



Chief Compliance Officers

Survey Reveals Compliance Weaknesses of Hedge Fund Managers Relative to Other Financial Services Firms, Including CCO Qualifications and Frequency of Annual Compliance Reviews

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Many private fund managers, including hedge and private equity fund managers, have fortified their compliance programs in response to increased regulatory scrutiny in recent years. Cipperman Compliance Services (CCS) recently issued the results of its 3rd Annual **C-Suite Survey** (Survey), which provides a snapshot of the current status of the compliance programs of hedge funds and other financial firms in light of this scrutiny.

Among the results captured in the Survey concerning hedge fund managers are the pervasiveness of dual-hatting of chief compliance officers (CCOs); the surprisingly small percentage of hedge funds that have been examined by the SEC in recent years; the significant percentage of hedge fund managers that have failed to perform their required annual compliance reviews; and the sizable amount of revenue that managers have allocated to compliance. This article analyzes these and other key findings from the Survey.

For additional commentary from CCS founder Todd Cipperman, see our three-part series on the simultaneous management of hedge funds and alternative mutual funds following the same strategy: “**Investment Allocation Conflicts**” (Apr. 2, 2015); “**Operational Conflicts**” (Apr. 9, 2015); and “**How to Mitigate Conflicts**” (Apr. 16, 2015). For more on hedge fund compliance programs, see “**SEC Chief of Staff Shares Fifteen-Step Plan for Adjusting to Compliance Responsibilities**” (May 26, 2016); and “**RCA Compliance, Risk and Enforcement Symposium Highlights Methods for Hedge Fund Managers to Upgrade Compliance Programs**” (Jan. 14, 2016).

Survey Participants and Methodology

CCS asked an unspecified number of hedge funds and other financial services firms 16 questions about their respective approaches to compliance practices. In addition to hedge fund managers (9% of respondents), the Survey also reflects the practices of asset managers (52%), broker-dealers (11%), private equity firms (5%), wealth managers (10%) and “other” managers (13%).

Of the hedge fund respondents, most (87%) reported having less than \$1 billion in assets under management (AUM), including 60% with between \$500 million and \$1 billion in AUM. More than

half of the broker-dealers, wealth managers and other managers in the Survey reported up to \$1 billion in AUM. In contrast, nearly four out of five asset managers in the Survey, and more than half of private equity managers, reported having \$1 billion or more in AUM.

One third of the hedge fund respondents identified themselves as a CEO/chief financial officer (CFO); another third as CCO; one fifth as a legal or compliance employee; and the remainder as other. A notable distinction is that more than 20% of private equity respondents were general counsels (GCs), while none of the hedge fund participants held that role. Roughly half or more of the Survey participants from the other types of financial firms were CCOs.

Roles and Experience-Levels of CCOs

An encouraging fact revealed by the Survey is that every participant had a CCO. However, the results of the Survey show that hedge funds appear to be lagging behind the other financial services sectors in terms of CCO dedication and experience.

The CCOs of most hedge fund participants (87%) wear two hats. In addition to serving as CCO, nearly half also serve as CFO; one fifth serve as a general partner (GP) or CEO; another fifth have another unspecified role. Similarly, nearly two thirds of wealth managers employ dual-hatted CCOs. In contrast, less than half of private equity, asset manager, broker-dealer and other participants have their CCOs perform multiple roles.

For compliance issues relating to dual-hatting, see [“Simon Lorne, Chief Legal Officer of Millennium Management LLC, Discusses the Evolving Roles, Challenges and Risks Faced by Hedge Fund Manager General Counsels and Chief Compliance Officers”](#) (Sep. 26, 2013); and [“Benefits, Challenges and Recommendations for Persons Simultaneously Serving as General Counsel and Chief Compliance Officer of a Hedge Fund Manager”](#) (May 10, 2012).

The CCOs of roughly three quarters or more of each type of respondent had at least four years of regulatory/compliance experience; however, hedge fund respondents had the smallest percentage of CCOs (73%) meeting this experience threshold. Further, the CCOs of every category of respondents had at least one year of relevant experience, with the exception of 7% of hedge fund respondents whose CCOs had less than one year of experience.

Considered as a whole, the Survey provides interesting commentary on the role of CCOs in hedge funds as they have the highest percentage of dual-hatting and the least amount of experience.

Recent SEC Exam Experience

One fifth of hedge fund respondents said they had been examined in the last year, while another fifth had an exam between one and three years ago. However, more than half (53%) have not been examined in at least three years. This is unsurprising given the SEC's current rate of examining 10% of registered investment advisers annually. However, this figure may change in light of the additional resources the SEC has committed to reviewing hedge fund managers. See [“Former SEC Asset Management Unit Co-Chief Describes the Agency's Focus on Conflicts of Interests and Increased Efforts to Crack Down on Private Fund Managers”](#) (Sep. 15, 2016).

More than half of private equity participants have been examined in the last year, as have more than one third of broker dealers and other managers. Nearly half of asset managers, and more than half of wealth managers, have not been examined in more than three years. For more on

preparing for SEC examinations, see “[How Studying SEC Enforcement Trends Can Help Hedge Fund Managers Prepare for SEC Examinations and Investigations](#)” (Sep. 8, 2016); and “[Practical Guidance From Former SEC Examiners on Preparing for and Surviving SEC Examinations](#)” (Sep. 1, 2016).

Compliance Staffing and Resources

All private equity firms in the Survey – as well as most hedge funds (87%) and wealth managers (71%) – said they have one or two employees dedicated to compliance. More than half of each of the other participants have more than two such employees. See “[Trends in Legal and Compliance Hiring and Staffing: An Interview with David Claypoole on the Market for In-House Compensation at Hedge Fund Managers \(Part Two of Two\)](#)” (Mar. 19, 2015).

Most hedge fund participants (93%) said they allocate at least 1% of their revenues to compliance, including more than one quarter that allocate at least 5%. More than two thirds of wealth managers and asset managers, and more than half of broker dealers and other managers, also commit at least 1% of their revenue to compliance. At the other end of the spectrum, just 44% of private equity participants said they spent at least 1% of revenues on compliance. For more on compliance resources, see “[Recommended Actions for Hedge Fund Managers in Light of SEC Enforcement Trends](#)” (Oct. 22, 2015).

Four out of five hedge fund managers in the Survey said they outsource some (67%) or all (13%) of their compliance functions. Two thirds or more of asset managers, broker-dealers, private equity managers and other managers outsource some or all of their compliance operations. Private equity managers surveyed were by far the most likely to outsource their entire compliance programs, with one third saying that they do so. In contrast, 59% of wealth managers said they do not outsource any of the compliance function. See “[Cybersecurity and Outsourcing Remain Key and Potentially Costly Operational Issues for Hedge Fund Managers](#)” (May 5, 2016); “[The Role of Outsourced Compliance Consultants in the Hedge Fund Compliance Ecosystem](#)” (Jun. 27, 2014); and our two-part series on CCO liability in light of the recent SEC Risk Alert on outsourced CCOs: [Part One](#) (Mar. 3, 2016); and [Part Two](#) (Mar. 10, 2016).

More than half of wealth managers – and roughly one third of hedge fund, asset and other managers – said they spend more on their compliance programs than on legal counsel. In contrast, more than three quarters of private equity participants said they spend more on legal counsel than on their compliance programs.

For more surveys that benchmark private fund compliance programs, see “[DLA Piper Compliance Survey Offers Perspectives to Hedge Fund Managers on CCO Liability and Compliance Program Benchmarks](#)” (May 26, 2016); and “[ACA 2014 Compliance Survey Covers SEC Exams, CCOs, Compliance Reviews, Custody, Fees and Personal Trading](#)” (Dec. 11, 2014).

Compliance Program Reviews and Perceptions

Approximately 90% of asset managers, wealth managers, other managers and broker-dealers said they had performed a compliance review within the last year, and virtually all of those respondents had done so within the last 12-24 months. Hedge fund and private equity participants lagged significantly in this metric, as just over half of hedge fund respondents and two thirds of private equity respondents had done a review in the last year.

More alarming is the fact that that 14% of hedge fund and 11% of private equity respondents either last performed a compliance review more than 24 months ago or have never completed one. See our two-part series entitled “How Hedge Fund Managers Should Approach Preparing For, Conducting and Documenting the Annual Compliance Review”: [Part One](#) (Mar. 22, 2012); and [Part Two](#) (Mar. 29, 2012).

Prospective clients have most consistently asked to review the compliance policies or interview the compliance personnel of hedge fund managers (93%), private equity managers (89%) and asset managers (80%) in the Survey. There was a substantial drop-off for broker-dealers and other managers, as roughly 60% of them said they received similar inquiries. Only 18% of wealth managers faced such scrutiny. See our two-part series entitled “How Are Your Peers Responding to the Most Intrusive Requests From Hedge Fund Investors?”: [Part One](#) (Mar. 17, 2016); and [Part Two](#) (Mar. 31, 2016).

Hedge fund participants viewed compliance as either a way to keep the firm “honest and on our toes” (40%), to “protect the franchise” (33%) or to promote business and retain clients (27%). Comparatively, between 15% and one third of each of the other categories of participants in the Survey viewed compliance as a “cost of doing business.” Of all the Survey respondents, private equity managers (11%) were the only ones who called compliance “a waste of time and money.”

Adaptation of Compliance Programs

Just under half of hedge fund respondents said that they “currently focus enough on compliance.” The rest said they “need to focus slightly more resources on compliance.” See “[SEC Enforcement Action Shows Hedge Fund Managers May Be Liable for Failing to Adequately Support Their CCOs](#)” (Jul. 23, 2015).

Comparatively, two thirds of private equity respondents said they need to increase their focus on compliance, including nearly one quarter who said they need to commit “significantly more resources.” At least three quarters of all other categories of respondents said that they are focusing enough on compliance or only need to focus slightly more. Only asset managers (1%) and other managers (10%) indicated that they are “over-emphasizing compliance.”

CCO Liability

More than three quarters of hedge fund, asset manager, wealth manager, and broker-dealer participants indicated that they have not changed their compliance programs in response to growing regulatory focus on holding CCOs personally accountable. In contrast, 44% of private equity managers said this has caused them to change their programs. See “[SEC Division Heads Enumerate Enforcement Priorities, Including Conflicts of Interest, Valuation, Performance Advertising and CCO Liability \(Part Two of Two\)](#)” (May 5, 2016).

For additional coverage of the debate about CCO liability, see “[SEC Enforcement Director Assures CCOs They Need Not Fear SEC Action Absent Wrongdoing](#)” (Nov. 19, 2015); “[SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers](#)” (Jul. 16, 2015); and “[SEC Commissioner Speaks Out Against Trend Toward Strict Liability for Compliance Personnel](#)” (Jun. 25, 2015).

Whistleblowers

No hedge fund or broker-dealer respondent changed its compliance program in response to concerns over whistleblowers. Furthermore, 11% of private equity managers, and at least several percent of asset managers, wealth managers and other managers, indicated that they have changed their programs in response to such concerns. See “[How Promoting Internal Reporting Can Reduce Risk of Regulatory Intervention for Hedge Fund Managers](#)” (Aug. 11, 2016); and “[RCA Session Offers Insights on Dodd-Frank Whistleblower Regime, Incentives, Anti-Retaliation Protections and Risks](#)” (Apr. 9, 2015).

Cybersecurity

Virtually all respondents in the Survey said they are taking steps to address cybersecurity concerns. More than one quarter of hedge fund respondents said they are using “internal technology resources” to do so, while nearly half said they are using external resources. One fifth of hedge fund respondents said that cybersecurity is “still under review,” and just 7% said they do not plan any changes.

Between 71% and 92% of each other category of firm in the Survey are using either internal or external resources to address such concerns, with most of the remaining respondents indicating that their cybersecurity practices are still under review. See “[HFA Symposium Offers Perspectives From Cybersecurity Industry Professionals on Preparedness, Vendor Management, Cyber Insurance and Cloud Services](#)” (Jul. 7, 2016); and “[Growing SEC Enforcement of Hedge Fund Managers Requires Greater Focus on Cybersecurity and Financial Disclosure](#)” (Jul. 7, 2016).

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