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Chief Compliance Officers

Why Fund Managers Must Review Their Positions on Succession Planning and CCO Outsourcing (Part One of Three)

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By Shaw Horton, *Hedge Fund Law Report*

The SEC proposed – and recently withdrew – a rule that would have required registered investment advisers to adopt and implement detailed business continuity and transition plans. Pursuant to these plans, advisers would have had to identify key personnel and develop policies and procedures for their short- and long-term absence. Despite the rule's withdrawal, however, the SEC has signaled that it will continue to scrutinize the robustness of advisers' plans, which are broadly required under Rule 206(4)-7 of the Investment Advisers Act of 1940 (Advisers Act).

To the extent that advisers' business continuity and transition plans cover the departure of key personnel, they generally do so only with respect to founders; yet, from a business and regulatory perspective, they should also cover others, including chief compliance officers (CCOs). The proposed rule would have also required advisers to evaluate third-party service providers' business continuity and transition plans, including those of outsourced CCOs. The SEC has closely examined the efficacy of outsourced CCOs in, for example, a recent risk alert and in revisions to Form ADV. Ultimately, a manager cannot abdicate its compliance responsibility and must carefully evaluate whether outsourcing its compliance function is in its, and its clients', best interests.

This article, the first in a three-part series, discusses the SEC's proposed rule on business continuity and transition plans; the impact, if any, of the rule's withdrawal; the importance of CCO succession planning; and the risks of using an outsourced CCO. The second article will examine CCO hiring and onboarding; whether managers should separate their compliance departments from their legal departments; and the risks of high CCO turnover. The third article will evaluate the risks of poor succession planning and provide a roadmap for developing a robust succession plan.

See "Pro-Business Environment of New Administration Continues to Have Challenges and Pitfalls for Private Funds" (Sep. 14, 2017).

Proposed Rule on Business Continuity and Transition Plans

In June 2016, the SEC proposed a rule, entitled "Adviser Business Continuity and Transition Plans," that "would require SEC-registered investment advisers to adopt and implement business

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continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations." The proposed rule release states that advisers generally share certain fundamental operational risks, including the loss of key personnel.

Although Rule 206(4)-7 under the Advisers Act states "that an adviser's compliance policies and procedures should address [business continuity plans (BCPs)] to the extent that they are relevant to an adviser," it does not "identify critical components of a BCP or discuss specific issues or areas that advisers should consider in developing such plans." Thus, while SEC staff have observed that "most SEC-registered investment advisers may already have BCPs in place" – indeed, managing operational risks in this manner helps an organization mitigate client-relationship deterioration or financial losses – "the robustness of these BCPs is inconsistent across investment advisers."

The release states that advisers "should identify which key personnel either provide critical functions to the adviser or support critical operations or systems of the adviser such that the temporary or permanent loss of those individuals would disrupt the adviser's ability to provide services to its clients." Further, an adviser's business continuity and transition plan should include both short-term arrangements (*e.g.*, for when the key person is unable to work due to weather-related events) and long-term arrangements (*e.g.*, for when the key person leaves).

See "SEC Risk Alert Describes Deficiencies Found During Reviews of Investment Advisers' Business Continuity and Disaster Recovery Plans and Recommends Best Practices for Such Plans" (Sep. 26, 2013).

What Is the Impact of the Rule's Withdrawal?

The U.S. Department of the Treasury (Treasury), in its October 2017 report on the asset management and insurances industries, argued that the "existing principles-based rule already in place" under Rule 206(4)-7 renders additional rulemaking unnecessary and recommended that the SEC withdraw its proposal. The latest SEC Regulatory Flexibility Agenda, published in January 2018, indicates that the proposed rule has been withdrawn as of September 2017.

See "SEC's Reg Flex Agenda Promotes Transparency While Adding Potential Compliance Burdens" (Mar. 15, 2018).

Nevertheless, the Treasury recommended that the SEC continue to work with advisers to improve business continuity plans to the extent that they are not "sufficiently robust." In addition, the SEC, under Chair Jay Clayton, has repeatedly emphasized the importance of protecting retail investors. The proposed rule release emphasizes that advisers owe a fiduciary duty to their clients, which includes a robust business continuity and succession plan, stating that:

> clients of advisers who do not have robust plans in place to address the operational and other risks related to significant disruptions in their operations are at greater risk of harm during such a disruption than the clients of advisers who do have such plans in place. As fiduciaries, investment advisers owe their clients a duty of care and a duty of loyalty, requiring them to put their clients' interests above their own. As part of their fiduciary duty, advisers are obligated to take steps to protect client interests from being placed at risk as a result of the adviser's inability to provide advisory services.

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In addition, the SEC's Office of Compliance Inspections and Examinations (OCIE), in its 2018 National Exam Program Examination Priorities, stated that "[e]xaminations will . . . assess entities' readiness and business continuity plan effectiveness . . ., including whether these programs cover appropriate business units, subsidiaries, and related interconnected infrastructure."

Michael R. Manley, partner in Venable's corporate group, said that this year's SEC priority letter included a heavy focus on items that fall within the domain of compliance departments and CCOs. "We are going to continue to see plenty of focus from regulators on compliance and how firms are handling their compliance programs. These programs aren't meant to be static; they're meant to be ongoing, taking into account recent market developments, like changes in technology."

See "Retail Investors Top List of OCIE 2018 Exam Priorities" (Mar. 8, 2018).

Therefore, it is reasonable to conclude that the SEC will continue to emphasize the importance of robust business continuity plans despite the lack of a formal rule. In fact, it may be wise for firms to leverage the proposed rule as a baseline for their business.

The Importance of CCO Succession Planning

According to the 2017 Alternative Fund Manager Compliance Survey conducted by ACA Compliance Group (ACA), only "30% of respondents maintain a formal succession plan or 'key man' provisions outside of the language in the fund's partnership agreement."

See "ACA 2017 Fund Manager Compliance Survey Details Variety in Expense Allocation Practices and Business Continuity Measures (Part Two of Two)" (Jun. 8, 2017).

Thus far, adviser succession plans have principally focused on the loss of the founder. Indeed, various industry white papers, reports and news articles have also focused on this aspect of succession planning. The most important criterion for evaluating whether a position is central to an organization, however, is the consequence of that person's departure. Advisers must realize that the loss of a CCO could also result in a "significant disruption in the investment adviser's operations." This is particularly important given the "startling turnover of Chief Compliance Officers," as noted by Russell Reynolds Associates (RRA), an executive search firm, in its 2016 study entitled "How the Chief Compliance Officer role is transforming across Financial Services."

Outsourced CCOs

The proposed rule would have also required an adviser to identify and assess third-party services critical to its operation – a practice that advisers may wish to undertake regardless of the rule's status. In doing so, an adviser should consider a variety of factors, including its "day-to-day operational reliance on the service provider[,] the existence of a backup process or multiple providers . . . and whether the service provider is maintaining critical records or able to access personally identifiable information, among other things."

Moreover, an adviser should assess whether these critical providers themselves have business continuity plans. According to the ACA survey, while nearly 75% of respondents review key third-party service provider business continuity plans, only 63% of those review them annually – 38% at the outset of the relationship and 15% on contract renewal. The SEC Division of Investment Management released a Guidance Update in June 2016 that focused on business continuity plans for registered investment companies. Although not directly relevant to hedge funds, the

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guidance provides valuable insight into, for example, best practices for reviewing relationships with critical service providers.

In November 2015, OCIE issued a National Exam Program Risk Alert on the use of outsourced CCOs. OCIE staff observed that an increasing number of advisers are outsourcing their CCOs to unaffiliated third parties.

Importantly, as the risk alert notes, OCIE examinations focus on a registrant's "tone at the top and culture of compliance," given that this has a large impact on the effectiveness of a registrant's compliance program. Pursuant to the initiative discussed in the risk alert, OCIE staff observed that effective outsourcing generally involves:

- regular, in-person communication between a CCO and a registrant;
- a strong relationship between a CCO and a registrant;
- sufficient registrant support of a CCO;
- independent access by the CCO of a registrant's documents and information; and
- CCO knowledge about regulatory requirements and a registrant's business.

See our two-part series on CCO liability in connection with the risk alert: "Why All Investment Advisers – and their Compliance Officers – Should Heed" (Mar. 3, 2016); and "Steps All Investment Advisers – and Their Compliance Officers – Should Take" (Mar. 10, 2016).

Transitioning From an Outsourced CCO to an In-House CCO

Although the SEC permits an adviser to use an outsourced CCO, the risk alert questions the effectiveness of doing so. In 2004, Lori Richards, former Director of OCIE, stated that "[w]hile the rule does not preclude outsourcing . . . I am wary about whether a compliance 'rent a cop' could really be up to the task." More recently, the latest revisions to Form ADV which became effective October 1, 2017, require an adviser to provide the IRS Employer Identification Number of a CCO that is "compensated or employed by any person other than" that adviser.

See "With the Filing Deadline Looming for Many Advisers, Seward & Kissel Attorneys Provide a Roadmap to Amended Form ADV" (Mar. 8, 2018).

While there are advantages to using an outsourced CCO (For example, it is more cost-effective, as firms can avoid costs associated with hiring, employing and training internal CCOs.), there are also significant risks as outlined by the SEC risk alert, including that the outsourced provider may use generic, standardized checklists.

Although the SEC has brought enforcement actions against outsourced CCOs for negligently discharging their duties, the ultimate responsibility for compliance with the securities laws falls with the fund manager. "The SEC has indicated that you cannot abdicate your compliance responsibility by outsourcing," said Manley. "I'm not sure that it necessarily follows that the SEC has a preference for in-house CCOs, but it does mean that firms need someone who is responsible and accountable for compliance." For example, Manley noted that person must, "at the time of an examination, be able to provide the SEC with details about the compliance program and offer a comprehensive overview of how the program functions."

The use of an outsourced CCO likely exposes an adviser to unnecessary risk, increasing its chances of being subject to an SEC examination or increasing the depth of that examination.

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According to an SEC staff document entitled "SEC Examinations and the Risk Assessment Process," the SEC performs a risk assessment based on Form ADV filing information.

It is increasingly likely that the SEC will assign a higher risk rating to advisers relying on outsourced CCOs, particularly if the SEC staff have otherwise identified the outsourced CCO as problematic. For example, as Richards questioned in her speech, it may be a red flag if an outsourced CCO is servicing a large number of clients, as this calls into question the CCO's ability to closely monitor and interact with each individual client.

The SEC, in its final rule release for the Form ADV revisions, said that it understood a commenter's concerns that "identifying outsourced [CCOs] would invite additional scrutiny about an adviser's judgment in hiring externally versus internally." Nevertheless, it argued that the new requirements "will allow us to identify all advisers relying on a particular service provider and could be used to improve our ability to assess potential risks." These statements suggest that the SEC will continue to use data analytics to determine the likelihood that advisers that rely on outsourced CCOs are more likely to experience particular issues.

See "Co-Director of SEC Enforcement Division Champions New Retail Strategy Task Force and Cyber Unit" (Nov. 16, 2017).

"Compliance is a type of program where one size does not fit all. Whether you're talking about market participants or regulators, a good compliance program depends on several factors, including the size of the firm, assets under management, the number of investors, the number of employees, geography and so on," said Manley. "Programs must be tailored and dynamic; they should be adjusted over time."

Given the SEC's stance, one approach may be to combine the use of an internal CCO with third-party consultants that provide him or her with support. "In terms of outsourcing, a third party may be a good resource for monitoring the collection of employee annual or quarterly reports and taking the first cut at evaluating the content of those reports," said Manley. "Ultimately, whoever is responsible for compliance at the firm will still need to evaluate whether the firm has met its responsibilities under its policies and procedures. When it comes to an exam, the regulator will look to the CCO to speak with knowledge and intelligence about the information that has been reported or provided in connection with that monitoring function."

"Pairing a CCO with a third-party consultant can be useful, especially in establishing discrete programs," said Cynthia Dow, leader of the legal officers practice at RRA. "You are better off, however, with internal resources where deep knowledge of the business and the people are critical, such as with recurring activities." Therefore, before using an outsourced CCO, a fund manager should carefully evaluate its risk appetite and whether doing so would be in its clients' best interests.

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

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