

# DUQUESNE BUSINESS LAW JOURNAL

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# ORGANIC COMPLIANCE . . . DOING MORE WITH LESS

*Elizabeth Horrigan Rathz\**

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## INTRODUCTION

The risk management capabilities of a financial services management team have always been a game changer for shareholders, clients, and employees. For regulated entities, timely and perceptive identification of regulatory and reputational risk contributes to improved productivity and a greater return on capital investment over the long run. As business processes remain compliant, the firm’s reputation stays intact. In retrospect, it is apparent that the events leading up to (and through) the Great Recession of 2007–2009 have common risk tendencies, the most notable among them being the absence of timely and perceptive risk identification.

This article will explore the concept of *organic compliance* as an affordable and efficient refinement to the risk management capabilities of regulated financial entities. Organic compliance is the harness and leverage of internal professional observation, insight, and expe-

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rience to minimize the regulated entity's risk of regulatory and/or reputation compromise. With moderate adjustment to managerial orientation, timely and perceptive compliance risk *identification* can represent both fruitful and sustainable elements of the firm's compliance regimen. The primary elements of a successful organic compliance initiative are generally "shovel ready" to provide a much needed force multiplier for compliance professionals working with limited compliance resources in an increasingly regulated financial services industry that continues to experience profit margin compression and declining fee revenue.

Risk management failures evident in the recent financial meltdown will provide an appropriate context for this discussion whereby organic compliance is introduced as an essential risk management tool. Compliance scenarios derived from the author's compliance consulting practice will provide additional perspectives for the application of organic compliance principles and processes. Finally, discussion will focus on a discrete set of action steps for regulated financial entities to harness organic resources in an effort to strengthen risk management capabilities.

### 1. *Volatility Tells the Story*

For nearly two decades, the Chicago Board Options Exchange Volatility Index (VIX) has measured investors' expectations of volatility in the capital markets by tracking option prices of bonds, equities, and commodities. An option price is comprised of the intrinsic or embedded value of the option (starting at \$0) as measured by the underlying security as well as the risk associated with the time value of the option, i.e., the likelihood that the option will be exercised before or at the expiration date. It is this latter value which the VIX has reliably tracked and which in the autumn of 2007 began a spectacular ascent to levels, heretofore, limited to fictional portrayals of high finance.

The unprecedented and sustained spike in market volatility, as portrayed by the VIX since early 2007, clearly conveyed the overwhelming sentiment that the majority of market participants did not anticipate the waves of systemic risk that enveloped the financial services industry. In February 2007, the VIX posted a recent low closing print of 9.98, while by October 2008 it had posted an unprecedented

800% rise to a record-setting reading of 89.53.<sup>1</sup> After finishing 2008 at the 40 mark, volatility has been slowly declining throughout 2009, with the VIX closing on July 1, 2009, at 26.22.<sup>2</sup> In the wake of this period of sustained high volatility, shareholders, clients, and regulators alike have been compelled to demand change in the risk management attributes of the regulated financial services industry.

Why were the compliance risk management policies and resources of large multinational banks, broker-dealers, and investment advisers substantially incapable of navigating this period? Partly, these consequences may be ascribed to the hubris of some financial firms as they reportedly ignored regulatory concerns registered at the time regarding risk management. Indeed one firm was rumored to have knowingly and repeatedly violated its Value at Risk thresholds during the crash, which if true, would represent a significant compliance failure. However, hubris notwithstanding, many observers believe that the risk management attributes of institutions simply were not capable of identifying and managing compliance risk.

## 2. *The Calm Before the 2008 Storm*

The compliance risk embedded in the U.S. financial services business model circa 2008 was largely a function of the products offered by the enterprise, the client markets served, and of course the financial leverage the enterprise introduced onto its balance sheet. In this regard, the business models employed by banks, brokers, investment advisers, and hedge funds in the domestic financial marketplace were relatively diverse in the “deregulated” pre-crash era. However, the fact remains that with one notable exception, and despite significant deregulation in 1999,<sup>3</sup> they all retained a substantial element of oversight by their functional regulator.

The regulatory exception of course being the hedge fund industry which had circumvented mandatory Securities and Exchange Commission (SEC) oversight in 2006 when the Court of Appeals for the District of Columbia reversed the Commission’s decision which had given the SEC the power to regulate hedge funds.<sup>4</sup> Ironically, today

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1. CBOE.com, VIX Historical Data, <http://www.cboe.com/micro/vix/historical.aspx> (last visited July 2, 2009).

2. *Id.*

3. See generally Gramm-Leach-Bliley Act, 15 U.S.C. §§ 6801-6809 (1999).

4. Goldstein v. SEC, 451 F.3d 873, 883 (D.C. Cir. 2006).

the hedge fund industry continues to be perceived by many as the least culpable element of the financial meltdown of 2008 despite their lack of regulatory oversight during recent market turmoil. Some observers opine that this is due in no small measure to the associated risk management attributes of the industry.

Indeed by 2004 the regulated financial services industry in aggregate as comprised of brokers, advisers, and banks was required to develop and administer compliance policies which were designed to keep firms and their employees in compliance with federal securities laws. This then begs two questions: (1) Are regulated financial services entities under-regulated? (2) Alternatively, is the compliance risk management process in need of a more introspective reassessment regarding a firm's capability to identify compliance risk?

Clearly, the United States Congress and the Administration have responded with a resounding "yea" to the first question as new regulations and perhaps even new regulators are about to be introduced to the capital markets. The nature and magnitude of losses realized during this macroeconomic event preordained that at least part of the response to this historic event would be politically inspired and substantially out of the control of private sector interests.

The second scenario—effective compliance risk management capability attained by way of the development and maneuvering of in-house compliance resources to manage risk—is well within the execution capabilities and regulatory mandate of financial entities.

### 3. *Compliance Risk Management*

Risk as a general principle is not exceptional. Risk is not a dirty four-letter word, nor is it a private sector disease to be eradicated from financial enterprise by a super regulator. It is inevitable in business, governance, and everyday life. Risk is something that must be *identified* and then *managed* in the appropriate context. The compliance risk set of a particular firm is comprised of both homogenous and unique regulatory and reputational risks. Homogenous risk is shared by nearly all financial entities, and in aggregate is a function of the macro-regulatory scheme of the country in which the firm conducts business. This generally refers to the level of oversight responsibilities ceded to the various functional regulators and the manner in which they exercise their authority over regulated entities. The unique risk set is derived primarily by the manner in which the firm's employees react to regulatory authority with regard to markets, products,

clients, and other key constituencies including regulators and key service partners.

The coincidence of recent macroeconomic events and the fact that all regulated entities have had many years to develop and implement compliance policies retaining effective risk identification and management attributes suggests that there is a glitch in the implementation of compliance risk processes for many firms. How then are entities to best identify and manage risk in the regulated financial enterprise with finite compliance assets in what is certain to become a more stringent regulatory environment? Organic compliance is a great place to start. For the regulated entity, the organic compliance process can be the much needed force multiplier for limited compliance resources.

#### 4. *Organic Compliance 101 . . . The Art of the Science*

Regulatory compliance relies on the constant supervision and management of employees and products associated with the regulated enterprise. Were one to categorize organic compliance as a field of academic study it would assuredly be classified as equal parts art and science. Informed observation is an essential and valued scientific tool used in every aspect of all known scientific study and development. Likewise, organic compliance requires informed human observation to be focused on employee interaction with core processes pertaining to the firm's business plan, e.g., products, markets, clients, and other key constituencies.

In a sense, organic compliance derives from the science of systems theory. The foundation of systems theory is that the components of an organization are interrelated, and that changing one variable may potentially impact many others. A central theme of systems theory is that nonlinear relationships might exist between variables, meaning that small changes in one variable can cause huge changes in another.<sup>5</sup> Timely and perceptive detection of change is a precondition for sound risk identification and management. Organic compliance attains this attribute through structured collaborative input by experienced professionals throughout the regulated enterprise.

Line of business managers and other key personnel must be appropriately skilled in the compliance regimen of the firm. This

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5. David S. Walonick, *Organizational Theory and Behavior*, <http://www.survey-software-solutions.com/walonick/organizational-theory.htm> (last visited July 2, 2009).

process itself is a significant undertaking to the extent that the objective is to develop de facto compliance risk managers who are highly conversant with the firm's compliance policy and procedure and have a sound awareness of its intersection with their particular corner of the firm's business plan. Collaboration between the Chief Compliance Officer (CCO) and these risk agents develops informed and diversified observation while concomitantly reinforcing the mandate to independently develop and maneuver compliance resources as needed pursuant to the firm's risk mapping protocol.

Informed observation is crucial in the development and testing of the internal controls which are essential to a risk-based compliance regimen. In the words of SEC Commissioner Troy Paredes: "Effective compliance oversight is not a science that can be learned from a textbook. There is, in other words, no single blueprint for assessing risk or otherwise ascertaining compliance. Rather, ensuring compliance is in part an art that benefits from the kind of in-the-trenches know-how that experienced . . . professionals uniquely offer."<sup>6</sup>

### 5. *Organic Compliance Applied*

Organic compliance complements existing compliance technology through the incorporation of informed human scrutiny into various testing protocols. For example, line of business input regarding a substantial increase in step-out trading for illiquid securities would prompt a targeted sampling approach to transactional testing of best trade execution. Promoting collaborative input from line of business and other qualified sources is an essential element in soliciting informed observation particularly where complex interactions may occur, e.g., trade execution, product development, and client marketing. Organically engineered internal control and testing protocol will substantially fortify the ongoing relevance of the firm's compliance policy and implementing tools; both are essential attributes of a risk-based compliance regimen.

To the extent that effective compliance is achieved when employees do the right thing (execute policy) at the appropriate time (follow procedure), organic compliance seeks to refine the compliance corollary by forcibly introducing an element of proactive engagement in the policy and procedure mix. A firm implementing a proactive

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6. Troy A. Paredes, Comm'r, SEC, Remarks at the CCO Outreach BD National Seminar in Washington, D.C. (Mar. 10, 2009).

mindset would place a very high priority on the early identification of compliance risks, no matter how small.

Consider the scenario wherein the Chief Investment Officer initiates a seldom utilized covered call writing program to limit client portfolio losses and does so in accordance with existing policy and procedure. Timely communication of the hedging program by the investment management committee should prompt the CCO to review eligible client suitability and disclosure documentation and by extension ensure that best execution testing protocol is sufficient to include options trading processes and counterparties. By virtue of the initiated document review and/or testing protocol, the compliance process assimilates exceptional activity in the business process and renders compliant, vulnerable, or deficient status upon the underlying compliance policy and procedure.

Organic input must be solicited enterprise-wide to include marketing, staff support, trading, and investment personnel. Certain aspects of regulatory compliance involve a highly granular process whereby operational nuances of the firm may be identified for particular scrutiny due to the perceived risk associated with them. For example, a firm with an aggressive personal trading policy may be perceived to be at risk due to *potential* conflicts of interest. Assume that the firm's compliance testing revealed that related firm accounts (those managed for the benefit of employees) recently benefited from a trade management error. The red flag posted by the trade management error directly correlates to the risk-type associated with the personal trading policy, i.e., the prohibited practice of front running. Upon receiving notice of the trade management error and initiating a compliance investigation into the origin, resolution, and disclosure of the error, organic compliance might compel the CCO to perform an unscheduled review of personal trading activity occurring during the same period, reconciling compliance trading pre-approval with employee brokerage statements.

In both examples cited above, risk management as implemented organically incites compliance personnel to adapt testing and review protocol in response to internal business developments and identified problems.

## 6. *The "Organic" CCO is the Constant Gardener*

At its heart, organic compliance represents innovation. A risk-based compliance regimen requires that internal controls and testing

protocol remain relevant to both the business model and the regulatory scheme. The organic CCO is a constant gardener whereby in-house peer-to-peer relationships are established and nourished while interrelated compliance risk-types unique to the firm are continuously identified, evaluated, and managed.

The following considerations are essential when instituting the organic compliance process into the firm's compliance regimen.

#### A. *Alignment*

The mandate of the CCO and compliance professionals must be routinely overlaid with the business plan of the enterprise. It is imperative that compliance personnel have a thorough understanding of the business model. This includes fluency in the product and service offerings of the enterprise, an understanding of the relevant financial/constituent markets, and an ongoing appreciation of real and potential conflicts of interest. The CCO must be watchful for changes in the business model which may significantly marginalize the relevance of the compliance program while designated de facto risk agents at all levels of the enterprise must understand compliance with a particular focus upon its relevance to their role in executing the firm's business plan.

#### B. *Credibility*

The regulated enterprise must ensure that ongoing compliance assets remain credible and relevant. This is realized through:

- solicitation of risk assessment input from line of business or staff professionals (risk agents) to ensure that internal controls and other elements of the compliance risk management apparatus remain relevant;
- implementation of ongoing compliance personnel and risk agent education and performance evaluation systems (e.g., compliance quality assurance reviews) to ensure visibility of compliance personnel and effective compliance administration and innovation; and
- development of a separate non-reporting CCO line of communication to the CEO and designated risk agents throughout the enterprise.



### *C. Best Practices*

Rules and regulations cannot possibly cover every situation and circumstance fraught with compliance risk. The noted Austrian economist Friedrich von Hayek believed that the surest way to stifle innovation was to adapt best practices and convert them into rigid requirements.<sup>7</sup> Best practices, nonetheless, often represent proven, prudent, and efficient activities which promote innovation while retaining the salient aspects of those principles from which they were derived. The organic compliance process relies heavily upon collaborative CCO engagement with key personnel in a structured, continuous manner. This engagement underlies the ongoing effort to ensure that internal control design and testing protocol remains innovative, relevant, and effective. Informed implementation of best practices can contribute to a culture of compliance.

Here are some best practices to consider:

- **Insist on Open Communication** – Ensure that employees are capable of identifying and communicating compliance risk. Process and discipline are vital attributes of any financial service firm. Failure to communicate problems and emerging risks dilutes corporate accountability at a time when the regulated enterprise can least afford its absence.
- **Follow the Money** – Significant revenue streams warrant heightened scrutiny due to the increased potential for conflicts of interest to arise. The bedrock of the financial regulatory scheme has been, and surely will continue to be, the assurance that investors and other financial service consumers are dealt with fairly and that all conflicts of interest are identified, managed, and fully disclosed. Conflicts of interest tend to lurk where the greatest revenue flows.
- **Beware of Exception Processing** – Compliance exceptions are not that unusual; however, it is their recurring nature that may present the most significant threat to the compliance culture if exceptions are routinely processed through the mainstream policy and procedure apparatus of the enterprise. Compliance exceptions should be handled rigorously from identification to remediation in a fully documented manner.

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7. GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 31 (2009).

- Apply the 80/20 Rule – It is not unusual for 80% of a key business metric to be correlated with 20% of firm counterparties, line of business units, or third parties. For example, 80% of trading volume may be transacted with 20% of the firm's counterparties, or 80% of client referrals originated from 20% of the firm's service partners, etc. The ratio is not inherently problematic but does warrant scrutiny in light of the potential to exacerbate conflicts of interest and other regulatory events such as transactional concentrations (e.g., AML, best execution) or trade allocation (performance dispersion metrics).

- Mix it Up – “And yet not choice but habit rules the unreflecting herd,” according to William Wordsworth.<sup>8</sup> It behooves the regulated enterprise to update and refine audit tools and testing techniques by occasionally utilizing manual oversight of automated compliance functions as well as periodic, forensic, and transactional test types of varying frequency and sample size. It is difficult to obfuscate anomalies, vulnerabilities, and deficiencies when the audit process is varied in format and timing.

- Know the Hot Spots – Regulators rely on the advertisement of hot topics and current examination findings to provide immediate regulatory input on various widely adopted business practices which are deemed to be exposed to heightened risk or systemic abuse. The SEC utilizes the *CCOutreach* forum to publicize areas of enhanced scrutiny with the intention that firms will adopt an internal vigilance toward eradicating significant risks.<sup>9</sup> Use the regulatory ping to your best advantage.

- Gut Check – Human instinct should hold a prominent place in the risk management process. Are test results too good? Are compliance query respondents consistently under-providing information required for effective documentation to the exceptional event cycle? Are trade and client records too clean? Is investment performance, commission income, or revenue growth suspicious? If professional intuition perks up, compliance professionals are obliged to take the initiative to refine testing parameters, dig deeper, and most importantly invite all tiers of personnel to weigh in as appropriate.

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8. WILLIAM WORDSWORTH, ECCLESIASTICAL SONNETS. IN SERIES Part II. XXVIII, excerpt available at <http://www.allthingswilliam.com/haste.html> (last visited Oct. 8, 2009).

9. *The Broker-Dealer CCOutreach Program*, SEC seminar, (Mar. 10, 2009) (transcript available at <http://www.sec.gov/info/bdccc Outreach.htm>).

## CONCLUSION

Investors want to know that both the companies they invest in and the partners they hire to achieve their investment objectives are doing more than mandatory compliance protocol. Organic compliance is derived from ongoing professional collaboration to produce a collective risk management perspective of the regulated entity. The objective is clear—the assurance that the compliance culture of the firm remains vibrant, relevant, and ultimately prescient in *identifying* and managing the compliance risk of the firm while protecting the reputation of the enterprise and preserving the assets of clients.

At a recent General Counsel Forum focusing on corporate ethics, the majority of participating lawyers indicated that they would be required “to operate with fewer compliance and internal control resources” due to budgetary constraints and other corporate distractions.<sup>10</sup> Budgetary conditions notwithstanding, survival in the new normal for regulated financial entities will be seriously jeopardized if the compliance efforts of the firm are marginalized. Despite recent cost cutting and margin compression, there will be no room for compromise by regulators, shareholders, or investors. In fact, in February of this year, the SEC very adamantly stated their position that even during times of staff reductions and downsizing, it would not be prudent for regulated entities to cut compliance.<sup>11</sup>

It cannot be forecast with precision what the consequences of a failed or dysfunctional compliance program will wreak upon a firm’s stakeholders, employees, and investors as all continue to observe and absorb the detritus of recent events. One may speculate, however, that the consequences would be greater and the ramifications far more profound than we currently appreciate. As Gene Kranz, lead flight director for the fateful Apollo 13 Mission, announced to the ground crew in Houston: “Failure is not an option.”<sup>12</sup>

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10. White Collar Crime Prof Blog, [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/2009/03/nacdl-heritage.html](http://lawprofessors.typepad.com/whitecollarcrime_blog/2009/03/nacdl-heritage.html) (last visited Mar. 3, 2009).

11. Lori A. Richards, Dir., Office of Compliance Inspections and Examinations, SEC, Compliance in Today’s Environment: Step Up to the Challenge, Remarks Before the IA Compliance Best Practices Summit 2009 in Washington, D.C., (Mar. 12, 2009).

12. See Jeff Foust, “We Must Never Fail”: Gene Kranz, Apollo 13, and the Future, THE SPACE REVIEW, Apr. 18, 2005, <http://www.thespacereview.com/article/357/1> (last visited Oct. 8, 2009).

