

# ACA Insight

The weekly news source for investment management legal and compliance professionals

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“You’re preparing for any number of kinds of unpredictable events – one of which might very well occur.”

## Don’t Fall Victim to a Black Swan: Prepare Now for the Unexpected

**Long Term Capital Management.** Russia’s debt default. **Enron.** **Arthur Andersen.** The 2008 mortgage crisis. **Bernie Madoff.** It’s what you don’t expect that will get you.

Most risk management programs help your firm prepare for the expected – a change in interest rates or the inflation rate, a change in the White House, most new rules from the SEC. Unexpected events, on the other hand, are close to impossible to predict.

What you can do, however, is know that there will be unexpected events and prepare for the unexpected, also known as “black swans,” even if you don’t know the exact nature of the black swan that will strike. The result will be that your firm is likely to weather whatever storm hits, from both a compliance and a business perspective, better than firms that take no preparatory measures.

Black swan events can occur from external or internal sources. External sources include natural disasters, like a tornado or hurricane; a major market event, like a significant Dow drop or a large bankruptcy; or a major political event, such as a government shutdown. Internal sources might be a rogue employee who discloses confidential information, an IT error, a high-speed trading error, a whistleblower, misappropriation of client funds, or a custodial failure.

Firm CEOs and other upper management may look askance at spending more time and financial resources preparing for events that are unlikely to happen, but the reality is that black swans do occur – you just don’t know the nature of the event and when it will strike. Your firm will be far better off preparing for a broad array of possibilities than not, said **Dechert** partner **Adam Wasserman**, who spoke on the topic March 27 at **ACA Compliance Group’s** Spring 2014 Compliance Conference in Orlando. “You really aren’t preparing for one specific black swan. You’re preparing for any number of kinds of unpredictable events – one of which might very well occur,” he said. In fact, a majority of those informally surveyed during the session at the conference had experienced at least one black swan during the course of their career.

“The premiums you pay for insurance may seem a waste if your house never burns down,” said **DLA Piper** partner **Nicolas Morgan**, but “given fires that have occurred, I’m sure those homeowners are very glad they paid them.”

## Don't Fall Victim to a Black Swan

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### Enterprise risk management and disrupter analysis

Among the first steps that firms should take is designating an internal enterprise risk management person or team whose job it is to look for areas where your firm may be exposed to risk, said Morgan, who noted that having a person in such a position can pay off. "If that person is incorporated into your operations, his feedback is listened to, addressed, and policies are changed," he said. "That person goes from being a quasi-whistle-blower to your best defensive witness."

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In fact, noted **Haynes and Boone** partner **Kit Addleman**, former director of the SEC regional office in Atlanta, the existence of an enterprise risk management function within advisory firms is something OCIE examiners look for. "It's high on the SEC's radar screen this year."

Next, go beyond enterprise risk management, which focuses on likely events, to perform disrupter analysis, which prepares your firm for the truly unexpected, said Morgan. Done effectively, it consists of four parts:

- **Enterprise mapping.** Create a map of your organization, one that incorporates not only its "geographical footprint," Morgan said, but other aspects, including its regulatory environment, operations, supply chains, channel positions, industry structure, and competitive dynamics. "Go beyond first-order relationships" to find additional areas of vulnerability, he said, giving the example of Apple products, many of which rely on batteries to function. The relationship to the battery vendors should be included in the maps, as well as any dependencies the battery

vendors themselves have that may affect the battery supply.

- **Disruptor lists.** Compile a directory of events that could impact your firm, by event type, such as market events or cybersecurity.
- **What if's.** In this list, describe how each event in your disrupter list may impact the firm.
- **Contingency plans.** For each "what if," come up with a potential solution. Some of these may resolve multiple situations, said Morgan. "Even devoting a few hours to this effort can pay huge dividends in the long run."

### Small firm challenges and solutions

Not all firms, of course, have the resources to devote a team of people to black swans. "The most important thing is to give black swans the time, thought and attention that are needed," said Wasserman. If you have a small firm with only three or four employees, consider gathering everyone one day over the weekend and spending a few hours reviewing the black swan possibilities, he said. "Smaller firms might have an easier time getting their hands around the issues than larger firms will," he said, as all the people with responsibility and knowledge are right there in the room.

Small firms can also address the resource issue by simply scaling the program back, suggested Morgan. "Have the same function performed by one person instead of three, and spend 20 percent of your time on it instead of 100 percent." Firms with limited resources can choose to outsource part of the work. Those that choose not to outsource may instead choose to add it to existing responsibilities, if that is realistic.

### Creation of black swan teams and drills

These are the people who will take responsibility for key aspects of any unexpected crisis, said Addleman. "Have the right people from the outset," she said, as you don't want to find out, halfway through a crisis, that some members lack expertise you thought they had.

Those on the teams should represent a range of expertise, including IT, risk management, compliance, legal, human resources, operations and external professionals with expertise in key areas. “Put all the information you have on (these team members) in a book with contact information, and widely circulate it,” she said. Black swans are not only unexpected, they can occur during unexpected periods, such as during the evening or on weekends. When that happens, you want everyone to have the book of team members.

Just like a fire drill, stage a mock black swan, Addleman said. Her firm, she said, has done that with some clients, where the chief compliance officer interrupted a scheduled meeting to say, “Oh my gosh, put your agenda aside, we have an event we have to deal with.” The ruse cannot continue for long, she said, but “this has been very effective to grab the attention of senior management.”

### The black swan strikes

Preparation is important, but what do you actually do when the unexpected occurs? One of the first steps is to deal with the psychology of the situation, said Wasserman. Acknowledge the event and the impact it had. Don’t attempt to shrug it off – that will just make it more difficult to handle as the severity of the event becomes apparent.

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Your first steps should be to gather necessary information from documents and individuals, said Morgan. Then, check with either internal or external counsel. Later steps – contacting investors, self-reporting to the SEC, handling the public relations, and calling your insurance – should ideally be done “after you have ascertained as many of the facts as possible,” said Morgan. That said, when these events do occur, depending on the specific circumstances, doing these

in that order is not always possible.

Using a technique he called “active passiveness,” Wasserman said you should assess the situation and take stock of its effect on the firm before rushing into action. Focus on the facts, then concentrate on finding a solution, rather than assigning blame, he said.

This is when you choose which members of the black swan team to notify, depending on the nature of the situation, said Addleman. It would be a good idea to have attorneys or other external experts involved, as you will be engaged in running the business while dealing with the crisis. “It’s like flying the plane while repairing the wing,” she said. External professionals, such as public relations firms, can deal exclusively with their aspects of the crisis, freeing you of that burden.

### Task-specific steps

Public relations can be critical during such a period, as you want to avoid as much negative press as possible. Your firm’s reputation is at stake. This includes not only traditional press, like newspapers and web sites, but social media. You want someone following Twitter and Facebook to see what is being said about the event and your firm’s place in it.

Since many black swan events deal with IT, it is critical you have a data response team ready to preserve information that may otherwise be damaged or lost. Addleman said. The data response team can also prevent additional technical problems from occurring. After the crisis is over, it can help to determine how the crisis began and where responsibility lies.

Knowledge of IT will also be helpful in non-disaster recovery events, Wasserman said, such as an SEC enforcement investigation into your firm. It will be very useful if your legal/compliance departments already know how emails, instant messages and trading data are stored and retrieved. “It’s better if compliance staff understands such issues in advance rather than have to learn about them on the fly in the middle of a crisis,” he said. ☞