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FORMER CFTC CHAIRPERSON SPEAKS OUT ABOUT REGULATION

Feature Interview with Sharon Brown-Hruska

BY RUSSELL WASENDORF, SR.

When Sharon Brown-Hruska, Ph.D., took her first economics class, she fell in love with the way markets work. From then on, she focused her education in that direction. As an undergraduate at Virginia Tech, she studied international finance, Russian and Spanish. She says her goal was to focus on international economic issues. But she detoured from the financial world for three years to teach Spanish after she graduated.

However, the call of the marketplace proved too strong for Brown-Hruska to ignore. She returned to school and earned her master's degree and Ph.D. in economics. While finishing her dissertation, she did some research for the Commodity Futures Trading Commission (CFTC), which eventually became a permanent position as a staff economist.

After five years with the CFTC, Brown-Hruska moved on to teaching at the university level for seven years. But she returned to the CFTC as a commissioner in 2002, serving as acting chairperson from 2004-2005. While at the commission, Brown-Hruska was a member of the President's Working Group on Financial Markets, testified before Congress in support of legislation to reauthorize the CFTC and was instrumental in initiating the Transatlantic Cooperation Initiative between the Committee of European Securities Regulators and the CFTC. During her time as a regulator, Brown-Hruska frequently wrote about and spoke to various groups, focusing on

energy derivatives, hedge funds and international regulation. She represented the commission at numerous domestic and international forums, including the International Organization of Securities Commissions and the World Forum on Energy Regulation.

Through all of this activity, she has been a proponent of market-based solutions to economic issues, especially encouraging the CFTC to be more open to the use of tools derived from economic analysis.

In 2006, Brown-Hruska decided to become an independent voice in the economic community and joined NERA Economic Consulting in Washington, D.C.

RW: How did you get started in financial regulation?

SBH: It wasn't until I moved here [Washington, D.C.] and I was all but done with my dissertation that I started working in the field at the CFTC. I worked from 1990-'95 there, researching how markets were developing, how they were becoming more electronic. Things were changing: the swap market was taking off and we were dealing with the post '87 and '89 stock crashes. So to be at the CFTC in the economics analysis division at that time was a real training ground for me to think about the issues of having a largely speculative market.

It was a challenging time for the CFTC to come in and work with the exchanges, too. That's when I

learned how important it is to work with the industry and try to come to some solutions and also to educate people, especially on Capitol Hill, about the importance of these markets.

RW: You had to be greatly outnumbered as an economist at the CFTC in the pre-1995 period.


SBH: Actually at that time, Wendy Gramm, the chairperson as well as an economist, had the goal to increase the staff to more than 20 economists, which I think was the highest it has ever been. But slowly after she left, during the Clinton administration, the focus shifted back toward attorneys. When James Newsome took over the chair, he built up the economics core again, and it has been a positive influence for the CFTC.

I don't think any of the other government agencies, except maybe for the Federal Trade Commission, has focused so much on economic solutions to problems or what economics can teach us about the way markets operate. That's the core of what we focused on in the early '90s, and that's the same thing I felt compelled to

focus on when I came back in 2002, to be careful about the constraints we put on the market.

RW: The CFTC has exclusive jurisdiction as a federal agency over the futures industry, compared to other federal agencies that have to work with state authorities on issues, such as the Securities Exchange Commission (SEC). I think this is an important element to futures industry regulation.

SBH: Yes it is. I recently wrote an article for the *Futures and Derivatives Law Report* about this very issue. It is concerning to me that the Federal Energy Regulation Commission (FERC), using the agency's new manipulation authority, charged Amaranth with manipulation for conduct that took place in the futures market. I found it disconcerting that FERC would choose to interpret its memorandum of understanding with the CFTC as giving them the ability and the invitation to breach exclusive jurisdiction. Unfortunately, I think that there is always going to be that conflict between the CFTC and other regulatory authorities.



"I think the CME and CBOT are going to use their platform wisely and not going to stand in the way of futures on polar bears, or whatever [Richard] Sandor is devising."

Again, I think it is possible to share jurisdiction and to think about ways of working together because agencies don't want to step on each other's toes as they are trying to catch the bad guys. For regulation, we really want to see where our markets complement each other and how we can provide information to each other. But you don't want duplication of effort, as it appears to be with FERC and the CFTC in this recent action against Amaranth. We want to have efficient regulation that is focused and targeted.

I think that drafters of the Commodity Futures Trading Commission Act were right on when they gave the CFTC exclusive jurisdiction. They were concerned about the SEC wanting to regulate new financial products, such as the mortgage-backed securities in the futures market, and that this regulation could stifle the introduction of these products.

RW: It is amazing to me, the forward thinking in the Commodity Futures Trading Commission Act in 1974. It is interesting to see how well the 1974 act fits markets that have evolved 10, 20 and 30 years later.

SBH: Right, especially in their ability to encourage innovation. I do think that they were very enlightened when they set up this regulatory program. I know that there is a lot of impudence to move toward the United Kingdom's Financial Services Authority (FSA) model of a single regulator for all financial services, and there is some wisdom to that, but I do believe that the CFTC has a great deal of expertise in its particular class of assets that makes it effective and open to innovation. If you have 50 state regulators trying to regulate these products, you are going to have many conflicts.

RW: You were not at the CFTC when the Commodity Futures Modernization Act came into play, but you were probably an interested spectator. If you look back on that, the negotiation between the SEC and CFTC regarding single-stock futures, you would have thought that it was a battle lost by the CFTC.

SBH: Actually, I thought that the foundation for the CFTC to win that battle was fair, but in the negotiations, just as in the negotiations between FERC and the CFTC on the memorandum of understanding, the CFTC didn't hold its ground. I can give you an example of how this played out. One of the issues was whether the CFTC would enable portfolio margining on single-security futures and related products. I was committed to enabling that, and I believe that the CFTC and SEC needed to push for it. But instead, the SEC took an approach that because stock options call for margining of 20 percent for the seller of the option, let's require single stock futures to be 20 percent on both sides. At the CFTC, we argued for getting those margins to reasonable levels, recognizing that the risk profiles were different. I also believe they are fundamentally and economically different risk-management tools and, thus, even the reasoning was flawed that the SEC used for having these leveled margins.

It is unfortunate because it is still an unresolved issue. We have not yet gotten to sensible portfolio margining for products that are extremely closely related.

RW: I am of the belief that one of the reasons we have been able to sustain a bull market since 1981 in the U.S. stock market has been the fact that the S&P 500 launched soon thereafter and enabled portfolio managers to hold their cash portfolio during times when concerns about the economy came into play. Rather than liquidating their portfolios, they would take short positions or hedge positions in the futures market and reduce the volatility of the underlying market.

SBH: I agree with that completely. It made a huge difference. Fast forward to today, why shouldn't some of the narrow-based products or an indexed portfolio in corporate bonds or other securities-based products be available on the exchanges? Again, this constant battle for jurisdiction kept many innovative products from coming to market, and it's still a bit of an issue in

terms of how credit default swap products, introduced by the exchanges, are going to be regulated, for example. But I am pleased that the leadership, especially at the SEC, has been open to a more shared regulatory approach to creditable products, because, I think, they have grown rapidly in the past five years. It's more of an open and competitive market type of approach, and that's excellent thinking.

RW: The Commodity Futures Modernization Act attempted to clarify these jurisdictional issues, but when products fall between jurisdictions, we end up with problems. For example with over-the-counter markets, an earlier issue was when the CFTC decided to exempt energy markets, even though energy products are clearly commodities. Many people look at that as a reason that Enron was allowed to happen and could become a serious economic problem.

SBH: For the over-the-counter swaps market, the thinking was that they wouldn't be regulated in the same way if they were financial or energy products. The impetus was to include them in the suite of banking products, which is really how swaps were viewed at that time, rather than the commodity products. Nevertheless, we felt they should be subject to a higher level of scrutiny because they have such an important impact on the consumer economy and the economy at large.

Enron Online had a specialized market that actually was fairly successful at bringing liquidity to the energy market, where it had not been before. It encouraged innovation. Do regulators need to rethink their approach? Yes. But was it a decision to not regulate or was it a decision to provide a conducive environment for the trading of OTC products? The idea was that these are commercial markets—not available to the retail public—and therefore, they should not be subject to that type of regulation.

RW: The Enron situation, WorldCom and so forth spawned the Sarbanes-Oxley Act. Certainly, the bad

guys at Enron and other companies were found guilty—but by enforcing the existing regulations, not Sarbanes-Oxley. Do you think the legislation was needed and do we still need it?

SBH: Certain aspects of Sarbanes-Oxley were in response to concerns about accounting practices, but clearly they overshot the mark.

At the time, I was teaching investments at George Mason. I had the students use dividend-discount and cash-flow models to help calculate valuations of companies based on such things as what the earnings per share should project. But the models gave us numbers that were way too low, given where the market was trading. All of us in the finance profession were trying to come up with explanations for this. What we found was that while the performance on which people were basing their decisions and some of the accounting practices were abused during that period, the underlying economics suggested lower valuations.

Since it is hard to design a regulatory structure to govern the psychology of markets and its tendency toward irrationality, Sarbanes-Oxley really wasn't all that effective in dealing with that issue. The Public Company Accounting Oversight Board (PCAOB) comes into question as a regulatory body. To fund the PCAOB, they tax all publicly traded companies and created this entire apparatus whose main focus is regulating a few accounting firms, the largest ones, numbering less than five. Why should we go to that kind of expense to deal with a problem, that, as you said, already had a regulatory apparatus in place?

RW: In my experience, regulators tend to create better rules for the industry than representatives or senators.

SBH: That is so true. Take your example of Enron: The CFTC took action against Enron when it had found some manipulative activities there, as did the SEC and FERC. There was certainly no shortage of regulators to deal with

those issues. So Sarbanes-Oxley and that sort of regulatory fervor really has cost the American tax payer heavily, as well as the American economy in terms of its added costs to businesses.

But I am told that the costs are ameliorating over time. And the PCAOB, for example, needs to be a narrowly focused, efficient organization, but it didn't start out that way, which is disappointing.

RW: One of the biggest events from the year has been the merger between the Chicago Mercantile Exchange and the Chicago Board of Trade, but the merger was opposed by the Futures Industry Association. Why do you think FIA opposed it?

SBH: Basically its main concern was about creating a monopoly. The organization's members thought that there would be too much market concentration and power after the merger. Because about 90 percent of all futures trading in the U.S. would have been on this single marketplace, the FIA focused on some of the

historical issues that they had with the Chicago exchanges, rather than looking forward to the efficiencies that could be created.

RW: I contend that an exchange cannot be a monopoly in the futures industry. An exchange can only have an "earned monopoly" in individual markets, based on the exchange's ability to deliver an efficient, liquid market. So I think the reason the FIA opposed the CME-CBOT merger is that the FIA-controlling investment banks thought that for the first time, an exchange would have the economic power to compete with over-the-counter markets, which are the bread and butter of investment banks.

SBH: Well, things are changing rapidly. The exchanges are moving fast to develop new products all across the spectrum, meaning over-the-counter markets, clearing solutions, collateral management and depository services directed toward over-the-counter markets. It's an exciting time to watch the potential as exchanges get in there and compete. So I do agree with you.



RW: Let's use your imagination. Think about what would have been the outcome of this summer's market crisis if there were a futures market on subprime debts?

SBH: It could actually have prevented, or at least mitigated, the damaging effect that subprime is now having across our economic world. Unfortunately, there are not enough people in powerful positions, especially in regulating the futures market, that really understand the effectiveness of the futures market for risk management and how it can prevent damaging effects to our stability. I agree, the risks that are inherent in OTC derivatives markets in terms of credit, settlement, operational, documentation and legal, are huge, and now with subprime, we are really seeing that those risks come to bear on investors.

It is a shame to see how concentrated some of these entities were in this area and how backed up some of the operational processes were among hedge funds and investment banks. This was the area that I was mentioning before, the credit default area. This is an area that would be excellent to have a futures contract on subprime debt, even if it were just an index.

With a subprime futures product, the liquidity would be much greater. The liquidity crunch that occurred in the subprime area was phenomenal; there were no deals getting done. It was difficult to get prices on all of the assets that were there. If we had an exchange-traded product or take just the privately negotiated contracts in subprime or in OTC derivatives and allow exchanges to warehouse that price information to provide a mechanism to collateralize that information, to provide portfolio margins against similar corporate traded assets, then you could lower the costs of transacting in that area and increase the transparency of that sector. I don't think we would have the same liquidity crunch and the same severely high spreads that funds and investors are facing right now. If you had independent pricing and multilateral risk management by a separate entity, such as the futures clearinghouse, that could bring a lot of efficiency to over-the-counter markets.

RW: Have you followed the Sentinel situation at all?

SBH: Somewhat. I know that the concern was whether the funds would be dealt with properly. This case also highlights the benefits of the protections for customer funds deposited at the clearinghouse in segregated funds. I thought it was interesting how in the case of Refco there were investors who wanted to have their funds treated as segregated accounts, subject to regulatory protections, and some of those same issues are coming up in Sentinel. The funds that were in the segregated accounts that were held by the clearinghouse were protected, and those funds were eventually released.

The SEC tried to step in and say that the money shouldn't be released to those futures brokers, but the CFTC argued that they should be released, as well as the customer funds under the commodities laws. Again, that's an example of a smart regulatory model for futures capital and how to protect it from misappropriation, which apparently was going on.

RW: It's an interesting argument that comes up as we start talking about segregated funds as compared to Securities Investor Protection Corporation (SIPC) funds and which is the better system. We argue in the futures industry that segregating those funds is a better system, because all are put in that basket and then you watch that basket very closely. So the concern that I have is how was Sentinel being watched?

SBH: In fact that has been disconcerting to me, that no one seemed to be aware of the problems that Sentinel was having. I understand that the self-regulatory organizations (SROs), including the NFA and the exchanges on the Joint Audit Committee, audit these capital management firms on a periodic basis.

RW: First of all, Sentinel was under a no-action letter regarding how much regulatory capital it put up as compared to all the FCMs, and so there is some ques-

tion about whether that was a good decision in the first place—whether Sentinel should have been enabled to operate with such a small amount of capital. That was one of these things that created a number of problems.

SBH: It does raise this issue of what is the optimal regulatory model? The concern with the SIPC model has always been that it also creates some moral hazard and adverse selection, meaning that firms will take greater risks because they know that they have insurance. So there is no perfect solution.

But I have always felt that market-based solutions are the best, and the concept behind the clearinghouse—the mutualization of risk—and the incentives that creates for the exchange as a self-regulatory authority to monitor the financial condition of firms is critical—monitoring, not in an obtrusive fashion, but in a sophisticated, risk-management-focused model.

From time to time, we’ll see these cases where self regulators let down their guards too much. Amaranth is a good example, where NYMEX, as the SRO, set aside the position limit. In retrospect, it should never have been done, but again, the thinking was, that this was a big, sophisticated trading operation, they knew what they were doing, and so NYMEX raised it. The result was that an aggressive trader took full advantage of those high levels.

So it takes focused monitoring and surveilling of the market participants, but, again, it is the concept of mutualization of risk and vigilant self regulation, where all participants are appropriately incentivized, and that encourages liquidity and the efficiency of the system overall. It’s kind of a democratic process that makes good economic sense.

RW: What are some of the challenges for futures regulation going forward?

SBH: Right now, I think the key issue is how over-the-counter energy markets are regulated—and whether

Congress increases the CFTC’s authority over exempt markets. It’s not an easy question.

The international regulatory issues are also important. When I was with the CFTC, we started the transatlantic dialogue with the European securities regulators. It is critical to find areas of common ground and to make practical improvements in regulatory frameworks to facilitate international commerce. Thinking that helps to lower regulatory costs and reduce duplicative regulation across borders is important to continued market growth.

I am hopeful that U.S. regulators will continue to push those ideas forward. There are some tough questions and Treasury Secretary Henry Paulson has approached many of them. In accounting, we have different requirements for listing across jurisdictions that have caused many publicly traded firms to go to the lowest or least burdensome regulatory model. Although you have to encourage cross-border competition, you don’t want regulation determining where companies are going to list or where products are going to be offered.

RW: With the London exchange now doing more business than NASDAQ and the New York Stock Exchange combined, I think that American exchanges have primarily lost market share because of Sarbanes-Oxley.

SBH: I think that you might have hit the nail right on the head. It’s unfortunate that that has been the cost of corporate scandals generally, as well as an overreaction on the part of the legislature to try to solve a problem that we already had the tools with which to fix it.

I saw it often at the CFTC, where we argued against overreaction to solve a so-called market failure. If you look at Amaranth, the CFTC has adequate jurisdiction to go after that behavior. Why do we need to increase it through a legislative agenda? Why do we need to increase disclosure requirements and erect market constraints on the exempt commercial markets if the CFTC has everything it needs to do the job and police the markets? But there are numerous proposals on the Hill to

increase regulation of exempt markets. It seems to be a constant drumbeat of reaction on the part of Congress to try to fix the problem or at least have the appearance of fixing a problem, when probably all of the regulatory apparatus was there to address it in the first place. Regulators just need to be faster, smarter and more focused.

RW: Electronic trading has been the biggest change to the industry during the past 10 years. So how does that change the regulatory environment?

SBH: I don't think it has changed the regulatory environment that much. Believe it or not, I think the fact that the CBOT and CME have gone electronic is what really ameliorated the FIA's argument against their merger. It's because they now have to be so much more efficient, as they are not controlled by one particular sector, floor brokers or one particular stakeholder, if you will. It's a much more transparent model for trading now.

Everything can be captured with electronic trading from the entry of the order to the execution of it and the way the order is handled within the clearing and settlement mechanism. So much can be summarized, aggregated and surveilled with greater precision. So it has really opened up this world for more efficient regulation, as well as rapid innovation—the possibilities of more sophisticated risk management and the lowering of systemic risk in the derivatives space. It has been so critical to the development of this industry.

RW: But electronic trading could presumably make it so that exchanges could go directly to customers, and there are those of us who have a vested interest in being in the middle of that transaction. I argue that exchanges would give up a great deal if they tried to bypass the intermediary.

SBH: Regulators would give up a great deal, too. I think the risk for individual consumers [would be great without an intermediary] because of the characteristics of derivatives and the markets in general. The market and

margin work well as a risk-management process, but it does make possible a great deal of leverage and ratchets up the impact that a single trader can have, so you really need that intermediary to act as an additional layer between the clearinghouse and the customer. Not just for customer protection, but again for solid risk management, making sure that suitability requirements are met and just managing portfolios across a spectrum of activity in a more effective way.

There are important services that intermediaries provide that exchanges aren't equipped to offer. I would rather that they not try to become both the intermediary and the exchange. There is specialization of duty and service there that can't be duplicated by one or the other.

RW: You touched on this a minute ago, that within a clearinghouse, all the clearing members are mutually responsible for each other. If you take into consideration the book value of all of the clearing members who are promising to safeguard the customer's financial interest, it's much larger than the combined CME and CBOT. That, in itself, is the strongest argument to maintaining the intermediaries as an important link between the customer and the exchange.

SBH: It really is, and it gets you back to diversification ability, as well, because I've seen a lot of diversity in intermediation services. There are sort of niche clearing members in terms of types of customers that they serve and trades that they do. There is efficiency in that, too. Again, the clearinghouses are important and efficient, but from a regulatory perspective, I would be suspicious of a direct line to the customer, unless it's the most plain vanilla of products. Even then, I still would be cautious in that area.

There was a great deal of talk about hedge funds going direct to exchanges without going through an intermediary. Well that's a perfect example of where excess risks can sometimes be taken in pursuit of greater returns. I'm not saying that there's anything wrong with that. I think it's part of their specialization, and it's important that they

PROFESSIONAL ACHIEVEMENTS OF SHARON BROWN-HRUSKA, PH.D.

- 1983: Graduated from Virginia Tech with a bachelor of arts degree in economics and international studies.
- 1984: Taught Spanish in Frederick County Public Schools in Virginia.
- 1987: Returned to school to pursue graduate study in economics.
- 1990: Became a staff economist at the CFTC while finishing her dissertation.
- 1995: Earned her Ph.D. in economics from Virginia Tech.
- 1995: Took an assistant professor position at Tulane University in New Orleans, teaching risk management and international finance.
- 1998: Became assistant professor of finance at George Mason University in Virginia, focusing on securities, derivatives and alternative asset markets.
- 2002: Appointed commissioner at the CFTC.
- July 2004: Designated acting chairperson of the CFTC, serving through July 2005.
- November 2004: Confirmed by the Senate for a second term as CFTC commissioner.
- 2006: Joined NERA Economic Consulting.

and their investors be able to pursue their strategies. But to have them go direct without having to deal with an intermediary to monitor their collateral and hold them accountable when they exceed their limits—an intermediary whose incentives are aligned because its capital is at risk as well—I believe that extra layer is important for the broader market.

RW: What do you want to leave behind as your legacy in the industry?

SBH: I think a strength in my convictions, in the work that I've done, for honesty and integrity in the way I approached it. It doesn't matter what you do in some sense;

it's how you conduct yourself in doing it and how much you love it. And I truly love being an economist and focusing in and thinking about these issues.

I want to be remembered for having a clarity of vision. I firmly believe in free markets and minimal regulation, protecting individual investors, while also ensuring that they have the best products and services available to them. Staying true to those goals is important to me.

RW: You have been a low-key presence in the industry. It's too bad, because I think that you are an individual more people should get to know.

SBH: Thank you. I have not purposefully been low key. In fact, I have probably published more and have spoken at more conferences and to more gatherings than any other commissioner in the history of the CFTC—again, with this desire to teach, to be out there and sharing my excitement and my interest in the markets and my observations. There is a lot to explore; there are a lot of possibilities out there.

RW: This has been fun. Thank you. ●

Russell Wasendorf Sr. is Publisher of *SFO* magazine.



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FINANCIAL REGULATION and COMPLIANCE LITIGATION

OUR PRACTICE

NERA is widely recognized as a leading firm in the economics of securities and finance. The members of our securities and financial services practice bring to bear a thorough understanding of financial markets, regulatory processes, and valuation. As a pioneer in the field of asset valuation, NERA uses innovative models and techniques to measure value in real-world scenarios, including regulatory investigations, litigation, and impact analysis.

NERA also has strong economic expertise in regulatory design and assessment in the financial services sector. NERA has worked extensively with US and UK regulators to determine the quantitative and qualitative impact of regulation on firms and the wider market. We also have expertise in the areas of market structure, securities and commodities trading, OTC derivatives, and risk management. NERA's expertise in valuation techniques and financial regulation enables us to support clients in all economic aspects of regulatory policy, including handling market abuse investigations, defending enforcement action, providing expert testimony, and quantifying regulatory impacts and risks.

KEY AREAS OF EXPERTISE

Regulatory Investigations—Market Abuse and Enforcement Action

NERA has provided economic expertise to clients undergoing regulatory investigations that include allegations of market abuse, as well as to clients that are the subjects of enforcement actions. In such cases, NERA experts have applied the theories of financial economics in innovative manners. For example, our approaches to valuation can be used both *ex-ante*, to help clients think about the regulatory risks facing their organization and the associated costs; and *ex-post*, to determine the but-for scenario had the alleged conduct not taken place, and hence the economic cost of the action. NERA has used this type of economic analysis in scenarios ranging from helping clients understand regulatory costs to providing expert testimony.

Litigation

NERA's extensive experience regarding economic advice in litigation, combined with our expertise in financial markets, enables us to provide valuable economic support in arbitration cases as well as court proceedings. Our economists have helped law firms and companies navigate investment and contract disputes in various arbitration venues. We apply our expertise in financial economics to offer objective and independent analyses and provide expert reports and testimony if necessary. NERA experts have conducted numerous damage and compensation analyses using sophisticated financial modeling techniques, interpreted regulatory decisions, and valued complex financial derivatives.

Managing Legal and Regulatory Risks

As regulators have increased their scrutiny of markets and market users (particularly hedge funds, over-the-counter derivatives, and commodities trading), compliance and litigations costs have risen as financial institutions, intermediaries, and end users are often asked to demonstrate the economic or business purpose of their trading, and are subject to increased disclosure and reporting requirements. NERA helps clients control these costs by applying product and asset knowledge drawn from extensive experience in financial markets and commodities, and trading and risk management in energy markets. We assist clients in understanding the environment from a regulator's perspective, and can help build risk-based compliance protocols to manage legal and regulatory risks. By implementing a focused, surveillance program that is aligned with regulatory requirements, companies can better prepare themselves to handle increased regulatory and legal risk.

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