

2010 Annual Seminar
SIFMA Compliance & Legal Division
National Harbor, MD

Understanding Control Risks
May 6, 2010

Jane Carlin
Morgan Stanley

Frederick Krieger
NYSE Regulation

Richard Wilson
BNP Paribas Securities Corp

Gloria Greco
Merrill Lynch/Bank of America

Anne C. Flannery
Morgan Lewis & Bockius, LLP

1. Developing an Effective Corporate Governance Structure

- **Defining elements of a corporate governance structure**
- **Considering a Firm's size and complexity when constructing an effective model**
- **Does every firm need a fully integrated risk management and compliance process to escalate risk control issues effectively?**
- **Effectively navigating risk management in a Firm where responsibilities are dispersed among various control groups, such as internal audit, legal, compliance and risk management**
- ***Emerging issue:* Firms in transition to the bank holding company model and managing the different expectations of bank regulators toward risk management**
- ***Emerging issue for global entities:* Financial Services Authority (FSA) Consultation Paper 10/03 and the Walker Review**

Useful Reference Materials:

- **January 2010 Financial Services Authority (FSA) CP re Effective Corporate Governance**

http://www.fsa.gov.uk/pubs/cp/cp10_03.pdf

- **October 2008 Federal Reserve Board Supervisory Letter re Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles**

<http://www.federalreserve.gov/boarddocs/srletters/2008/SR0808.htm>

- **FINRA Rule Series 3000 (Supervision and Responsibilities Relating to Supervised Persons) and NASD Rule 3010 (Supervision)**

http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5664

http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3717

- **FINRA Notice to Members (NTM) 08-18 April 2008 (Supervision relating to “Rogue” Proprietary Traders)**

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038276.pdf>

- **NASD NTM 99-92 (now FINRA) Nov. 1999 (SEC, NASD Regulation, and NYSE Issue Joint Statement on Broker/Dealer Risk Management Practices) (also known as NYSE Information Memo 99-42)**

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p004054.pdf>

- **NYSE Rules 342 (Offices - Approval, Supervision and Control) and 351 (Reporting) and Interpretations**

http://nyserules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_5&manual=/nyse/rules/nyse-rules/

- **NYSE Information Memo 09-40 (Regulatory Guidance on Handling Large Orders)**

[http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNYSECom/85256FCB005E19E88525760900727364/\\$FILE/Microsoft%20Word%20-%20Document%20in%2009-40.pdf](http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNYSECom/85256FCB005E19E88525760900727364/$FILE/Microsoft%20Word%20-%20Document%20in%2009-40.pdf)

- **Bank for International Settlements – Principles for Enhancing Corporate Governance (March 2010)**

<http://www.bis.org/press/p100316.htm>

- **Basel Committee on Banking Supervision Paper on “Compliance and the Compliance Function in Banks” (April 2005)**

<http://www.bis.org/publ/bcbs113.htm>

2. Developing a Comprehensive New Product and Transaction Approval Process

- **Governance issue: defining new products and transactions subject to approval process**
- **Identifying stakeholders who should participate in the process**
- **Defining the role of Compliance in the process**
- **Drawing distinctions where product/transaction emanates from or is being sold within the Firm, from or to third parties, sold to institutions or retail**
- **Sample Product Approval Checklist:**

Product Description

- **Product Lifecycle/Exit Strategy**
- **Funding Needs**
- **Pricing**
- **Financial Projections**
- **Tax Considerations**
- **Infrastructure/Delivery Needs**
- **Technology Requirements**
- **Operational Requirements**
- **Product Management Structure/Ongoing Monitoring**

Controls & Supervision

- **Client Suitability/Eligibility Requirements**
- **Sales Force Qualifications**
- **Policies & Procedures**
- **Product Disclosures and Delivery**
- **Marketing Plans/Materials**
- **Supervision**
- **Training/Communications**
- **Oversight/Testing**

Due Diligence

- Investment Risk Management
- Legal and Regulatory Analysis
- Vendor/Third Party Analysis
- Conflicts Management
- Liquidity & Trading
- Competitive Analysis

General Risks

- Reputation Risk
- Credit Risk
- Market Risk
- Personnel Risks

Useful Reference Materials:

- **FINRA NTM 09-31 June 2009 (Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds)**

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118952.pdf>

- **NASD (now FINRA) NTM 05-26 April 2005 (NASD Recommends Best Practices for Reviewing New Products)**

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf>

- **NASD (now FINRA) NTM 05-59 September 2005 (NASD Provides Guidance Concerning the Sale of Structured Products)**

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014997.pdf>

- **Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities. Final Statement issued effective January 2007 (Office of the Comptroller of the Currency, Treasury (OCC); Office of Thrift Supervision, Treasury (OTS); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Securities and Exchange Commission (SEC)**

<http://www.sec.gov/rules/policy/2006/34-53773.pdf>

3. How Risk Management Fits with the Legal and Compliance Functions

- **Identifying opportunities for leverage**
- **Avoiding duplication and control arbitrage**
- **Issues for broker dealer only firms**
- **Issues for firms dealing with both bank and broker dealer regulators**

Useful Reference Materials:

- **SIA White Paper on the Role of Compliance (July 2005)**

<http://www.sifmacl.org/attachments/articles/8/Role%20of%20Compliance.pdf>

- **Bank for International Settlements – Compliance and the Compliance Function in Banks (April 2005)**

<http://www.bis.org/publ/bcbs113.pdf>

- **Basel Committee on Banking Supervision – Framework for Internal Control Systems in Banking Organisations (September 1998)**

<http://www.bis.org/publ/bcbs40.pdf>

4. How to Identify and Manage Risk

- **Conducting Risk Assessments**
- **Compliance Monitoring and Testing Programs**
- **Coordinating with Internal Audit**
- **The October 2008 Federal Reserve Board Supervisory Letter cited below offered the following guidance useful to most regulated entities:**

*Risk Assessments and Monitoring and Testing Programs. Risk assessments are the foundation of an effective compliance monitoring and testing program. The scope and frequency of compliance monitoring and testing activities should be a function of a comprehensive assessment of the overall compliance risk associated with a particular business activity. * Many larger, more complex banking organizations, however, remain in the process of implementing comprehensive risk assessment methodologies. This presents a challenge to the effectiveness of compliance monitoring and testing programs as the effectiveness of these programs relies upon comprehensive risk assessments. Larger, more complex banking organizations are strongly encouraged to complete the implementation of comprehensive risk assessment methodologies and to ensure that compliance monitoring and testing activities are based upon the resulting risk assessments.*

Useful Reference Materials:

- **October 2008 Federal Reserve Board Supervisory Letter re Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles**

<http://federalreserve.gov/boarddocs/srletters/2008/SR0808.htm>

* *Risk assessments should be based upon firmwide standards which establish the method for, and criteria to be utilized in, assessing risk throughout the organization. Risk assessments should take into consideration both the risk inherent in the activity, and the strength and effectiveness of controls designed to mitigate the risk.*

5. Considerations for Outsourcing Arrangements

Strategic Assessment

- **Inventory specific functions and activities to be outsourced by the Firm**
- **Consider financial, reputational, and operational impact should the service provider fail to perform, and the capacity of the Firm to conform with regulatory requirements and subsequent changes in these requirements**
- **Potential regulatory impact to Firm where key regulatory issues/functions require more stringent and detailed oversight controls than for non-regulatory functions**
- **Potential regulatory issues for the service provider, where functions involve soliciting accounts, accepting customer orders, or other activities involving direct contact with customers and investors (e.g., registration issues)**

Vendor Selection Due Diligence

- **Review the experience and operational ability of the service provider, as well as the service provider's reputation, track record and financial status (e.g., Vendor Integrity Program)**
- **Where the service provider will have access to customer information, include a careful review of the service provider's privacy and confidentiality policies and controls**
- **Where a non-U.S. service provider is involved, or activities are performed outside the U.S., review local laws and business practice of the foreign jurisdiction (especially privacy laws) along with related political and legal factors**
- **Document due diligence review in writing**

Adequate Documentation of Vendor Contract

- Formalize the relationship in a legally binding contract
- Detail the specific services to be provided, the service levels to be maintained by the service provider, the Firm's ability to audit the service provider and the Firm's exit rights
- Specify regulatory matters, such as access to books and records, compliance with applicable securities regulations, and the receipt of applicable regulatory approvals or licenses
- Consider a detailed service level agreement that articulates service objectives, measurement calculations, frequency of reporting, and penalties for failing to meet target performance levels

Oversight Controls: Post Transition Management

- Ensure Firm supervisors understand that although functional responsibility may be outsourced to a service provider, legal responsibility cannot be outsourced.
- Document specific procedures and controls to supervise and monitor the service provider's performance
- Ensure securities regulators have the same access to the records produced by the service provider that they would have if the records were produced by the regulated entity

Useful Reference Materials:

- NASD (now FINRA) NTM 05-48 - July 2005: Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers

<http://www.finra.org/Industry/Regulation/Notices/2005/P014736>

- 2006 FINRA Interpretive Letter on Regulatory Notice 05-48

<http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/ConductRules/p017175>

- *See also*, NYSE Rule 19b-4 filing 2005-22 Amendment #2 on Outsourcing, filed in April 2007. It replaced the original filing and Amendment #1 in their entirety. It was withdrawn following the merger with FINRA

[http://apps.nyse.com/commdata/pub19b4.nsf/docs/BB3E1F26E5F6CA3D852574170053B5EE/\\$FILE/NYSE-2005-22%20A-2.pdf](http://apps.nyse.com/commdata/pub19b4.nsf/docs/BB3E1F26E5F6CA3D852574170053B5EE/$FILE/NYSE-2005-22%20A-2.pdf)

- 2002 NYSE Information Memo 02-48 (Electronic Order Entry) (includes some discussion of outsourcing)

[http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNYSECom/85256A71006FB86385256C4B005AF649/\\$FILE/Microsoft%20Word%20-%20Document%20in%2002-48.pdf](http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNYSECom/85256A71006FB86385256C4B005AF649/$FILE/Microsoft%20Word%20-%20Document%20in%2002-48.pdf)

- Federal Reserve Board Supervisory Letter SR-004-Feb. 2000: Outsourcing of Information and Transaction Processing

<http://www.federalreserve.gov/boarddocs/SRLETTERS/2000/sr0004.htm>

- *See also* Financial Service Authority (FSA) Rules at:

<http://fsahandbook.info/FSA/print/handbook/SYSC/8/1>

- FSA Q& A on Outsourcing

http://www.fsa.gov.uk/pages/About/What/International/mifid/key_topics/outsourcing/index.shtml#new

- Markets in Financial Instruments Directive (MiFID) (European Law Directives)

http://www.mifidconnect.org/content/1/c4/92/35/MiFID_Connect_Outsourcing_Guide.pdf

- **Guideline B-10 (Canadian Outsourcing Guidance) from Office of the Superintendent of Financial Institutions (OSFI) Canada**

**[http://www.osfi-
bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/b10_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/b10_e.pdf)**