws of several countries and learn the techniques and styles of many foreign regulators. This is difficult because it increases exponentially the number of rules that a compliance professional must monitor. Equally important, compliance professionals must develop tools to keep up to date on developments in foreign countries and must learn the styles and tones of different foreign regulators. All of this is made more difficult by the need to master foreign languages, as well as time zone differences which often force compliance professionals to work during their leisure hours.

The final challenge and burden facing compliance professionals arises from continuous innovation on Wall Street by the so-called wizards of Wall Street. Twenty years ago, simple mortgage backed securities and a couple of simple derivative instruments were viewed as major Wall Street innovations. Today, complex new products are introduced regularly. Many of them are highly complex, based on sophisticated mathematical models that are difficult for layman to understand. Compliance professionals need to understand these products to do their

jobs, but this can be a daunting task. These products are hard to understand and continuous innovation forces the learning process to be repeated over and over, frequently with too little time to do the job properly. Again, compliance professionals can find their time and intellectual resources taxed to the limit simply keeping up with new financial products, with the slightest mistake potentially having the most dire consequences.

The Uncertain

Finally, how is the fate of the compliance profession uncertain? Two clear uncertainties exist. First, the compliance profession is a relatively young profession and is still defining its role and responsibilities. While it is clear what a doctor or lawyer is expected to do, it is less clear what a compliance professional is expected to do. In this more uncertain environment, there is a risk that the role of the compliance professional will be redefined in strange and harmful ways. For example, there is a debate in some circles about the role of compliance professionals in risk management. There is also a debate about whether compliance professionals have a general role in the promotion of ethics and, if so, how that role should be defined. There is also a debate about whether compliance professionals should be viewed as "insurers" that all relevant laws are being obeyed, so that if a violation occurs, the compliance professional should always be blamed. Each of these debates reflects a struggle to define the role of the compliance profession. The outcome of this debate will define the profession for the future.

Related to the debate about the role of the compliance profession is the debate about the role of the SEC's Office of Compliance Inspections and Examinations, or OCIE. That Division of the SEC is the primary regulator of the compliance profession in the same way that the Division of Trading and Markets regulates the brokerage industry and the Office of the Chief Accountant regulates the accounting profession. Today, OCIE is undergoing a critical self-examination. Major

changes have already been implemented and others are being discussed. To the extent that the organization, functions, and missions of OCIE are unsettled, the compliance profession is unsettled by reactions to these changes at OCIE. The most extreme possibility is that OCIE will be radically transformed, leaving the compliance profession with a far different regulator.

NSCP plays a critical role in addressing these major uncertainties confronting the compliance profession. Through its efforts to strengthen the compliance profession and to serve as its voice, NSCP is helping to shape the debate on both issues – helping to define the roles of the compliance professional and their regulator, OCIE.

In summary, there is much good news for the compliance profession, but there are also many new challenges and uncertainties. Perhaps the greatest challenge is the ongoing debate about the role and responsibilities of this relatively new profession. Together with NSCP, each compliance professional needs to play a role in this important debate, out of which will emerge a more mature and better defined compliance profession.

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## REGIONAL MEETINGS

Southern Regional Meeting :: Atlanta, GA :: Monday, February 22, 2010

West Coast Regional Meeting :: San Francisco, CA :: Monday, February 22, 2010

New England Regional Meeting :: Boston, MA :: Monday, March 22, 2010

Midwest Regional Meeting :: Chicago, IL :: Monday, April 12, 2010

Canadian Membership Meeting :: Toronto, ON :: Monday, May 3, 2010

East Coast Regional Meeting :: New York, NY :: Monday, June 7, 2010



## NATIONAL MEETING

Baltimore, MD

Monday, Nov. 1 - Wednesday, Nov. 3, 2010

Hilton Baltimore

## NSCP's Growing Role in the National Debate on Financial Services Reform

by David H. Lui

Thank you, Joan, for the work you've done over the course of your 22 year association with NSCP to forward the interests of the Compliance community. Those of us who know you and work with you, know that your commitment to NSCP is more than a professional obligation, your commitment is a labor of love, the fruit of which is the presence of all of us here today.

This afternoon, I'd like to focus on NSCP's growing role in the national debate on the reform of the Financial Services Community.

I was Chair of NSCP last year and am now the Chair of the NSCP Regulatory Affairs Committee. I was asked to speak here today because NSCP is on the cusp of reaching a **new** level in its development. A threshold of using its formidable membership base — and the large percentage of companies in the securities industry represented among its members — to start down the path of working to ensure that the Compliance Model represented in the SEC Compliance Rules is embraced as part of any revision of the regulatory framework of the financial services community.

In order to describe our activities on Capitol Hill, I'll start with a brief overview of the changes in the regulatory environment and then discuss how they affect the Compliance Profession. I'll transition to the actions NSCP has taken to affect the debate, and close with a discussion of what the future might hold.

America is on the threshold of historic changes in the way financial services regulators interact with financial services firms. Historic

changes which are the result of the most volatile year on Wall Street in our lifetime.

Who would have thought that with all the forces for change that existed last year:

- Huge failures among the pillars of the industry,
- Wholesale downgrades of large classes of securities,
- And a loss of liquidity throughout the financial services community which made valuation of individual securities difficult —

Even with all that, who would have thought that this year would have a bigger blow waiting still.

It's a story that conjures up black-and-white images, one that calls to mind men wearing 1920's straw hats and long lines outside of broker's offices. Few would have thought that in today's complex system of checks and balances, a \$50 billion Ponzi scheme could level the life savings of tens of thousands of people.

That a fraud could be masterminded by one of the most trusted figures in the industry, a former head of the NASD. A man whose brother and son served him as CCO and whose niece was his Compliance lawyer before she married their firm's SEC examiner. That was Madoff.

So this year found us on very unfamiliar and shaky ground, mired in what's been acknowledged to be the most profound economic dislocation since the great depression — a “great recession of 2009” — following on the heels of the only true financial panic which has occurred since the great crash.

In this context, all of us at last year's NSCP conference, which was held days before the election of Barack Obama, could discern the broad outlines of what could be expected in our industry. Secretary Paulson's White Paper, issued in June 2008,

provided the guideposts for what became Secretary Geithner's Plan for Regulatory Reform in the Financial Services Industry this year.

In Geithner's plan, Paulsen's three part approach was still clearly visible:

- Paulson's “Business Conduct Regulator” became Geithner's Consumer Financial Protection Agency.
- Paulson's “Prudential Regulator” was Geithner's National Banking Supervisor, and
- the “Market Stability Regulator,” always seen as a role for the Fed, was formalized with oversight authority given to regulate all subsidiaries of Tier 1 Financial Holding Companies, to maintain jurisdiction over *any* company which was deemed to be “too big to fail.”

But several important transitions also occurred.

First, what had been generally characterized as a financial services crisis, came to be characterized as a national *banking* crisis, with a trillion dollar infusion of capital into the Nation's largest banks. Hence, what Paulsen had viewed as the creation of a “Prudential Regulator,” reviewing the safety and soundness of firms throughout the financial services community became a National *Banking* Regulator in the Geithner proposal.

With this, the SEC dodged what might have been a lethal bullet, as it had been widely assumed that an SEC, significantly reduced in size and scope, was intended to fill the role of the “business conduct regulator.” That the SEC would become an anti-fraud agency for financial products, a type of “national blue sky regulator,” circumscribed from engaging in substantive regulation like the State Securities Regulators had been restricted by NISMIA in the 1990s.

But this recharacterization of the financial crisis as a *banking* crisis, more than anything else, gave the SEC

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some breathing space, space to pull its head above water — because in the face of a *banking* crisis, the SEC could find space to survive.

Working in the other direction was Madoff — throwing all our assumptions about the effectiveness of the SEC regulatory and examination program into question; and specifically calling into question whether the creation of OCIE in 1995 had been the right course. Notwithstanding this, all here will acknowledge that OCIE is clearly the governmental entity which best understands the importance of maintaining a strong culture of compliance at each firm, and has been a key factor to the success experienced by the Compliance Profession over the past six years.

In this confusion, all the ingredients for significant changes in our industry are present, and even if some of the most far reaching changes suggested since the collapse of Lehman and Bear Stearns are not implemented, it became clear to the Board of NSCP, in its role as the only dedicated representatives of the Compliance Community, that the voice of the Compliance Profession had to be made part of the debate to ensure that the success enjoyed by the Compliance Rules since their implementation in 2004 would not be unwound.

For many of us in this room, the Compliance Rules form the foundation of what makes the role of a Compliance Professional a worthwhile exercise. A rollback to days when the Compliance person often became a “designated fall guy” — either because he tried to impact an issue which was considered by management to be beyond the scope of the compliance function, or worse still, because he had failed to speak out for fear of the management response — was unthinkable.

So NSCP decided to act.

- Act to preserve our relationship to OCIE and the SEC.
- Act to ensure that policymakers understood the value of the Compliance mission as a means to emphasize ethics and cultures of Compliance from

within Wall Street firms

- And act to ensure that whatever the outcome of the current regulatory upheaval — the greatest since the early days of the Roosevelt Administration — the compliance model enshrined in the SEC Compliance Rules *would be part of* any solution enacted by Congress.

So — in the time since the release of the Paulson Whitepaper, NSCP has met with over 30 members of the House Financial Services Committee and the Senate Banking Committee, and their staffs, to underscore the fact that the work that *you* do — every day — in each of your firms — is some of the most important work being done in America to restore confidence in the ability of Wall Street firms to maintain compliance with Federal Securities Laws:

- It's work that you do which ensures that a discussion of the regulatory impact underlying of any business decision will be brought to the table;
- It's work that you do which ensures that all levels of management at our firms understand that the Compliance Reports which we are required to draft will bring our mutual fund boards and senior management into processes where otherwise a more expedient path might be chosen;
- And it's work that you do that allows firms to be stronger by developing structures from within that protect the hard won reputation of our industry while allowing for a smaller and less intrusive government. It has fostered the development of a Compliance Profession, which has (as far as we can tell) over twenty thousand practitioners, rather than an SEC with 20,000 new examiners, which — even if they could be funded — would be nowhere near as effective as the work we do from within.

So, with this backdrop, NSCP delegations went to Washington to emphasize the need to make Compliance part of any revision to the regulatory structure — the need to ensure that *any* change in the SEC's

jurisdiction didn't call into question the gains made in the Compliance world in the past five years since the passage of the Compliance Rules.

We went from office to office — though the corridors of Russell, Hart, Longworth & Cannon — Visiting as many members of the House and Senate Oversight Committees as we could in the short time we had available. Because unlike some of the mammoth industry trade groups resident in Washington, NSCP has no permanent Washington delegation — so we had to rely on members who had the time and inclination to fly to Washington and take a day or two away from their day jobs.

And so, with that huge challenge, and those scant resources, what happened?

Well, first we found that each of our meetings had very similar themes. Policymakers were genuinely very interested in our message. A very large proportion of the offices that we sent letters to requesting meetings responded to our letters and granted our requests.

In those meetings, time and time again, when we were unable to schedule time with the Congressman personally, we were very pleasantly surprised to find that the Congressman unexpectedly decided to join his staff in meeting with us. Given the importance of our message regarding Compliance as a vehicle to develop controls from within Wall Street firms, it's not hard to understand why.

In our meetings, we consistently delivered the message developed by our Regulatory Affairs Committee and NSCP Board of Directors.

- We introduced the Congressman to NSCP, and explained how the SEC had required Broker Dealers, Investment Advisers and Mutual Funds to have CCOs with oversight responsibilities for reasonably designed procedures, unique to each firm, that were both adequate and effective to prevent, detect and correct violations of federal securities laws;

**NSCP'S ROLE IN REFORM***(Continued from page 23)*

- We discussed how the CCO has responsibility to include material compliance matters in an Annual Report delivered to senior management and a mutual fund board of trustees, and how this Report was accessible to SEC examiners;
- We discussed how the SEC rules made it illegal to exert “undue influence” on a CCO in the discharge of his or her duties;
- We discussed how the enactment of the new SEC rules had brought upwards of 20,000 compliance professionals into the securities industry and how these individuals had come to be viewed as a force for reform from within; and
- We discussed how the new Compliance requirements were seen by management at the overwhelming number of firms as providing an important second line of defense against issues which could tarnish the reputation of firms which had taken lifetimes to build.

And all the time, the Senators and Members of Congress who we met with listened intently. More often than not, even in light of months of debate on issues of regulatory reform, *virtually none* of the Representatives that we met with had been introduced to the Compliance function. Few knew what Compliance was, or understood its importance to the development of internal controls.

More often than not, the individuals we spoke to thought the notion of having a “compliance” function was just plain common sense, and wondered aloud why it would require SEC rulemaking to mandate the existence of a Chief Compliance Officer who had a mandatory connection and reporting responsibilities to senior management.

But as we discussed —

- The importance of having a focus on the development of ethical culture from within;
- The impact of enhanced compliance

controls versus merely increasing the number of SEC examiners; and

- The extreme increase to the cost to the government to achieve the same result without a Compliance Program —

**And they got it and their response was a response that knocked us flat.**

Instead of debating the merits, discussing the various constituencies which would be affected, asking for more information, or even telling us that they needed to digest what we had to say, several key members reflexively offered up the “secret handshake” that legislators use when they agree with something you’ve said,

And the question they asked was simple and disarming: “do you have text?”

“Text?” we asked.

“Yes, something ... we could include in a Bill.”

<PAUSE!>

Well — needless to say, that caused a flurry of activity among the people on the NSCP Regulatory Affairs Committee, the Board of NSCP, and others who’ve been active in the NSCP network over the years. It also caused some soul-searching to understand what was important to us in terms of a legislative agenda for the Compliance Profession. Here’s what we came up with:

We were split as to whether many of the proposals in the form expressed in the Geithner plan were the right direction for the industry. Some supported the consolidation of regulatory authority while others opposed it. Likewise, we found that while some Compliance people strongly supported the notion of an Investment Adviser Self-Regulatory Organization, others opposed it just as strongly.

But there were some issues where we found strong consensus.

There was almost universal support for OCIE’s role in fostering the emergence of Compliance as a profession. The positive impact which their emphasis on compliance had on

improving the culture of compliance at each firm was reflected in the improved SEC examination results throughout the industry. The Board’s view was clearly that OCIE’s investment in our industry had borne fruit and the benefits gained by that relationship must not be lost.

Likewise, while we could not gain a consensus for any of the regulatory proposals on the table in the Geithner plan, there was unanimous support for the fact that, should any of the proposals be implemented, Compliance must be made part of the new regulatory scheme.

Our sense was that had the 1934 Act, the Adviser’s Act or the Investment Company Act been drafted today, the provisions of Rule 38a-1, 206(4)-7 and Rule 3010 & 3013 would have risen to the level of being incorporated into statute. So, in drafting text for any potential statute coming out of the reform proposals for the financial services industry, we used each of these rules, as well as the Federal Sentencing Guidelines, to formulate a model statute to support the inclusion of Compliance as part of any reformed regulatory regime.

The elements we included in our model text will be very familiar to you:

- A CCO
- Who has oversight responsibility for procedures tailored to the business model of a firm
- Procedures which are reasonably designed to prevent, detect and correct violations of the act to which it relates.
- An annual report detailing any known material compliance matter
- The use of training programs to help assure the development of a culture of compliance
- And the prohibition against exerting “undue influence” which prevents a CCO from fulfilling his or her statutory obligations.

Of course, as you might suspect, this formula was completely unknown to the members of Congress with whom we met.

A draft of the text, as requested by the Congressmen we met with, was

just sent out in early September at the conclusion of the Congressional recess. A copy of it is on the NSCP website if you'd like to take a look at the exact wording that our Regulatory Affairs Committee developed.

In discussing this, though, you should know that we wouldn't have been able to pull it together, but for the hard work of three key members of our team. The creativity of Chuck Senatore, who crafted our approach and drafted our powerpoint presentation to the legislators; the commitment of David Porteous, whose follow through and stamina was the force that made our Washington trip come together; and the intellectual power of Rick Marshall, whose understanding of statutory construction was our secret weapon in drafting the Model text. I owe each of them, as well as all the members of the NSCP Regulatory Affairs Committee, a debt of gratitude.

Soon, as the debate over healthcare yields to a renewed discussion of financial reform, we'll return to Washington to emphasize the Compliance perspective further. In addition, we're starting the work of coordinating with other representatives in the securities industry to ensure that the perspective of Compliance Professionals is a perspective that receives their endorsement as well.

This is new ground for NSCP: ground that in the coming years will grow richer and more important. Each of us, over the past six years has been present at the birth of a new profession. In that, each of us can rightfully claim to have been a pioneer of the world that will be the foundation for the reforms that will play out over the next 18 months.

And after that, issues related to the relationship between Compliance and Risk Management, and the utility of the Model offered by the Compliance Rules as a mechanism to formalize the role of the Chief Risk Officer will probably come into clear focus. This question of whether a CRO can serve as a conduit of information to management and regulators regarding

Material Risk Exposures, especially in firms that are "too big to fail," will have a prominent place in the debate over the next decade. NSCP will need to play a role there too.

But no matter how these issues develop, the voice of the Compliance Profession must be part of that debate going forward.

All of us know that life in the Compliance Profession can be a mixed bag. There are days when each of us feel like Compliance work is the least meaningful work on earth. Days when it seems like no one at all is listening.

But whenever I take a step back and view the larger landscape, I know that the work I do is the work of protecting the hard won assets and retirement dreams of tens of thousands of people. It is the work of ensuring that an ethical perspective is always a part of the discussion and the work of ensuring that business goals are attained in a way that creates the least regulatory exposure possible.

And in this vein, you can be proud of the impact of your membership in NSCP and what that membership has done to create a compliance profession that emphasizes ethical controls from within each of our firms.

I used to work for a man at the beginning of my career who from time to time offered me a warning as he mentored me, he cautioned me with a strange but loving admonition calling my attention to the fact that there were no "old" compliance people.

Especially at its upper echelon, he said, Compliance was a perennially young profession — because at some point in every person's career as CCO, some issue would arise which would make it impossible to continue to hold the role with dignity, and force that person to leave their job.

He told me that, in training me, the true opportunity would ultimately focus on becoming an expert witness or in consulting to whoever the current CCO might be. That was the path for most — and I found that vision of my future chilling.

NSCP is committed to seeing:

- That we are effective as a profession;
- That we have the opportunity to use our roles in the financial services arena as a force for good; and
- That our energy is expended for the promotion of an ethical culture in a corporate context.

If you support these goals, the Board and Staff of NSCP will work tirelessly on your behalf so that, if you decide to stick with Compliance until you retire, you can become a member of the first generation of **old** compliance people and you'll retire knowing that your work had a larger meaning.

Thank you.

## Dark Marketplaces in the Canadian Equity Market – An Overview

*by Alison Crosthwait*

In the third quarter of 2009, 19% of Canadian equity trading occurred on a venue other than the TSX. The fragmentation of equity trading has encouraged competition in trading fees and trading technology. Most of the trading on Alternative Trading Systems (ATSs) occurs on venues set up to look much like the TSX. We call these “light” or “displayed” venues. Light alternative venues in Canada include Alpha, Chi-X Canada, Omega, and Pure. Market share by light venue in Q3 was as follows:

Alpha	14.02%
Chi-X Canada	3.65%
Omega	0.04%
Pure	1.00%

Alpha is owned by a consortium which includes the bank-owned dealers. It is structured almost exactly like the TSX. Chi-X is owned by Instinet and is all-anonymous with pure price-time priority. Omega ATS is an independent ATS which has struggled to gain a foothold in the Canadian marketplace despite an innovative pricing structure. Pure Trading is owned by CNQ and was the first light competitor to the TSX. It focuses on small cap and venture names but its market share has dwindled in the past couple of quarters. The light venues compete for liquidity on price, technology, and functionality. As Electronic Liquidity Providers (ELPs) have entered the Canadian marketplace over the past year, dealers have seen their trading fees rise as they are forced to cross the spread more often and pay what is known as the “active trading fee.” Typically, the active side pays a fee, while the passive side receives a rebate. This has increased the importance of fees in the competition between light venues. Dark markets are structured quite differently and compete on functionality and structure as much as on fees.

Dark markets, also known as

“dark pools” or “non-displayed venues” are equity trading vehicles that have garnered media attention lately. Canadian equity markets have fragmented in the past three years. Traditionally, equity trading was done on the phone with brokers working trades and matching blocks between customers. As Canadian equities have become internationally held and electronic trading has emerged, sources of liquidity have become fragmented and the availability of electronic trading venues to execute larger blocks of stock has become an important source of liquidity. In September 2009, 21% of Canadian equity trading volume occurred on a venue other than the Toronto Stock Exchange. Dark markets are a type of alternative trading system (ATS) that has emerged in response to these structural changes.

What does it mean to trade in the dark? Dark marketplaces are trading venues that are alternatives to displayed markets such as the Toronto Stock Exchange. The structure of dark marketplaces is quite different from that of displayed markets, however. On a displayed market, bids and offers are visible. You make your decision to place an order with knowledge of the current set of outstanding orders placed by other traders. In a dark market, you send an order without prior knowledge of the other orders on the dark market. You do not know whether your order will result in a transaction immediately and your order does not broadcast information to other market participants. Most dark trades take place within the context of the displayed market quote so you have price protection within the prevailing market. Thus dark markets allow one to post large bids and offers without broadcasting size or side information to the rest of the market while being protected with respect to price within the current market quotation for the security. Dark markets are an attractive option for trading the large blocks of stock traditionally handled by upstairs block

trading. There are two dark markets in Canada: Liquidnet and MATCH Now. CHI-x Canada is a displayed market which has a hidden order type which can also be considered dark trading.

MATCH Now is operated by TriAct Canada Marketplace, a subsidiary of ITG Canada. Liquidnet Canada is a dark pool operator owned by the U.S.-based firm, Liquidnet. Between the two, MATCH Now has an average market share of over 90% in volume and value of all dark market trading between June and September of 2009. In total, dark markets are a small but rising component of the Canadian equity market, trading an average of 1.03% market share in volume and 1.36% in value in the 3 months between June and September of 2009 (Figure 1). The average daily volume of Canadian dark market trading is 5.8 million shares over the same period.

### **Liquidnet Canada**

Liquidnet Canada is open to buy-side participants only. Liquidnet integrates with the Order Management System of the buy-side trader, allowing the system to interact with their order flow and alerting traders to possible matches with other Liquidnet clients. Size and price is negotiated once an offsetting order is found. Many American and European institutions already have Liquidnet technology integrated with their OMSs, facilitating ease of use in Canada. However, Liquidnet’s volume in Canada has leveled off in recent months and its market share is declining as MATCH Now grows at a faster pace.

*See Figure 1.*

### **MATCH Now**

MATCH Now is a dark marketplace accessed through broker-dealers where orders are entered and crossed with offsetting orders as they arrive. There are two types of orders that participate in the market:

- Liquidity providing orders sit passively in MATCH Now. These orders cannot be seen by other market participants.

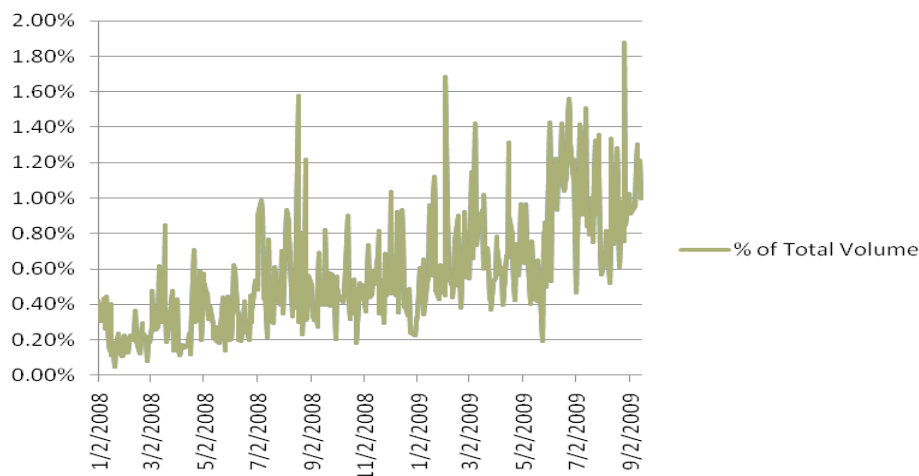


Figure 1. Daily Volume of Dark Market as % of Total Market Volume

- Market-flow orders pass through MATCH Now and matches are executed against a contra-side liquidity providing order at a price within the National Best Bid/Offer (NBBO). The NBBO is the best bid and the best offer available considering all Canadian marketplaces where the security is traded. If a market flow order does not trade on MATCH Now, the broker's router re-routes the order to a displayed marketplace.

At regular intervals (approximately 5 seconds starting November 2009), liquidity providing orders are matched amongst themselves. When a liquidity providing order trades with another liquidity providing order, the trade occurs at the midpoint of the NBBO. When a liquidity providing order matches with a market flow order, 80% of the NBBO spread goes to the liquidity provider and the 20% (up to a maximum of \$0.01) goes to the market flow order. Figure 2 illustrates this with an example. With the exception of locked or crossed markets, (when the bid is equal to or

greater than the ask) all MATCH Now trade receive price improvement versus the NBBO.

MATCH Now has been growing steadily since its launch in July 2007. Almost every day more than 15 names trade over 10% of their Canadian volume on MATCH Now. In September, MATCH Now traded 0.86% of Canadian equity trading, or 115.6 million shares. **See Figure 2.**

#### Chi-X Canada

Chi-X Canada is a displayed marketplace which traded 4% of Canadian equity trading volume in September 2009. One of the features of their marketplace is the hidden order type. Hidden orders are placed on the exchange and interact with all the flow going to that marketplace. Thus the hidden order is similar to a dark order in that the orders are invisible to market players until trades are executed against them. These orders are protected within the displayed book of Chi-X Canada. In September, 10.4% of Chi-x Canada's

volume (55.5 million shares) was trades in hidden orders. This represents 0.4% of market share in Canadian equity trading.

#### Advantages of Dark Pools

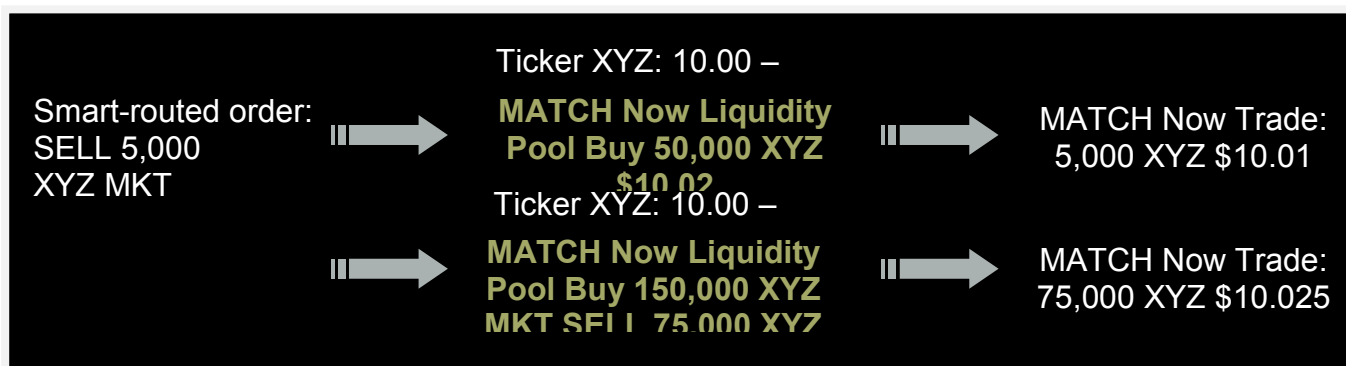
Dark pools offer numerous advantages to equity traders. Large blocks of stock can be placed in the hidden book without fear of moving the market. With MATCH Now, active orders receive the opportunity to seek out liquidity and price improvement before entering displayed markets. Retail orders come through MATCH Now on their way to another transparent market to take advantage of potential price improvements. Immediate or Cancel (IOC) orders can sweep Chi-x looking for hidden liquidity. For institutional investors, both Chi-X and MATCH Now are broker neutral, providing them with full control of the distribution of commission. This complements Direct Market Access (DMA), allowing clients to control their orders themselves.

#### Anti-Gaming

The biggest concern with dark markets, which is also relevant to displayed markets, is the possibility of gaming. Algorithms used by institutional traders need to employ anti-gaming logic which reacts to unexplained short term price movements and protects traders from predatory market players. Users can place minimum fill conditions on orders sent directly to dark pools. Hence, if a trader tries to "ping" or infer the content of the book by sending in a small order, he cannot infer for certain that there isn't any liquidity on the book when his order doesn't fill. There may be plenty of liquidity on the book but

Figure 2: Example: Price Improvement in MATCH Now

(Continued on page 28)



**DARK MARKETPLACES***(Continued from page 27)*

with conditions that his order doesn't meet. Furthermore, all orders can be tagged "anonymous," to protect broker identity even after the trade has been printed. In general, all orders sent to any market place should have limits to ensure price protection.

**The U.S. Case**

Since Canada's dark marketplace has a very short history, it is worthwhile to examine how it differs from the American dark marketplace, which is more mature. Also note that many of the largest Canadian names are also listed in the U.S. and thus can also be traded in U.S. dark pools, so it is important for Canadian traders to understand U.S. market structure. There are more than 40 dark pool venues in the U.S. and they vary greatly by ownership and trading structure. Internalization pools are operated by bulge bracket firms to match up the order flows within the firm, providing the firms with more control over their flow. Ping destinations are operated by hedge funds or electronic market makers. Ping destinations accept Immediate or Cancel (IOC) orders which interact with the operator's flow. Exchange pools are operated by exchanges and include hidden order types embedded in an existing displayed market such as those on Chi-X Canada.

The main advantage of such an arrangement is to attract more liquidity to the exchange. Consortium based pools are operated by a group of institutions and serve as a back-up liquidity pool after checking the institution's own internalization pool. As the U.S. case shows, Canada is just beginning its evolution with respect to dark pools. While we clearly cannot support 40 dark venues, the marketplace is likely to see the advent of internalization pools and more widespread use of hidden order types in the years to come. An important note of differentiation: in Canada, trades in the dark are printed to the tape and available on data vendors such as Bloomberg. In the U.S., trades are reported but not attributed to venues so one cannot tell where the trade occurred. This difference leads to a disparity in the

level of transparency between the two marketplaces and impacts the ability to do analysis on execution quality in the U.S. versus Canada.

**Conclusion**

Canadian dark markets are developing quickly as a viable supplement to displayed markets for firms seeking liquidity. Due to their anonymity, dark markets are an invaluable tool for the trading community in today's highly fragmented market, allowing traders to combat price impact. As the Canadian marketplace matures further, we are likely to see new venues develop as well as new order types on existing venues. Dark pools are an important source of liquidity in increasingly fragmented and electronic markets.

1. Mittal, Hitesh. "Are You Playing in a Toxic Dark Pool? A Guide to Preventing Information Leakage."

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# 2009 NSCP

## NATIONAL MEMBERSHIP MEETING



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### **2009 National Meeting Materials Workbook and CD**

The Workbook/CD combination contains all the printed and supplementary information materials from our 2009 National Meeting. The CD is searchable and fully-indexed: materials are in PDF format. This information is a valuable addition to your reference library, one that you'll refer to repeatedly.

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- Conflicts of interest management strategies
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- Case analysis for testing the design, implementation, execution and review of specific compliance calendars and checklists
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# 2009 NSCP

## NATIONAL MEMBERSHIP MEETING

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