

Managing Uncertainty In The SEC Fair Fund Process: Part 2

By **Alan Friedman** (June 19, 2018, 1:41 PM EDT)

In the first article of this two-part series, we provided the historical background needed to understand the U.S. Securities and Exchange Commission's complicated fair fund distribution process. We laid the groundwork for maintaining realistic outlooks regarding process completion. In this article, we provide six specific suggestions to help manage expectations and ultimately shave time, maybe even years, off the timeline.



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Managing the Distribution — Positive Steps

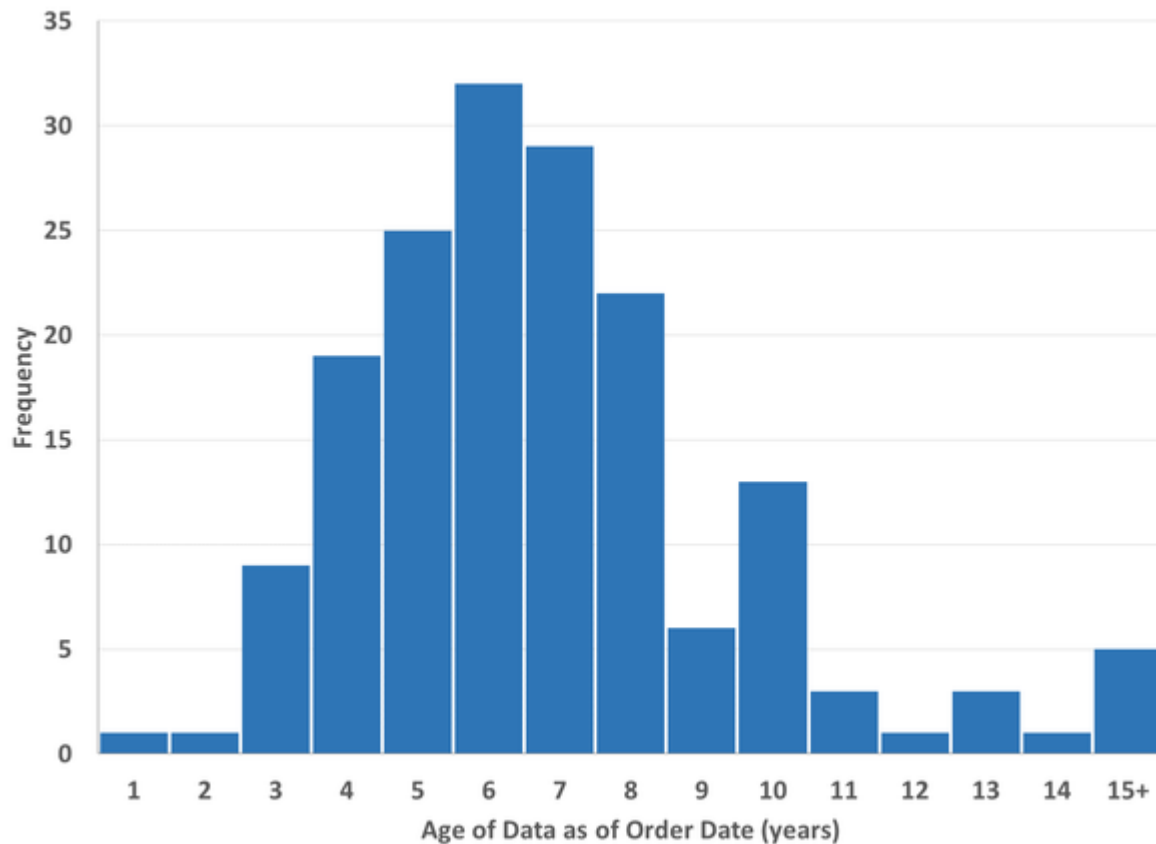
Respondents that are subject to fair fund distributions should recognize that planning for these distributions can be a difficult task, and that exact activities, timetables and costs are not easy to predict. This is due to factors such as the form and availability of underlying data, the complexity of the analyses to estimate harm, the number of potential parties to compensate, responses from eligible investors, the time lag between the underlying events and the date of the distribution, and the reaction of the SEC and the public to any proposed plan of distribution. To cope with the uncertainty inherent in a fair fund distribution, respondents can take actions to reduce the organizational burden. Six specific suggestions are included below.

1. Review the underlying data and flag known difficulties/changes in the data and systems.

The basic building blocks of a damage analysis and payment allocation algorithm are the recorded transactions, accounting records, valuations and other relevant information. It is not unusual for a settlement to be reached many years after the relevant transactions or acts have taken place. A review of the 172 SEC fair funds[1] created between 2003 and 2017 shows that the average time elapsed between the beginning of the relevant period[2] and the date of resolution[3] is about seven years, with some as long as 15 years. When one includes the time to form the respondent's fair fund team and to start gathering information, this means that the data to be analyzed could be over 10 years old.

Since it is common for companies to upgrade software or hardware over time, the underlying data could be in an "unfriendly" form. Not only that, but the information technology professionals and the operations managers who were in place at the time could have retired or left the company. Combined with inevitable errors in original source data, even if corrected and reconciled, this can make the analytical task more difficult and time-consuming.

Figure 1: Age of Data as of Order Date[4]



If there are known data-related difficulties, the respondent's management team can reduce the time and effort required by taking some proactive steps. For example, identify:

- Relevant sources of transactions and information;
- System changes and dates;
- Policy and procedure changes that may have impacted operations or reporting;
- Time periods when data accuracy was questionable, restated or known to be incomplete;
- Organizational "historians" who may have familiarity with older systems and past practices, and alert them in advance of the need for their assistance.

Finally, if difficulties are anticipated, senior management should be alerted to the need for the assignment of appropriate organizational resources, and the possibility of an extended project timeline.

2. Utilize experienced advisers.

In about two-thirds of fair fund cases, usually the larger and more complicated ones, the fair fund process is managed by an independent distribution consultant (IDC) or fund administrator (FA), and a tax administrator (TA), which are selected by the respondent and accepted by the SEC.[5]

In most of those cases, the IDC accomplishes three roles. First to prepare the formal plan of distribution, second to perform the economic analysis leading to a computation of payments, and third to monitor the execution of the plan. The plan of distribution includes criteria for identification of eligible recipients, details on administering the fund, the method of providing payment to harmed parties,[6] de minimis payment levels, allocation of residual amounts, and dispute resolution mechanisms.

The economic analysis, usually accomplished by the IDC or with the assistance of an economic adviser, or EA, estimates the harm resulting from the relevant events, and then creates an approach to fairly compensate eligible recipients. The allocation methodology will differ based on each case and the identified relevant transactions.[7] The analysis is informed by underlying respondent data at a detailed level, observed marketplace activity and pricing, portfolio manager actions, investor behavior, and other inputs that ultimately can be used to determine payments on an investor-by-investor basis.

The fund administrator, in concert with the IDC or EA, handles all direct payee communications, including creating a special website and a call center to provide information to eligible recipients, printing and mailing checks, monitoring available funds, and the management/resending/logging of all correspondence and fair fund actions.

The FA also acts as a point of contact for the fair fund's tax administrator and provides regular reporting to the SEC to enable oversight of the distribution. The FA, after approval from the SEC, also arranges for the transfer of any residual, undistributed fair fund monies to the Treasury[8] and helps ensure proper accounting to enable final closure.

The TA prepares tax returns and tax-related documents for the funds, obtains necessary tax-related identifiers, and performs other tax-related and reporting duties on behalf of the funds.

Some recent cases have seen a modified self-administration approach, with the SEC outlining the major elements of a plan of distribution within the order instituting administrative cease-and-desist proceedings. Under this approach, the respondent retains an economic adviser to focus on developing the financial analyses and payment algorithms, as well as a fund administrator and tax adviser to assist in administration of the distribution activities. These modified self-administered fair funds are likely to reduce the time and costs involved in a fair funds distribution, as some plan elements are prespecified, eliminating the need for independent creation, and formal approval, of the distribution plan.

Finally, the SEC may also choose to utilize SEC staff to perform the advisory functions or allow the respondent to do so. These fair funds have typically been less than \$1 million while those managed by outside advisers have typically been over \$25 million.[9] This relationship may change if recent trends toward modified self-administration continue.

With all of the potential management scenarios, experienced advisers are able to bring knowledge from prior cases to provide context and insight, especially for respondents with little or no fair fund familiarity.

3. Identify a knowledgeable senior manager as a single point of contact for the IDC and FA.

Although most tasks will be accomplished by the IDC and the FA, in most cases the respondent has important information and data that the IDC and FA need to make loss computations and identify individuals or entities that could be eligible for payment.

In the case of a mutual fund, for example, this could mean explaining share allocations among portfolio managers making trades in the same stock on the same day, providing information about internal reporting systems, and gaining access to the fund and shareholder accounting systems. It is important that the respondent control and manage access to the individuals responsible for those areas and identify individuals within the organization with whom the advisers will work.

The respondent's point person should be senior enough and knowledgeable about the operational and information-management processes as well as the management organization to smoothly coordinate (and potentially mediate) between the needs of the advisers and the realistic capabilities of the organization. This point person should also be in a position to provide progress reports to senior management and to disseminate information to the organization, as needed.

4. Recognize that external data will be required to complete the distribution.

Often, the information needed to complete the distribution resides outside the respondent's organization. For example, if shareholders in an investment fund are eligible for payment, and if those shareholders purchased and sold shares through an account at a brokerage firm that bundles trades for its account holders ("omnibus accounts"), then identifying those shareholder trades will require the assistance of the omnibus account manager.

To gather the information from omnibus account managers, an outreach effort is typically conducted by the FA. This requires a degree of diplomacy to convince those managers to provide sufficient detail to identify and make payment to eligible accounts. This outreach is not always 100 percent successful, especially when requesting records that can be 10 to 15 years old and could easily include inactive accounts. Incomplete omnibus responses can result in alternative approaches to payments to subaccounts within the omnibus accounts.[10]

5. Expect the SEC to be meaningfully involved.

SEC fair funds involve oversight. A special unit within the SEC (Office of Distribution, Division of Enforcement) has the responsibility to monitor the fair fund process and to guide execution of the plan of distribution. Some of the areas in which the SEC is likely to be involved are:

- Acceptance of the appointment of the IDC, the FA and TA;
- Review and acceptance of algorithms and formulas for allocating payment to eligible recipients;
- Approval of distribution plan mechanics, such as time allotted for cashing checks, efforts required to locate recipients, de minimis payment levels, and communications with potential recipients;
- Review of early drafts of a proposed plan of distribution;
- Posting of the final draft of a proposed plan of distribution for public comment and final plan approval;
- Transfer of monies from the U.S. Treasury to the fair fund-disbursing bank account;
- Monitoring of check cashing and fund balances;

- Approval of each payment tranche;
- Approval of the transfer of residual monies, final accounting and closure of the fair fund.[11]

SEC involvement is an integral part of the oversight process. In addition, SEC-suggested changes to a plan of distribution are based on experience with scores of plans, and increase the likelihood that distributions proceed without objections and/or difficulties encountered by earlier plans. It should also be noted that once the proposed plan is posted by the SEC for public comment, final plan approval is relatively quick. On average, the time gap between posting a proposed plan and final plan approval has been about five months. The overall process is shortened further if the SEC has already specified key plan elements in the order, such that no formal plan of distribution is required.

6. Prepare management for possible delays and additional costs.

The fair fund process, with all its uncertainties, can cause delays in the distribution of monies and increases in costs. Examples of common delays include:

- Shareholder data that is incomplete or doesn't reconcile to fund net asset value, or NAV, calculations;
- Omnibus managers who do not fully provide requested information;
- SEC questions about plan design or damage computations;
- Unforeseen analytical complications;
- Recipients who cannot be located.

While none of these issues can be fully eliminated, clear communication with management about the real possibility of delays, and the actions taken to minimize them, can help to calibrate expectations.

Managing Expectations Can Reduce Stress, Trim Timelines

The fair fund process is intended to allocate and distribute monies to eligible parties based upon the agreement reached between the SEC and the respondent. Although the process can take a number of years, the suggestions in this article are intended to reduce organizational stress, bring some order to an otherwise uncertain process, and reduce the time and costs required to complete the task.

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[1] As shown on the SEC fair fund website <https://www.sec.gov/litigation/fairfundlist-archive.htm> and <https://www.sec.gov/litigation/fairfundlist.htm>.

[2] The relevant period is defined as the time period during which the harmful acts occurred.

[3] Defined as the date of the order instituting administrative cease-and-desist proceedings.

[4] <https://www.sec.gov/litigation/fairfundlist-archive.htm> and <https://www.sec.gov/litigation/fairfundlist.htm>.

[5] The IDC and FA need to be “not unacceptable” to the SEC.

[6] See SEC Rules of Practice p. 104.

[7] For example, in a case involving failure to obtain best execution on the trading desk, a trade-by-trade analysis is done to determine harm by trade — including the estimation of the market price of each trade at that exact point in time. The trades are then tracked back to those portfolios that were harmed, and then to individual accounts. In a case involving inaccurate NAVs, the analysis begins with a recalculation of NAV day by day for the entire relevant period, correcting for errors made, and then the identification of all transactions at incorrect NAVs. This not only leads to determining harm by transaction, but in the case of shares of a fund that were sold at a depressed NAV, it could possibly lead to the computation of dilution to those investors in the fund who were diluted by the sale of fund shares to other investors at a reduced price. Calculations involving expense overcharges begin by identifying payments made from the fund that should have remained and earned the portfolio returns, compounded over time. Individual transactions in and out of the fund can then be tracked to accurately assess individual investor gains/losses.

[8] Occasionally an investor education program, or similar organization is the recipient of the residual amounts.

[9] For fair funds with information identifying the fund administrator or IDC, the median size of funds administered by the respondent or SEC staff is \$600,000; those administered by an IDC/FA have a median size of \$26.6 million. <https://www.sec.gov/litigation/fairfundlist-archive.htm> and <https://www.sec.gov/litigation/fairfundlist.htm>.

[10] Examples of possible alternate methods include: distributing directly to only those omnibus subaccounts identified; distribution of a lump sum amount to the omnibus manager who will utilize the fair fund methodology (or a method that it deems to be consistent with its fiduciary or other legal obligations) to make the distribution; or permitting the omnibus manager to decline the distribution.

[11] On average, the fair fund distribution process has succeeded in distributing about 90 percent of the monies in fair funds to harmed parties, with about 10 percent (residual amounts) transferred to government agencies.