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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, *Private Equity 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 its CCO and 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 outlined 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 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 where a lack of sufficient compliance resources or support played a key role.
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 in 2015 that they failed to provide sufficient support and resources to the CCO. Among other compliance failures, this resulted in the firm failing to conduct timely annual compliance reviews for several years. Specifically, when the inexperienced CCO requested assistance, Pekin Singer's principals denied his requests.

See "SEC Enforcement Action Shows 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 a settlement with U.S. Bancorp for 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), which was caused in part by inadequate staffing. 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." Potential buyers of the investment adviser itself may have similar questions about the adviser's compliance program, he added.

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.

See "Necessary Precautions for PE Firms When Using Employee Agreements to Protect Confidential Business Information" (Jul. 23, 2019); and "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 those 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 operation 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 our two-part series: "Benefits of Having a Dual-Hatted GC/CCO, and Alternative Solutions for Fund Managers" (Apr. 30, 2019); and "Challenges and Recommendations for Simultaneously Serving as GC and CCO of a Fund Manager" (May 7, 2019).

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, publications, seminars and similar events; and
- networks of other CCOs and general counsels.

"There is a lot of technology that can enable a resourceful and diligent individual 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 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."

"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 that software is not cheap," he added.

"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 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 that task, management decided that the CCO will start with the existing tool and that they will revisit the issue in six months."

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 then 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."