

To Email or Not to Email: Gauging Regulatory Risk

By Chidem Kurdas, New York Bureau Chief | Thursday, May 12, 2005

NEW YORK (HedgeWorld.com)—What will an examiner from the Securities and Exchange Commission make of that facetious quip you just sent off to a colleague?

Might that little electronic missive suggest that you are not taking seriously your fiduciary duty to the firm's clients? That derivatives pricing is a joke to you? That you're flippant about regulatory compliance?

Renaissance Technologies Corp., a US\$5 billion hedge fund, was recently subject to a routine audit by the regulator. It had to give the examiner its email messages and then explain any contents that raised questions. Hedge fund managers that register with the SEC, as most will be required to do, are subject to such inspections.

If a record exists, the SEC demands that it be produced for the examination, said Renaissance vice president Mark Silber, speaking at a recent Managed Funds Association seminar. An obvious way to reduce regulatory risk is not to send email and not to use instant messaging.

Indeed, some firms disable instant messaging, according to Richard Fleischman, a technology consultant. One reason: there is no confidentiality if data passes through a third-party IM provider. Other firms institute controls to monitor IM usage and to retain IM records

Options

Whether the SEC has a legal right to see everything is subject to dispute. There are documents that are not appropriate to hand over, said Paul Roth, founder of law firm Schulte Roth & Zabel LLP, speaking at the same MFA panel. Just say no and call your outside counsel, he suggested.

It does not create a good environment with the examiner if you give that reply often, said Mr. Silber. For instance, emails to and from one's lawyer should be protected by attorney-client privilege. But the Renaissance examiners made it clear they do not appreciate a wide application of this privilege to email.

Joel Press, senior partner at Ernst & Young's hedge fund practice and another speaker at the MFA seminar, predicted that the first two years of examinations will be difficult as the SEC learns about hedge fund strategies and hedge funds learn to live under a heavier regulatory regimen.

You don't want to say "no" to an examiner, Mr. Press said. Mr. Roth said some demands go too far and even if you comply with them, you should call your lawyer to register your objection.

Regardless of whether you have a right to withhold some emails, you need to have them stored safely. Otherwise, the examiner may start thinking you deliberately destroyed evidence—definitely not a good impression to create.

Mr. Fleischman, whose firm has some 300 hedge fund clients, said a regular mail server is not adequate for this purpose. Investment advisers have three options: acquire technology for internally archiving messages; outsource this function; or combine internal software with an off-site archive.

He finds that small funds and start-ups choose to outsource, while established firms prefer to build in-house, many arranging for offsite data storage in case of emergency. Richard Fleischman & Associates recently introduced a messaging compliance and disaster recovery service specifically for hedge funds.

An archiving system may be purchased for about US\$50,000, while the cost of outsourcing varies from US\$200 to over \$1,000 a month, Mr. Fleischman said. But the latter cost increases with the quantity of data—even a small hedge fund accumulates a lot, because everything gets saved.