Mysteries vs. Puzzles – Recognizing and Addressing the Differences between Compliance "Mysteries" and "Puzzles"

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As compliance professionals, we often address many issues in similar ways. This makes sense on several fronts. We are constantly asked to do more with limited resources. Using economies of scale helps maximize our resources. Also, success breeds success. If we've successfully handled previous compliance issues using certain methods, it would be natural to continue to use these methods.

I agree with this rationale up to a point. However, in the world of risk management and compliance, we are sometimes faced with challenges that did not necessarily exist in the recent past. If we can quickly recognize that we are facing a different type of challenge, we have a much better chance to address the issue, and mitigate risk, effectively.

In 2007, noted author Malcolm Gladwell wrote a piece regarding the Enron scandal for *The New Yorker* ('Open Secrets'). Gladwell contends that the most frightening aspect of the Enron scandal was that the vast majority of information, such as SEC filings and financial statements,[1] was *publicly available*. The problem wasn't that the information was hidden or inaccurate. Unfortunately, very few people with the required expertise properly analyzed the information. Often, they relied on someone else's analysis or interpretation. Gladwell dubbed Enron a "mystery" because the information was available, but very few accurately analyzed the situation until it was too late.

According to Gladwell, another problem occurs when there is not enough information available. Once the necessary information is gathered, the analysis is relatively straight-forward. Gladwell labeled these types of challenges "puzzles". Once the pieces (information) are in place, the puzzle is "solved".

This premise can prove useful in the world of compliance if you consider that we live in the Information Age. Infinitely more information is available today than even five years ago. Often, gathering information is not the biggest hurdle. The challenge lies in properly analyzing the available information. For example, could we classify the Mortgage Crisis of 2008-2009 as a mystery? It certainly appears that firms like AIG, Bear Stearns and others failed to adequately assess the risk of the mortgage market. How many firms reviewed each Collateral Debt Obligation (CDO) or tranche even though that information was available? Did they merely accept someone else's analysis?

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In regard to puzzles, new regulation (Dodd-Frank, SEC "Pay to Play") puts the onus to gather additional information squarely upon our shoulders. This is no easy task. The challenge lies in collecting accurate information in an organized manner. This process may not be easier than handling a mystery. But it is most definitely different.

In the following pages, we'll discuss examples and symptoms of compliance puzzles and mysteries. We will also offer clear, defined ways to address and mitigate puzzles and mysteries.

Puzzles

Let's take a look at compliance puzzles. By nature, puzzles lack information. The challenge lies in gathering that information. A perfect example of a puzzle is implementation of the SEC's new Pay to Play rule. Investment Advisers are now required to monitor and limit political contributions of their firms, affiliated companies and personnel. As with other puzzles, the challenge lies in gathering all available information. This information would most likely come from the following sources:[2]

- Disclosures from registered personnel
- Regular audits of firm payables
- Regular review of websites such as *www.opensecrets.org and www.followthemoney.org* that disclose political contributions

Once this information is gathered, we must determine if any potentially damaging contributions have taken place and act accordingly.

Once a puzzle has been identified, how do we address the situation? Our written supervisory procedures (WSPs) are the first line of defense. If the WSPs are inadequate or ineffective, the necessary information may not be effectively gathered. Just as important, we may not be able to prove to auditors and regulators that we have captured all required information.

Strong internal controls mean that our policies and procedures are being carried out properly by qualified personnel. Inadequate training, difficult to implement WSPs and poor communication all lead to weak internal controls. In the case of Pay to Play, failures to identify or investigate contributions are symptoms of weak internal controls. Keep in mind that recordkeeping and retention requirements should be addressed in adequate WSPs and managed through strong internal controls.

Finally, management's willingness to foster a "Culture of Compliance" is an important factor in addressing puzzles. The strongest WSPs and internal controls can be undermined if management is not willing to support the efforts of the Compliance department. In the case of Pay to Play, personnel may be hesitant to disclose political contributions if management is not seen as supportive of the initiative. Management support can be demonstrated by providing resources for proper training and refusing to grant leniency to top producers.

Adequate WSPs, strong internal controls and a "Culture of Compliance" are excellent tools to use when addressing compliance puzzles. What happens when these three tools are not used effectively? Although slightly dated, a perfect example of a compliance puzzle that was handled poorly is the MCI/WorldCom scandal.

Puzzle Examples

The MCI/WorldCom scandal did not occur solely because CEO Bernie Ebbers and CFO Scott Sullivan were accused of perpetrating one of the biggest frauds in U.S. history. There were factors that allowed fraud and other illegal activity to go undetected for more than 3 years. For instance, although the company headquarters was located in Clinton, Mississippi, departments such as Human Resources, Operations and Legal/Compliance were located in other parts of the country.[3] The geographical distance between senior management and Legal/Compliance clearly made it difficult to foster a culture of compliance.

Additionally, it was nearly impossible for senior management to forge relationships with Legal/Compliance that lead to open discussions and sound advice.

MCI/WorldCom also was found to have had major gaps in their internal controls. For example, senior account managers were able to make adjusting entries to the general ledgers of business units without the knowledge or consent of managers of the respective business units.[4] Unfortunately, senior management was able to use these adjusted entries to manipulate key financial ratios and continue their fraudulent reporting. Sound WSPs would have put in place a detailed process to be followed in the event that adjusting entries were necessary. Despite the lack of WSPs, concerns about the entries were raised by several employees. Not surprisingly, these concerns fell on deaf ears.

Another major shortcoming in WorldCom's supervisory structure is the fact that the Internal Audit department reported directly to CFO Scott Sullivan. Internal Audit could not effectively evaluate and review financial reporting when it reported to the office that was responsible for that activity. Internal Audit may have "dotted line" reporting obligations to the CEO or President, but it should report directly to the Audit Committee, Board of Directors or a similar independent body. An effective Internal Audit department need not have "carte blanche" with little accountability outside of the Audit Committee. However, it should have adequate expertise, authority and resources to carry out its charter.

We have come to find out that WorldCom had the antithesis of a "Culture of Compliance". It had major gaps in its WSPs and internal controls. In addition, it had a supervisory structure that limited the effectiveness of Internal Audit and enabled continued fraud. The result was one of the largest bankruptcies in history that lead to the collapse of a company that employed more than 17,000 employees and had a market capitalization of $180 billion.

A compliance puzzle gone awry within the financial services industry is the mutual fund breakpoint and Class B share abuse first discovered in the early 2000s. The concept behind breakpoints is relatively simple. The more shares an investor purchases, the smaller the up-front sales charge on Class A shares. Class A shares with little or no sales charges are preferable to B shares, which are not subject to breakpoints, but which have higher ongoing expenses and may incur Contingent Deferred Sales Charges (CDSCs). However, the payout to financial advisors on B shares was higher than A share payouts. Unfortunately, many broker-dealers had poor WSPs and/or internal controls that did not ensure clients purchased the most suitable class of shares and received all discounts for which they were eligible. For whatever reason, this was not an area that received enough scrutiny by supervisors, compliance officers and auditors. As a result, some financial advisors discovered that placing large investments in Class B shares appeared to be acceptable. Additionally, many broker-dealers failed to give appropriate breakpoint discounts to clients that had purchased large amounts of A shares. This practice continued until the Philadelphia NASD Office uncovered these issues during routine examinations in 2003.[5]

The result was mass over-charging of fees and ongoing expenses to clients, an embarrassing breakdown in internal controls, and regulatory breakpoint sweep examinations. What was the formula for this breakdown? Inadequate WSPs and weak internal controls allowed a system that did not best serve clients to remain in place.

Similar to many other puzzles, the problem was not in analyzing the information. It is not complex to determine whether a client has received the correct share class or breakpoint discount once all the information is gathered and organized. The problem occurred due to systematic failures while gathering and organizing information.

Recently, Illinois' 529 Plan, Bright Start Savings®, experienced an embarrassing gaffe. In June 2011, Treasurer Dan Rutherford sent correspondence to account holders offering to match contributions up to $250 per account for the first 2500 contributions.[6] Unfortunately, Bright Start Savings® and the plan's administrator, Oppenheimer Funds, failed to adequately track the contributions. When demand exceeded everyone's expectations, the result was that numerous account holders mistakenly believed that they qualified for the matching program.

How could this have been prevented? After reviewing available information, it seems evident that Oppenheimer was not prepared to track the wave of contributions. The evidence shows that many investors had ample reason to believe that they qualified for the matching incentive, when that was not the case. The web site was not updated in a timely manner to accurately reflect the number of contributions.[7]

What were the procedures for tracking eligible contributions? How were those procedures implemented? In other words, were there strong internal controls? If the answers to any of these questions are confusing, then this is likely a puzzle. Oppenheimer and Bright Start Savings® failed to put an effective plan into place to track contributions. Regardless of who takes the blame, this event lead to anger and a lack of confidence aimed at a respected financial services firm and an elected official.

What are some puzzles that may challenge us in the near future? Outside business activities (OBAs) continue to be a regulatory hot topic. When gathering and reviewing information regarding OBAs, compliance professionals need to be sure that *all* relevant information has been disclosed. Particular care needs to be taken when reviewing OBAs based in real estate and mortgage activities. Although many cases are still pending, there have been instances where brokers have not fully disclosed the nature of an OBA. For instance, consider a broker who discloses his OBA as real estate holdings held in an LLC. However, the broker fails to disclose that he is raising funds for the LLC (private placements) to purchase real estate.[8] A request for additional information or a discussion with registered personnel may disclose material information. Remember, new pieces of information help solve compliance puzzles. Probing questions and research lead to information. Robust WSPs, strong internal controls and a "Culture of Compliance" help us manage this information.

Mysteries

As mentioned before, mysteries do not require additional information. The information is available, but it is extremely difficult to analyze and find the answers. Because puzzles and mysteries are so different, there are different tools that we can use to manage mysteries. If the tools used to solve puzzles do not help us, what can make a difference? Mysteries require us to think outside the box.

First, there needs to be excellent communication between business areas and the Legal & Compliance departments. More than communicating, firms should consider embedding compliance personnel within business areas. This is not enhanced supervision. It is a way to learn from the business unit. What risks keep fund managers, traders, salesmen, etc. up at night? Is it something that compliance and/or risk management currently address or has it slipped through the cracks? If it is addressed, is the coverage adequate? If a firm has the resources to embed personnel within a business area (even on a temporary basis), it can lead to mutual trust and a more complete understanding of the business unit. I have encountered several instances where the business unit has been able to advise compliance personnel on how to strengthen policies and procedures once the business unit clearly understood what the Legal & Compliance department wanted to accomplish. Conversely, compliance personnel can often help a business unit not only remain in compliance, but become more efficient by clearly communicating which compliance goals need to be reached and how they should be documented.

From a selfish point of view, embedding compliance personnel increases the value of the Legal & Compliance department as well its employees. It is obvious that a department that truly understands all types of risk (financial, regulatory, reputational, operational, etc.) of issues such as pooled investment vehicles, Collateralized Debt Obligations (CDOs) or credit default swaps, as well as other products, is extremely valuable.

In addition to embedding compliance personnel, another step can be taken to address mysteries. That step is to clearly define the term "due diligence". For a term that is used so often, there does not seem to be a standard definition. Regulatory rules and updates often leave the definition of due diligence up to the firm. The firm must define the term and complete the process they have defined. This definition may be unique to your firm. There may even be multiple definitions of "due diligence" at your firm depending on the product. For instance, due diligence on a large cap mutual fund may be very different than due diligence regarding a private equity fund.

When creating or updating due diligence procedures, a firm should ask itself what due diligence will include. For instance, regarding due diligence of bond funds, will it include a review of every debt instrument? What will the review include? What about each tranche? What about each security? Is a detailed review of every tranche or security even possible, considering a firm's limited resources? In essence, how much depth and breadth will due diligence cover? Does the firm have the resources to perform due diligence at a level that satisfies all stakeholders? If the answer is no, further discussion needs to take place with senior management regarding the product's future at the firm.

Another tool that can be used when dealing with mysteries is stress testing. In its simplest form, stress testing measures whether a firm has adequate capital and assets to withstand various adverse scenarios. Firms that carry any type of inventory most likely conduct some form of stress testing. Most stress testing deals with the effect of interest rate changes on debt securities. Given the state of some of the world's debt markets, this is extremely important. However, we should not stop at debt inventory. Firms should contemplate what would happen to markets such as the repurchase agreement (repo) market in the event of another financial meltdown or the failure of a large market participant. If a firm does not use the repo market to finance operations, what happens to other sources of credit during a crisis?

Besides the debt markets, firms should be prepared for the effect that additional regulation or changing markets may have on each business unit. For instance, what would be the effect if, as proposed, FINRA regulates investment advisers? Will it merely require an increase in the resources available to compliance departments? Or will potential new rules directly affect the financial performance of business units? Also, firms need to plan for any unintended consequences of the Dodd-Frank Act. Will the newly formed Consumer Finance Protection Bureau (CFPB) create confusion within financial institutions that are currently under the jurisdiction of other agencies? If that answer is "yes", what is the financial impact to affected firms?

In Regulatory Notice 10-57, FINRA specifically addresses stress testing. FINRA expects broker-dealers to be proactive when examining their ability to function during future crises. In addition to interest rate changes, firms need to be prepared for the following challenges:[9]

- Significant withdrawal of customer assets
- Unexpected demands for cash arising from contingent liabilities (pending lawsuits)
- Negative publicity
- Significant decline in earnings

It may seem that this type of extended stress testing blurs the line between stress testing, business continuity planning and strategic planning. That is a positive outcome. Rather than getting a final "ok" from the Legal & Compliance departments, these departments should be involved in long-range planning from the beginning. This type of communication and planning allows these departments to offer sound advice on an ongoing basis as well as learn more about the intricacies of the business units that fall under their responsibility.

Mystery Examples

Mysteries are less common than puzzles, but the mysteries that are exposed tend to have much bigger fallout than puzzles. Besides Enron, a perfect example of a mystery is the Mortgage Crisis of 2008-2009. The U.S. financial system almost disintegrated because many of the biggest financial services firms in the world did not understand, or ignored, the risks inherent in the markets and securities in which they invested. It would be naïve to think that the tools used to solve puzzles would have avoided the worst financial crisis since the Great Depression. However, what if more people within the industry had said, "I don't understand this information. What is the upside of this investment? More importantly, what is the downside?" Instead, most professionals believed that the investment(s) were sound because they were so widely held. The information was publicly available so it was assumed that *someone* understood the investments that ultimately failed.

Often, gathering information is not the biggest hurdle. The challenge lies in properly analyzing the available information.

After the fact, we know that the subprime bond market was extremely overvalued. This overvaluation occurred because fund managers, CDO managers and risk managers did not understand the underlying investments. They did not understand that once "teaser" rates expired, foreclosure rates would skyrocket,[10] which would send the value of subprime debt spiraling. Few truly analyzed the information. Many reasoned that "if the analysis was wrong, the business model would not have been successful for this long."

Again, the problem was not the lack of information. It was all there in the offering documents and prospectuses. If a firm was inclined, they could have researched every loan pool or tranche. The problem was analyzing this information. Analysis of this information was incomplete, inaccurate or non-existent.

The fallout from this crisis has affected all of us, not just AIG, Lehman and Bear Stearns. Firms such as Charles Schwab and Morgan Keegan have been embroiled in lawsuits and regulatory inquiries regarding their proprietary bond funds. These lawsuits are similar to many others in that the plaintiffs contend that the firms did not understand the underlying investments within their funds.[11] In many cases, the plaintiffs and regulators allege that the breakdown occurred due to poor *due diligence.*

In June 2011, Morgan Keegan settled with the SEC and numerous state regulators for $210 million regarding allegations surrounding its bond funds. Additionally, Morgan Keegan is prohibited from creating, offering or selling any proprietary funds for 2 years. Morgan's parent company, Regions Financial Corp., is now considering selling Morgan Keegan.[12]

Would strengthened due diligence have prevented the mortgage crisis? Probably not. But could financial services firms such as Charles Schwab and Morgan Keegan have avoided some of the damage and fallout with a more robust due diligence process? Obviously, without diving into each firm's policies and procedures, it is impossible to know the answer. We do know that many firms have paid extremely large fines and settlements regarding charges that are closely related to due diligence.

What's Next?

What are the mysteries and puzzles that will challenge us in the near future? With the implementation of the Dodd-Frank Act and other regulatory initiatives, there should be no shortage of compliance puzzles. Previously unregistered hedge funds and private equity funds will now face new compliance puzzles that, in the past, only applied to registered investment advisers.

Compliance mysteries may be harder to predict. However, the dire financial condition of many states and municipalities leads many to predict a significant increase in the number of municipal bond defaults.[13] What will happen to the municipal debt markets if there is a significant increase in defaults? While we do not know the answer, we can use tools such as extreme stress testing and increased due diligence to protect our firms from potential fallout.

Looking away from our debt markets, we may want to use caution with social media companies as investments. While companies such as LinkedIn®, which has recently gone public, may be exciting to many investors and users, they may not be a suitable investment for any but the most risk tolerant investors. Firms need to make sure that they learn from the Tech Bubble of 2000. Strong due diligence gives firms a better chance of detecting trouble with new products and investments.

It is very easy to look back and discuss what we could have done differently. The real importance comes from changing our behavior. What did the Tech Bubble teach us? What did the Mortgage Crisis teach us? How do we protect our firms from future meltdowns? Identifying compliance mysteries and puzzles quickly is the first step to effectively handling many issues. If we determine something to be a puzzle, we know to rely on robust WSPs, strong internal controls and a Culture of Compliance. If we deem an issue to be a mystery, we begin by learning more about the issue through communication and embedding compliance personnel in the business area. From there, we need to focus on due diligence and look at stress testing in a different light.

Nothing discussed in these pages will prevent compliance puzzles or mysteries. However, effectively identifying challenges and using the correct tools will help firms discern between the proverbial light at the end of the tunnel and an oncoming train a little sooner.

ENDNOTES

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