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CHIEF COMPLIANCE OFFICERS

Why Fund Managers Must Adequately Support CCOs and Compliance Programs: Recent Failures Lead to SEC Enforcement Action (Part One of Two)

By Robin L. Barton, *Hedge Fund Law Report*

In a June 2015 speech, then-SEC Commissioner Luis A. Aguilar advocated for the support of chief compliance officers (CCOs) by investment advisers given the "vital role" that CCOs play. Aguilar would presumably take comfort in the fact that, according to the ACA Compliance Group's 2018 Alternative Fund Manager Compliance Survey, 70 percent of hedge fund and illiquid fund manager respondents said that they receive sufficient compliance resources. The remaining 30 percent, however, should be very concerned that failing to provide sufficient resources and support to their CCOs could undercut their compliance efforts and result in violations and enforcement actions. As Aguilar stated, "The potential costs of compliance failures can be costly . . . as measured by the financial sanctions that could be imposed by regulators."

Recent related SEC enforcement actions illustrate what can happen when a CCO's repeated calls for more resources and support go unheeded. In November 2018, Pennant Management, Inc. (Pennant), formerly a registered investment adviser, settled charges that it negligently failed to perform adequate due diligence and monitoring of certain investments contrary to its representations to clients, which ultimately contributed to substantial client losses. Separately, Pennant's former CEO, Mark A. Elste, also settled charges that he contributed to Pennant's violations by failing to address known resource deficiencies in its compliance program.

This two-part series explains why it is important for investment advisers to provide adequate resources to support their CCOs and compliance programs. This first article details the compliance failures in the Pennant and Elste enforcement actions. The second article will provide the key takeaways for investment advisers and their CCOs from these actions.

For other enforcement actions in which insufficient compliance resources played a role, see "Lessons Private Fund Managers Can Learn From U.S. Bancorp's Settlement of AML Violations" (Apr. 26, 2018); and "SEC Enforcement Action Shows Hedge Fund Managers May Be Liable for Failing to Adequately Support Their CCOs" (Jul. 23, 2015).

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Relevant Parties

Pennant, a Wisconsin-based corporation, was registered with the SEC as an investment adviser from April 1995 until May 2015. In 2004, Pennant became a wholly owned subsidiary of an Illinois holding company (the Holding Company). Elste founded Pennant in 1995 and was Pennant's CEO and chairman of the board of directors until March 2015 and its chief investment officer (CIO) until October 2013.

Due Diligence and Monitoring

From May 2013 to September 2014, Pennant advised clients to purchase interests in facilities and other investments containing repurchase, or "repo," agreements for portions of loans guaranteed by various government entities. Each facility contained loans sourced exclusively from any one of four counterparties. By the end of 2013, clients had invested a total of nearly $800 million in the program based on Pennant's advice.

First Farmers Financial (First Farmers) sought to use Pennant to finance what it claimed would be loans guaranteed by the U.S. Department of Agriculture. Pennant's initial due diligence of First Farmers identified concerning information about First Farmers' CEO, which was never escalated. Instead, Pennant continued to offer the First Farmers repos to clients despite growing concerns about the legitimacy of the investments, including questions about whether First Farmers lied about the existence of its auditor.

By the end of September 2014, Pennant determined that First Farmers had forged paperwork and that all of the First Farmers repo agreements were fraudulent. In fact, the DOJ later successfully prosecuted First Farmers' CEO and president for fraud in a $179-million sham loan scheme.

For more on repo agreements, see "Steps Fund Managers Should Take Now to Ensure Their Trading of Swap, Repo and Securities Lending Transactions Continues Uninterrupted After January 1, 2019" (Oct. 18, 2018).

The Compliance Program

In January 2012, Elste asked one of Pennant's portfolio managers to assume the role of interim CCO. The portfolio manager had no compliance experience but accepted the CCO position contingent on having access to outside counsel and compliance consultants as needed. The CCO began working extended hours to keep up with his retained portfolio manager duties.

The CCO took steps to educate himself on an investment adviser's compliance requirements, for example, by attending a compliance conference. He also reviewed Pennant's compliance policies and procedures.

Between March 2012 and February 2014, the CCO repeatedly advised Elste and others of concerns he had about Pennant's compliance program, as well as the insufficiency of the resources dedicated to compliance. The chart below details the various compliance concerns the CCO – and Pennant's presidents – raised and resource requests they made, as well as the responses and actions by Elste and others, including the Holding Company's management.

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Date	Compliance Concern/Request	Response/Action
March 2012	In an email to Elste and others, the CCO raised questions about Pennant's policies and procedures, adding, "In my opinion, we need the experience of an outside resource right now to help us evaluate the status of our compliance program, including our investment adviser policies and procedures manual."	Pennant did not retain additional outside resources at that time.
May 2012	The CCO notified Elste that Pennant had never completed a formal risk assessment, which he believed was necessary for an effective compliance program. The CCO also noted his understanding that the SEC was looking closely at compliance policies and procedures and warned that "inadequate policies could lead to enforcement action." The CCO completed his review of the policies and procedures during 2012, and completed a risk assessment by September 2012.	
August 2012	When Elste offered to make the CCO's interim position permanent, the CCO accepted on the conditions that: • he would have access to outside counsel; • Pennant would engage compliance consultants as needed to improve the compliance program; and • he would relinquish his portfolio management duties to eliminate inherent conflicts.	Although Elste agreed to these conditions, he soon gave the CCO additional compliance duties – without adding any additional compliance resources.
December 2012	The CCO and Pennant's president and COO (President A) gave Elste a list of high-priority compliance projects that needed to be completed and requested additional compliance resources.	Elste rejected the request and instead instructed them to "re-task" Pennant's existing staff to help with compliance. The CCO re-tasked the staff, but noted to Elste that he did not believe the re-tasking was sufficient. Pennant cut $80,000 that had been earmarked to hire another compliance staff member from its proposed 2013 budget.

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Date	Compliance Concern/Request	Response/Action
January 2013		Elste and the Holding Company management again expanded the CCO's compliance obligations and diverted some of the CCO's resources to new tasks.
February 2013	The CCO presented his 2012 annual compliance review to Pennant's board of directors, including Elste, in which he: • identified several weaknesses in Pennant's compliance program, including, but not limited to, compliance program testing and training; • noted his limited experience, which necessitated his reliance on outside resources, and the additional demands placed on him; • warned that "there is a risk that a compliance issue may go unnoticed due to limited resources available for testing and auditing of the numerous areas of the firm's compliance program"; and • repeated his request for the addition of a compliance officer who would focus on compliance program testing, training and other issues.	Pennant did not hire additional compliance resources in 2013.
Throughout 2013	The CCO and President A made multiple requests for additional resources.	Elste denied these requests.
October 2013	Pennant hired a new president and COO (President B) to replace President A and Elste as CIO. Soon thereafter, President B asked Elste for more compliance resources for 2014.	Elste and the Holding Company management did not approve additional resources for compliance at that time.
January 2014	The CCO presented his 2013 annual compliance review to Pennant's board of directors, including Elste. The report: • noted that, since the last review, the CCO assumed responsibility for compliance oversight of three other entities in addition to his role as Pennant's CCO; • clarified that because the compliance program was recently updated, and because of limited resources and increased demands on his time, the 2013 compliance review was not as in-depth as the 2012 review; and • reiterated his concerns about the risk resulting from insufficient resources, namely, that compliance issues may go unnoticed.	

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Date	Compliance Concern/Request	Response/Action
February 2014	The CCO raised the need for additional compliance resources with the trustees of two investment companies. The independent trustees then raised the issue with Elste.	In June 2014, Pennant hired a compliance analyst. In July 2014, Pennant engaged an outside compliance consultant to evaluate its compliance program.

See "Developing a 2018 Compliance Budget: How Investment Advisers Can Make the Most of Limited Resources" (Dec. 21, 2017).

Violations

According to the SEC, the denial of resources undermined the effectiveness of Pennant's compliance program, which resulted in compliance failures. Specifically, Pennant failed to reasonably design and implement policies and procedures regarding:

- initial and ongoing due diligence and monitoring of repo agreement counterparties;
- periodic monitoring of employee emails;
- allocation of investment opportunities in its repo program; and
- maintenance of repo trade allocation records.

See our two-part series "A Roadmap to Maintaining Books and Records": Compliance With Applicable Regulations (Nov. 2, 2017); and Document Retention and SEC Expectations (Nov. 9, 2017).

Pennant also failed to test whether its staff were following its policies and procedures. For example, because Pennant did not regularly monitor staff emails as required by its written policies and procedures, it failed to detect that one of its employees had repeatedly engaged in unauthorized activities, including violating Pennant's gift reporting policy.

In addition, in April 2013, Pennant disclosed in its Form ADV Part 2A that it had implemented a new policy requiring allocation of investment opportunities in repo agreement facilities to clients on a strict first come, first served basis. The CCO learned in January 2014 that:

- the employee responsible for repo allocation likely was not following the allocation policy; thus, certain clients may have received preferential treatment; and
- Pennant was not maintaining records formally documenting repo client indications of interest and the basis for allocation decisions.

Due to the scope of his duties and lack of resources, the CCO was unable to test compliance with the repo allocation procedure.

Further, as part of Pennant's ongoing due diligence of counterparties, the repo agreements required counterparties to provide Pennant with quarterly unaudited and annual audited financial statements. Although Pennant's repo program had a process for performing counterparty initial and ongoing due diligence and monitoring, this process

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was not included in its written policies and procedures.

See "ACA 2017 Fund Manager Compliance Survey Addresses SEC Exams and Practices Used to Mitigate Counterparty Risk (Part One of Two)" (Jan. 18, 2018).

Pennant's CCO warned that counterparty risk was a significant threat to Pennant in his 2012 and 2013 annual risk assessments, which he escalated to Elste and the board of directors. Although Elste advised an officer at an affiliated entity that he would be involved in developing the repo counterparty due diligence practices, this did not occur. In addition, Elste did not make any other efforts to amend Pennant's written policies and procedures to include counterparty due diligence and monitoring, and he denied repeated requests from the CCO and others for additional resources and staff.

As a result, the SEC found that Pennant willfully violated antifraud, compliance and books-and-records provisions of the Investment Advisers Act of 1940 (Advisers Act) and Rules 204-2(a)(3) and 206(4)-7 thereunder. Without admitting or denying the findings, Pennant agreed to a cease-and-desist order, censure and payment of a $400,000 civil penalty.

In addition, the SEC found that Elste willfully aided and abetted and caused Pennant's compliance violations under Section 206(4) of the Advisers Act and Rule 206(4)-7. Without admitting or denying the findings, Elste agreed to a cease-and-desist order, censure and payment of a $45,000 civil penalty.

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CHIEF COMPLIANCE OFFICERS

Why Fund Managers Must Adequately Support CCOs and Compliance Programs: Six Valuable Lessons From Recent Enforcement Actions (Part Two of Two)

By Robin L. Barton, *Hedge Fund Law Report*

Rule 206-4(7) under the Investment Advisers Act of 1940 – the so-called "Compliance Rule" – requires an investment adviser to establish compliance policies and procedures; appoint a chief compliance officer (CCO) to administer those policies; and review the effectiveness of the policies at least annually. Implicit in the Compliance Rule is the requirement that the adviser provide adequate resources to support the CCO and the compliance program.

Recent SEC enforcement actions against an investment adviser and its CEO illustrate the consequences of ignoring a CCO's repeated calls for additional resources and support. In November 2018, Pennant Management, Inc. (Pennant) and its former CEO, Mark A. Elste, settled charges that, among other things, they failed to address known resource deficiencies in Pennant's compliance program, which undermined the program's effectiveness and resulted in compliance failures.

This two-part series explains why it is important for investment advisers to provide adequate resources to support their CCOs and compliance programs. This second article provides the key takeaways – including six valuable lessons learned – from the Pennant and Elste enforcement actions. The first article detailed the compliance failures in those actions.

An Extreme Case Still Provides Lessons

"Although the facts of the Pennant and Elste actions are especially egregious," acknowledged Michael Emanuel, partner in Stroock's private funds group and former regulatory and compliance counsel for registered advisers and funds, "there are still many lessons that advisers can learn from these cases."

Lowenstein Sandler partner Benjamin Kozinn agreed, noting that the orders only present the SEC's recitation and characterization of the facts.

Although the Pennant and Elste actions may be extreme examples of failures to properly resource a compliance program, they are hardly the only cases in which a lack of sufficient compliance resources or support played a key role.

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For example, in a case with notable similarities to the Pennant and Elste actions, investment adviser Pekin Singer Strauss Asset Management Inc. (Pekin Singer) and three of its principals settled charges with the SEC that they failed to provide sufficient support and resources to the CCO, which led to the firm's failure to conduct timely annual compliance reviews for several years (among other compliance failures). Specifically, when the inexperienced CCO requested assistance, Pekin Singer's principals denied his requests. See "SEC Enforcement Action Shows Hedge Fund Managers May Be Liable for Failing to Adequately Support Their CCOs" (Jul. 23, 2015).

Similarly, in February 2018, the U.S. Attorney for the Southern District of New York announced U.S. Bancorp's settlement of violations of the Bank Secrecy Act's anti-money laundering (AML) requirements. The bank had been charged with willfully failing to have an adequate AML program and to file suspicious activity reports (SARs). Inadequate staffing was one of the causes of these violations. For example, an internal memo noted that the employees charged with investigating the SARs were "stretched dangerously thin." See "Lessons Private Fund Managers Can Learn From U.S. Bancorp's Settlement of AML Violations" (Apr. 26, 2018).

1) Compliance May Be Questioned at Any Time

Investment advisers are well aware that when the SEC conducts examinations, it may identify deficiencies in the adviser's compliance program, which may result in an enforcement action. The SEC, however, is not the only entity that may be interested in the adequacy of an adviser's compliance efforts.

In fact, the securities violations in the Pennant and Elste actions were uncovered by the DOJ's criminal investigation into the investments the adviser had made in what turned out to be fraudulent repurchase agreements.

"The lesson is that advisers never know when compliance issues may be discovered or when they may be questioned about their compliance efforts," observed Emanuel. "Advisers may be asked for evidence of the adequacy of their compliance infrastructures by regulators, institutional investors, vendors or banks – and advisers have lost clients because their compliance programs could not survive operational due diligence."

"For hedge funds, institutional investors and high net worth individuals are often the gatekeepers of compliance, meaning that they expect a certain culture of compliance," remarked Kozinn. "In my experience, operational due diligence teams from sophisticated investors are the ones who are kicking the tires of an adviser's compliance program." He added that potential buyers of the investment adviser itself may have similar questions about the adviser's compliance program.

The possibility of an employee becoming a whistleblower and revealing an adviser's compliance deficiencies to the SEC is another risk that advisers cannot ignore. The risk is particularly high given the financial incentives for whistleblowers. According to the SEC's 2018 Annual Report to Congress, fiscal year 2018 saw the highest number of tips and the highest individual and aggregate award payments in the history of the SEC's whistleblower program.

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See "SEC and CFTC Whistleblower Awards Continue to Grow" (Jan. 17, 2019).

Pennant's CCO started by bringing his requests for additional compliance resources and concerns about the compliance program to Pennant's management. He eventually raised these issues with the board, which finally took some action.

If the board had also ignored the CCO's requests and concerns, he would have been left with two "nuclear options": quit or become a whistleblower, said Emanuel. Both options are bad for an adviser, he explained, which will either have to hire or appoint a new CCO or prepare for a possible SEC investigation.

"Investment advisers are certainly attuned to the risk that someone could go to the SEC and say, 'I tried my best. I did my job and raised these issues, but no one listened to me,'" observed Kozinn. "If a CCO really believes that something is going wrong and management is not listening, he can go to the SEC – and it will listen."

For more on whistleblowers, see "Proskauer Attorneys Evaluate the Dodd-Frank Whistleblower Program and Its Future Under the Trump Administration" (Jun. 1, 2017); and "Asset Managers Must Adapt to Increasing Protections for Internal Whistleblowing Under Dodd-Frank" (May 18, 2017).

2) Wearing Multiple Hats Is Risky

Pennant's CCO was a portfolio manager who had no prior compliance experience. For an extended period of time, he was acting as both portfolio manager and CCO. Wearing multiple hats is challenging under the best of circumstances, but it is especially risky when the individual has little compliance experience.

"In a small firm with few employees, it is not unusual for a CCO to play multiple roles. This is not always an issue, but advisers must be cautious," warned Kozinn. "Depending on the firm's investment strategies, a portfolio manager may make a better CCO than a lawyer. In the Pennant case, however, the CCO/portfolio manager was trying to do both jobs at a time when, in hindsight, the firm was most vulnerable."

"Although not the most ideal scenario, elevating a portfolio manager to CCO may be acceptable in some firms," said Emanuel. "A CCO should be someone who has seniority; the ear of the chief executive; and the ability to facilitate the implementation and running of the compliance program. Sometimes, that happens to be a person on the investment side."

"If a firm is large enough, however, it should not have one individual act as both CCO and portfolio manager. It is not a de facto violation to be both CCO and portfolio manager or another position; dual roles sometimes happen out of necessity," continued Emanuel. "The problem with holding both positions simultaneously is that it creates conflicts when implementing procedures, and it may be difficult to do either job well. When someone is trying to do two full-time jobs, one may lose priority – and that may create problems and additional conflicts."

See "Benefits, Challenges and Recommendations for Persons Simultaneously Serving as General Counsel and Chief Compliance Officer of a Hedge Fund Manager" (May 10, 2012).

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3) Resources Include More Than Personnel

The resources a CCO and a compliance program need will depend on many factors, such as the size of the adviser, the fund's strategy and the CCO's experience. When determining resourcing needs, it is important to remember that "resources" does not just mean personnel – it also includes:

- software and other technology;
- compliance consultants and outside counsel;
- compliance-related conferences, seminars and similar events; and
- networks of other CCOs and general counsels.

"There is a lot of technology that can enable an individual who is resourceful and diligent to fulfill the CCO's duties without a big staff. Services like Global Relay and Smarsh can streamline email monitoring and searches. Order-management systems can monitor trade allocations and ensure compliance with restricted lists," noted Kozinn. "These compliance tools can take care of the ministerial or mundane tasks, so the CCO can focus on more nuanced issues such as insider trading or expense allocation."

Emanuel agreed that technology can be very useful for CCOs. "These services are often costly, but once they are set up, they are easy to use and provide the tools a CCO needs to be more efficient," he said.

See "How Hedge Fund Managers Can Use Technology to Enhance Their Compliance Programs" (Nov. 17, 2011).

4) CCOs Must Advocate for Compliance

Although the Pennant CCO was inexperienced, once he accepted the position, he did everything he reasonably could to ensure the adviser was compliant with the securities laws and to advocate for the resources he believed the program needed.

"The CCO did what he could to educate himself on the adviser's policies and procedures and the applicable rules, including attending a compliance conference. He understood what he did know – and what he didn't," noted Emanuel. "After the CCO identified gaps in the compliance program, he asked for more resources to address those gaps. When those requests were denied, he not only continued making these requests – and documenting them – but also escalated the issues up the chain."

For example, after going to Elste, the CEO, proved ineffective, the CCO marshaled the support of Pennant's president. After the president was replaced, the CCO received the support of his replacement. They both then went to the board, which finally took some steps to address the compliance issues they had identified.

"For someone who was put in a tough spot, the CCO seemingly did nearly everything he reasonably could with his knowledge and the resources that were given to him. He was essentially shouting from the mountaintops," remarked Kozinn. "Although the CCO did all the things that one could expect him to do, however, he did not have buy-in from management that what he was doing was critical to the business."

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"Compliance departments often have to fight for every dollar they get. CCOs have a strong argument at their disposal when making the case for resources: compliance is a regulatory requirement," commented Emanuel. "CCOs, however, cannot simply rely on that argument. They must also be really well informed and prepared to explain why the firm needs a specific resource, how much that resource costs and why that cost is justified."

Kozinn added that when CCOs ask for more resources for a particular task, they should be prepared to answer questions such as, "Why is the current resourcing inadequate? Is there a way to do this task with our current resources but with changes to our processes, procedures or current staffing?"

Emanuel provided an example of how questions regarding compliance resources should be handled. "Many firms have multiple offices across the country and the world, and instant communication is key. Employee texting can be a convenient and valuable way to stay in touch," he said. "To allow texting, however, the adviser needs to acquire and utilize software to capture the communications for compliance purposes – and this software is not cheap," he said.

"The adviser needs to conduct a cost/benefit analysis of allowing texting, including utilizing resources that may have been allocated from different departments within the adviser," continued Emanuel. "The adviser must weigh its ability to run the business without employees being able to text each other against the cost of software and the time allocated to remain compliant. That is the kind of process CCOs and advisers may need to go through when making resourcing decisions."

For an example of a CCO who failed to take even basic steps to ensure compliance, see our two-part series "What a Recent SEC Opinion on a FINRA Disciplinary Action Says About CCO and CEO Liability": Part One (Jan. 24, 2019); and Part Two (Jan. 31, 2019).

5) Documentation Is Critical

One of the most important steps the Pennant CCO took was to document his resource requests and the compliance issues he raised with Elste and others, as well as the responses. This documentation likely helped the SEC build its case against Pennant and Elste – and may have been one of the reasons the CCO escaped personal liability.

"The CCO kept documenting his progress, whether positive or frustratingly negative, in emails and reports. All CCOs must keep good notes, especially if they feel like they are not getting resources or that compliance issues are not getting addressed," advised Emanuel. "There is no right or wrong way to do it. For example, some people take notes directly in Outlook, while others write memos to themselves." Emanuel recommended that CCOs discuss these issues in formal business or governance committee meetings for which minutes are kept.

Of course, there may be circumstances in which management has valid reasons for denying a CCO's request for additional resources. In that case, Emanuel and Kozinn agreed that it is equally important for management to keep records of its reasons for rejecting the request.

"If an adviser denies a CCO's request for more resources or a particular resource, it may later be required to defend that decision to the SEC. I don't think the adviser needs to create a massive file on the issue, but it should, at a

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minimum, document the discussion," observed Kozinn. "Suppose the CCO requests new software for a specific task. The notes may indicate that because the current software has a tool that can be used for this task, management decided that the CCO will start with that existing tool and that they will revisit the issue in six months."

See our two-part series "A Roadmap to Maintaining Books and Records": Compliance With Applicable Regulations (Nov. 2, 2017); and Document Retention and SEC Expectations (Nov. 9, 2017).

6) Discovered Issues Must Not Be Ignored

In addition to requesting additional resources, the Pennant CCO also raised deficiencies in the adviser's compliance program – such as inadequate training – and it does not appear that Pennant or Elste took appropriate steps to investigate his claims and, if necessary, make changes to address those deficiencies.

"Once the CCO has raised an issue to the CEO, it cannot be ignored. The CEO must ensure that something is done to address the issue, and the CCO must follow up to ensure that the issue has, in fact, been addressed," explained Emanuel. "Remember, the CCO's role is not to complete all compliance tasks; the CCO's role is to make sure that those tasks are done and that the adviser is compliant."

"When a CCO tells an adviser's CEO that there are glaring gaps in the compliance program, management is now on notice and must take appropriate steps to fill those gaps," echoed Kozinn. "If someone says there is a hole in the compliance program and is ignored, the adviser is just asking for an enforcement action. That kind of response is indicative of a cultural failure by the CEO, the management team and the adviser."

Compliance Is Like the Foundation of a House

"The Pennant and Elste actions are good examples of cases that should be distributed to every law firm client, accounting firm client, fund manager and adviser," observed Emanuel. "They drive home the point that if you do not allocate adequate resources to compliance, you are building an empire on a bad foundation."

"Compliance is like the foundation of a house. When you own a house, it's easy to focus on the landscaping, the furniture, the artwork and the fancy shower. You may not pay any attention to the foundation," continued Emanuel. "If you only spend money on paintings, shrubs and computers, however, eventually the foundation is going to crumble and the house will collapse."

Kozinn suggested that CCOs use the Pennant and Elste actions to open discussions with management about the proper resourcing of their compliance programs. "This should not be a one-time conversation, however," he warned. "There should be ongoing conversations between CCOs and management about what is happening in the businesses, as well as any impact changes or events may have on the compliance program and its needs." He added, "Although it may sound cliché, a culture of compliance and buy-in from the top as to the value of compliance are critical to ensuring that the necessary resources are there."

See "SEC Chair Offers Observations on Culture at Fund Managers and the SEC" (Jun. 28, 2018).

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