

Effectively Managing Change – a Model for Compliance Officers

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Overview

The only constant in our regulatory environment is *change*. Often, legislative and regulatory changes are implemented in response to high-profile scandals uncovered by regulators, recessions or whistleblowers. The discovery and subsequent hype surrounding these scandals often result in certain compliance events, known as High Profile Events (“HIPES”), coming under the spotlight. The purpose of this article is to introduce a model that you may use to effectively guide your compliance programs through the lifecycle of a HIPE.

At times, the scandal highlights a new HIPE while at other times the HIPE is the scandal. Over the past ten years alone, a number of specific scandals have shaped the regulatory landscape of our industry leading to HIPES as illustrated below:

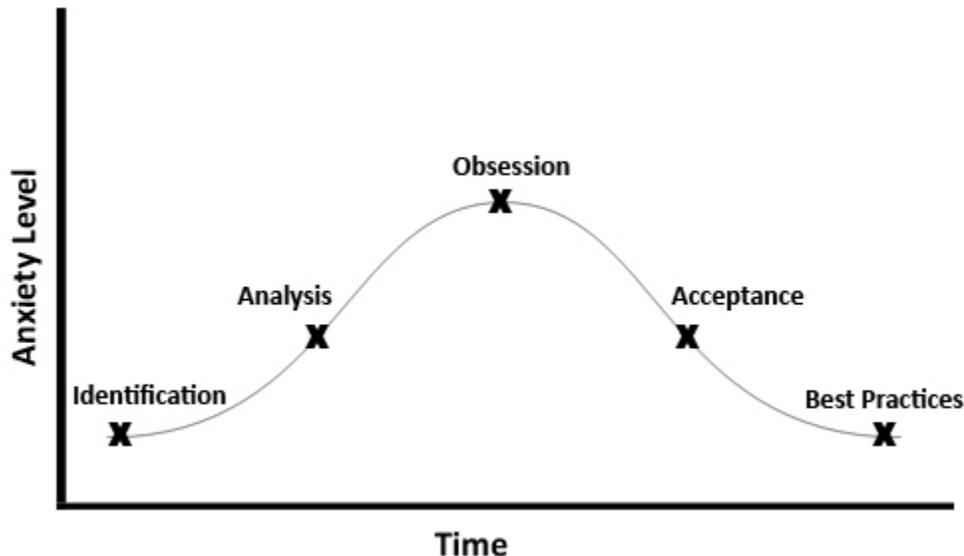
- Market Timing & Late Trading → Email Retention & Review
Market timing and late trading were the core issues surrounding the Canary Capital case in 2003, during which time email retention and reviews also came under the microscope. Eliot Spitzer’s team used historic e-mail messages to help identify the extent of the market timing activities at Canary.
- Gifts and Entertainment
In 2004, gifts and entertainment became the subject of regulatory scrutiny following a well-publicized bachelor party for a Fidelity trader, paid for by brokers.
- Custody
Late 2008 uncovered custody as a major compliance issue, after the SEC found that Bernard Madoff’s fictitious account statements played a central role in his fraud.
- Insider Trading
Insider trading is currently in the spotlight, following the discovery of the largest insider trading case involving a hedge fund.

Our experience in working with clients, participating in roundtables and presenting at conferences has taught us that compliance officers often struggle with addressing these

issues in an effective manner. The ability to identify discernable trends in how the lifecycle of these HIPEs behave may help compliance officers address future issues more effectively.

The Vista360 HIPE Curve

The HIPEs outlined above have all followed a similar lifecycle, as outlined within the model below.



The *Vista360 HIPE Curve* is comprised of the following critical stages:

1. **Identification:** This stage represents the genesis of the HIPE, when the industry first learns of a scandal. As the press lends it more attention, the public, legislators and regulators often start playing the blame game, often resulting in the identification of a particular compliance component that failed.
2. **Analysis:** In this stage, the industry and regulators start analyzing the issue in more detail in an effort to determine how a particular compliance component failed. Anxiety starts to increase. Will this simply be an issue of the day or will it become a dominant issue in the industry? This stage is often marked by the following:
 - An increase in SEC staff and management comments.
 - A steady stream of media attention.
 - Uncertainty among compliance professionals – Will resources be strained? How much will the issue cost? Is this busy work or value-added?
 - Heightened activity on agendas at conferences and roundtables.
3. **Obsession:** This is the stage where both regulators and the compliance industry become obsessed with the issue, and anxiety runs at its zenith. During this stage:

- Regulators become very public in their expectations of registrants with respect to the compliance matter.
 - Regulator's views on the issue often shake the compliance world and expectations voiced by regulators may be unrealistic, unleashing a flurry of activity and hand-wringing in the industry.
 - Depending upon the nature of the issue, regulators may issue drafts of new (at times, extreme) rules to address the HIPE. The industry often reacts strongly to these drafts.
 - Industry conferences may have workshops dedicated to the issue, where advice provided is often inconsistent and represents an opinion rather than best practices.
 - Industry press is routinely covering the issue.
 - No roundtable seems to be complete without an extensive discussion of the issue and what is expected of advisers and funds.
4. Acceptance: At this point, anxiety starts to recede as the industry accepts the regulators' expectations to incorporate the HIPE into registrants' compliance programs. This stage may include the following:
- Regulators' expectations become more realistic and easier to digest by the industry.
 - Where applicable, final rules are adopted, generally incorporating comments by the industry on the draft rules.
 - Advice provided at conferences tends to be more consistent than the Obsession stage. Presenters, like the rest of the industry, are starting to get their arms around the issue.
 - The press' coverage of the issue drops, often precipitously.
 - The topic is still routinely raised at roundtable discussions, but the discussions are shorter. The most experienced participants of the roundtable provide relatively consistent advice to the less experienced participants of the roundtable.
5. Best Practices: At this point the industry has fully embraced the issue by establishing best practices and incorporating new rules established by regulators. This stage often finds:
- Regulators largely focused on other matters (perhaps the next HIPE!).
 - Conferences rarely include the issue as a stand-alone topic.
 - The press no longer covers the issue on a routine basis.
 - Inexperienced compliance professionals may raise the issue from time to time at roundtables; however, the topic is generally addressed in short order, with very succinct best practices advice provided to the group.

HIPE Illustrations

The following chart illustrates the various stages involved when a scandal causes heightened industry attention, leading to awareness and often new regulations. The summary below focuses on the timeline of the Canary Capital market timing/late trading/email retention scandal relative to the model described above.

Market Timing / Email Review		
HIPE Stage	Regulator/Government Actions	Industry Reaction
Identification September 2003	<ul style="list-style-type: none"> Eliot Spitzer, then Attorney General of New York, issues a complaint against Canary Capital Partners LLC alleging illegal market timing arrangements with Bank of America's Nations Funds. Spitzer's staff effectively uses email to assist in its investigation. 	<ul style="list-style-type: none"> The issue makes an immediate splash on the industry, but most compliance officers are still largely in the dark with respect to the extent of the issue, and how it will ultimately impact them.
Analysis Email: Late 2003 Market Timing: 2003-2004	<ul style="list-style-type: none"> The SEC, caught largely off guard by Spitzer's allegations, launches its own investigations, and brings high-profile market timing actions against numerous organizations including Strong Capital Management and Alliance Capital. The SEC's staff becomes more vocal regarding its expectations that registrants retain emails, although not required by any rule. 	<ul style="list-style-type: none"> Internal assessments of market timing issues occur at most fund companies. Compliance officers assess companies' ability to retain emails, often discovering emails are routinely destroyed after a year or two. Email retention vendors start to advertise more frequently.
Obsession Email: 2004 Market Timing: 2004-2005	<ul style="list-style-type: none"> The SEC and Spitzer continue to announce high-profile settlements regarding market timing activities. The SEC's staff becomes very vocal regarding its expectations that all email be retained (some email for up to 20 years!) and made 	<ul style="list-style-type: none"> Email retention vendors are everywhere with new products becoming available on, seemingly, a daily basis. Market timing and email retention become standard discussion items at compliance conferences and industry roundtables. Compliance officers become

Market Timing / Email Review		
HIPE Stage	Regulator/Government Actions	Industry Reaction
	<p>available within 24 hours, and taking a hard line approach on attorney-client privilege logs.</p> <ul style="list-style-type: none"> • During exams, the SEC staff requests (and apparently reviews) an enormous volume of email messages. Hundreds of thousands in some cases. • The SEC proposes Rule 22c-2 of the Investment Company Act of 1940 in March 2004, including a requirement for funds to charge redemption fees of up to 2%. 	<p>frantic regarding reviewing emails (some spending upwards of 20% of their time).</p> <ul style="list-style-type: none"> • Many in the industry feel pressure to provide email in response to SEC requests without exerting privilege. • Compliance officers voice concerns about what regulators will do with compliance matters discussed in emails. • The industry reacts strongly to the SEC's proposed market timing rule requiring funds to charge redemption fees. • Vendors create new products in response to proposed Rule 22c-2.
<p>Acceptance</p> <p>Email: 2005 – 2006</p> <p>Market Timing: 2005-2007</p>	<ul style="list-style-type: none"> • Regulators now presume most registrants accept that emails represent required records. • Regulators no longer request emails to be produced in connection with every examination. • The SEC adopts Rule 22c-2 in March 2005 after an extensive comment period. The Rule permits (rather than requires) funds to charge a redemption fee and includes a requirement for intermediaries to track shareholder activity. 	<ul style="list-style-type: none"> • Funds consider or adopt market timing procedures. • The industry is concerned with the requirements and potential cost of Rule 22c-2, particularly related to the requirement to monitor shareholder activity. • Vendors supporting 22c-2 initiatives emerge at very high costs. • Funds work to obtain meaningful information from intermediaries, particularly smaller intermediaries. In March 2006, the Investment Company Institute provides guidance to assist the industry with these data requirements. • Registrants largely accept their responsibility to retain emails, and either engage an outside vendor or determine how to implement using in-house technology. • Registrants become more careful about maintaining privilege logs related to emails.

Market Timing / Email Review		
HIPE Stage	Regulator/Government Actions	Industry Reaction
		<ul style="list-style-type: none"> • Conferences still include these matters on agendas, but the advice provided appears to be more focused. • Roundtable discussions are more relaxed.
<p>Best Practices</p> <p>Email: 2006 – Present</p> <p>Market Timing: 2007 - Present</p>	<ul style="list-style-type: none"> • Market timing rules are well in effect. • SEC staff has acknowledged record retention rules for advisers, funds and brokers are outdated. Initiatives are underway to update record retention rules. 	<ul style="list-style-type: none"> • Market timing practices are well in place at funds. Agreements are in place with intermediaries, and compliance officers have implemented a process to monitor market timing. • Many funds back off on their initial hard-line approach with respect to redemption policies. • The review and retention of email has become routine. Email reviews no longer dominate a compliance officer’s day. • The industry has accepted that all mediums of electronic communication must be assessed for retention. • The issues are no longer routinely raised at compliance roundtables.

Gifts and Entertainment: A similar analysis could be conducted on the gifts and entertainment HIPE, where we are likely in the Best Practices stage. The scandal initially broke in July 2005 when it was discovered that certain Wall Street brokerage firms paid for a lavish bachelor party for a Fidelity trader two years earlier. Regulators became skeptical regarding whether funds and advisers were using investors’ commissions to engage brokerage firms based on gifts and entertainment received rather than service and price. As a result of the heightened regulatory scrutiny, compliance officers increased their focus on gifts, often attempting to require business units to report all gifts and entertainment, regardless of value. The topic largely dominated discussions at roundtables and was routinely covered by the press. By the time Fidelity settled charges with the SEC in 2008, most compliance officers had embraced a reasonable approach to reviewing and monitoring gifts and business entertainment, and regulators now appear to be satisfied with the industry’s response.

Current HIPEs

Custody: The current custody HIPE is in the Acceptance stage. The Obsession stage likely occurred in early- to mid-2009, when the SEC was struggling to get its arms around custody issues after the embarrassment of the Madoff scandal. In the Obsession stage, the SEC suggested requiring all advisers with custody over client assets (even custody solely as a result of debiting fees directly from the clients' custodian) to undergo a surprise audit. Now that the SEC has released the final custody rule with subdued language, advisers should seek guidance on and incorporate the relevant rule amendments into their compliance programs. The SEC will likely continue to maintain a heightened focus on custody controls until we move into the Best Practices stage.

Insider Trading: The current insider trading HIPE is in the Analysis stage. While the SEC staff has expressed concern with potential insider trading matters over the past several years, this issue entered the Identification stage in October 2009 with the shocking allegations of a massive insider trading scheme involving Galleon Group, which has implicated many players throughout the industry. We believe this issue quickly entered the Analysis stage with the SEC's launch of national specialized units within its Enforcement Division in late 2009, one of which focuses on broad-based insider trading and market manipulation matters. The key question now is how will the SEC react in the Obsession stage? If the SEC determines the industry's reaction, still to be seen, is sufficient, it certainly may allow the issue to fade into the background. It would be prudent for you to be prepared for the issue as it enters the Obsession stage, and for you to actively review and enhance your compliance program's approach to addressing insider trading matters now.

Application of the Model

This model provides a tool for you to use in analyzing and addressing issues of high focus by regulators. Considering the stages outlined above, estimate where the HIPE rests on the Curve. While this approach requires judgment, using the clues provided in this article will assist in minimizing the risk of mislabeling the current status. Being conservative is preferred – it is critical not to become too aggressive in the analysis by estimating too far out on the Curve.

Once you are comfortable with the estimate of where the HIPE rests on the Curve, analyze what is likely to occur next. Implement a strategy to address the issue, using the knowledge of how the industry and regulators may react to the issue going forward. You should be in a position to take a strategic approach in addressing the issue. For example, you may make a decision to be more aggressive in addressing a compliance matter given the location of the issue on the Curve, with the knowledge that you may be able to take a more liberal approach in the near future. In other situations, given the risk/ reward nature of the issue and your analysis of where the issue resides on the Curve, you may be willing to take a less radical approach in addressing the issue, with the knowledge that the

ultimate Best Practices phase will not be nearly as intense as the current phase (perhaps, Obsession).

Regardless of where they rest on the Curve, all HIPEs should be a focus during your annual review of the compliance program.

Conclusion

Regulatory change can be unnerving, but it is a challenge we must face successfully. While the Curve does not provide the entire solution to addressing regulatory change, it provides an additional arrow in your quiver. The more tools you have available to combat these compliance challenges, the greater the chance of a successful outcome.

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