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Treasurers and Chief Compliance Officers:
Critical Roles, Difficult Challenges

Thank you for that very kind introduction. It is truly a pleasure to be here this afternoon and have the opportunity to address this rather impressive group. I thought it would make sense to talk today about the critical role that treasurers and chief compliance officers play inside financial services firms and some of the difficult challenges they encounter.

I have been quite fortunate in the opportunities I have had in the financial services area. Before joining the Securities and Exchange Commission in 2006, I held various positions inside major firms including Global General Counsel for Merrill Lynch Investment Managers and Executive Vice President and General Counsel at OppenheimerFunds. In those positions I had responsibility for legal, compliance and other areas. I worked with fine and dedicated treasurers and compliance personnel and appreciated the importance of those roles in the firm.

I am concerned that some financial firms may not fully appreciate the difficult jobs you do and the need to devote adequate resources to your areas. Especially in times when revenues may not be growing, financial firms might quite naturally focus on the “cost” side and especially

at those areas that are considered "overhead". This can lead to pressure to do more with less, to automate functions, reduce headcount and possibly eliminate subscriptions to necessary third party sources of information. At the same time the investment side of the firm is seeking to improve portfolio performance by investing in more sophisticated type instruments and employing less traditional investment strategies. Financial firms also are realigning operations, combining units and questioning the need for certain traditional separations and information barriers. The combination of these trends may not lead to an optimal outcome for the firm or its clients.

Rogue Trader:

I would now like to address the challenge of the *rogue trader*. It seems that every few years there is a *rogue trader* at a firm that causes significant losses and raises questions about the controls within financial firms. How does this happen? Why does it keep happening? Why don't we hear of *rouge traders* who cause huge gains at firms? What can we do to prevent *rogu*e *traders* or at least catch them early?

The recent case of Kweku Adoboli at UBS is but the latest in a long string of such episodes. Joe Jett (Kidder Peabody), Toshihide Iguchi (Daiwa Bank), Nick Leeson (Barings Bank), John Rusnak (Allied Irish Bank) and Jerome Kerviel (Societe Generale) are some of the more notable ones. The losses they caused were staggering and often resulted in the demise of their firms. How could they do this in firms where risk, financial and compliance controls were in place? Some had "back office" experience and were able to use that knowledge to exploit "gaps" in the systems. Fictitious trades were used in some cases and accounting anomalies in others. Manipulation of VAR calculations and the use of error accounts were employed in others.

What lessons should we learn from these cases? What I glean from these cases are the following:

- Compliance and similar concerns should be raised to independent functions within the firms
- Senior managers and supervisors must fully appreciate the complexities of the products and markets their firms deal in
- Mandatory vacations are good.
- Strong and knowledgeable supervisory controls are essential
- Operations, risk management and compliance reporting lines should be independent from business lines
- Strong back office functions are essential
- Challenging highly successful investment personnel should be encouraged
- Valuation needs to be separate from portfolio management and traders.

Now I suspect that the room may be divided between those of you who believe that this could not happen in your firm and those who wonder whether it could. Remember, these *rogue traders* often exploited a weakness or a gap in the risk, compliance or financial accounting areas. If I had your responsibilities I would be asking myself and my colleagues how do I know this could not happen? I would look at areas that had exceptional returns relative to peers and I would review policies and procedures and critical dependencies. I would focus on error accounts, supervisory structures, and on newer or less well understood instruments, trading and investing strategies. I would also consider asking someone else to come in to independently review the policies, procedures, controls and structure of the firm's compliance and risk functions.

Information Barriers:

Another important topic I wanted to raise today was that of information barriers. I have observed that some lawyers and compliance professionals may not be quite as familiar with information barriers, as they should be. Knowing all their uses, their minimum requirements and the potential consequences of not having them or not having them designed or employed properly. As compliance professionals in addition to be asked to enforce them, you may also be requested to design, modify or permit exceptions to the information barriers. To handle those requests effectively you really do need to have an appreciation for the purposes the barriers are serving and the potential impact of modifications or exceptions to the barriers. Understanding the minimum requirements for barriers expected by regulators is also essential.

Now I am sure everyone here is quite aware of the need for barriers separating investment banking from research and from asset management and the need to separate areas that may have access to material nonpublic information. Information barriers are also put in place by asset managers for some of the following purposes, or to effectively deal with issues arising from:

- Pending research
- Syndicated Loans (sometimes including High-Yield also)
- Pipes
- Creditors Committees
- Proprietary Trading
- Aggregate Reporting of Beneficial Ownership: Sections 13(d); 13(g) and 16(a) of 1934 Act

- Tender Offers: Rules 14e-3 and 14e-5e of the 1934 Act
- Short Sales: Reg SHO
- Reg M: (1) Distribution of Securities during Restricted Period (Rule 101); and (2) Short selling in connection with Public Offerings (Rule 105)
- Investment Company Act Section 17 and Rules 10f-3(c)(7), 17d-1 and 17j-1
- Investment Advisers Act Section 204A, and Rules 206(4)-6 and 204A-1

Information barriers must be carefully tailored to adequately address the issues to which they pertain and the firms operations. The minimum elements of an effective information barrier have been described as follows:

- Policies and procedures for information barriers are formalized, organized and incorporated within a firm's procedural policy manuals
- Restraining access to files likely to contain material nonpublic information
- Providing continuing education programs concerning insider trading and obtaining periodic acknowledgments
- Restricting or monitoring trading in securities about which the firm employees possess material nonpublic information ("Restricted List", "Watch List")
- Diligently monitoring trading for the firm and individual accounts
- Physical and electronic separation of different functions.

In addition, in some instances, there is a requirement that there be no common officers, directors or employees among the functions separated.

I expect that information barriers will increasingly be an area of concern to the regulators and one that you might want to devote some resources to.

Regulators and the CCO:

I have been asked recently whether I think that the regulators may be "after" chief compliance officers. I understand that this has been a more frequent question since the Urban case. First, I believe that regulators are quite familiar with the proper role of the CCO within a financial firm and the supervisory responsibilities that others bear. Typically it is the "supervisor" within the firm, not the CCO, who is responsible for the actions of personnel in the firm that violate the law. This is a fact that "supervisors" within firms would do well to remember. I believe that the regulators recognize the critical and difficult job CCOs have and are not targeting compliance officers. But they do expect that you will be trying your best to do your job. There are, however, some areas where I would expect that action against a CCO might be considered by a regulator. Such as where:

- There was no compliance with the CCO Rule(s)
- Compliance deficiencies from prior exams (or internal or external reviews) were identified, recognized and then ignored
- The CCO wears many "hats" and fails to adequately discharge duties relevant to those other "hats" (you don't get a "pass" because you also happen to be the CCO)
- The CCO fails repeatedly to follow procedures or to have procedures appropriately tailored to the firm's operations
- The CCO alters or manufactures documents and presents them to the regulator
- "Red flags" are ignored
- "Supervisory" responsibilities are assigned to the CCO or undertaken by the CCO and not properly discharged.

In short, if you are diligent in your work I would expect that you would not have much, on the personal level, to worry about from the regulators.

I hope my remarks today don't drive some of you to want to leave the financial services business and open a taco stand. That certainly was not my intent. Rather, I wanted to acknowledge the importance of your roles and the difficult challenges that you and your firms face.

Thank you for listening today and I hope you enjoy the rest of this fine summit.