Evolving rules and regulations have increased the personal risk and responsibility placed on legal professionals at hedge funds

BY MIKE SHEEN

From April 2017, the penalties faced by New York-based CCOs in the event of a regulatory breach could potentially become a lot more severe. It is the latest in a string of developments which have raised concerns among hedge fund legal professionals about the extra personal responsibilities they are being forced to carry.

Proposals from the New York Department of Financial Services (NYDFS) would see every investment adviser with a New York presence having to develop a strict system of controls to monitor money laundering and terror financing risks.

NYDFS made the proposals, claiming its investigations had shown a number of "shortcomings" in firms' systems and controls and a lack of robust governance. Compliance professionals told *HFMWeek* at the time they felt the NYDFS was "raising the bar" and the proposals would hold CCOs personally accountable for compliance failures.

The regime is much stricter than current anti-money laundering and anti-terror financing liability under federal law and falling foul of the regulation could see CCOs facing jail time. In recent years US CCOs have become accustomed a growing sense of professional and personal liability.

"As the requirements have grown and the focus has become more intense, the role of the CCO has had to evolve accordingly," says partner and managing director at Cordium Patrick Shea.

Ever since Rule 206(4)-7 made CCO registration mandatory, there have been accusations that the SEC and other regulators have put a target on the back of CCOs. So much so, the SEC has felt it necessary to publicly deny this is the case.

"With regards to CCO liability, I have been with the commission now almost three years. I have never been in a meeting where they have said 'let's go do some exams and get some CCO scalps'," The SEC's Office of Compliance Inspections and Examinations acting director Marc Wyatt told the National Society of Compliance Professionals' annual conference in November 2015.

Between 2009 and 2014, of the 751 enforcement actions taken by the SEC, 80 were taken against CCOs. This includes a record high in 2013 when 19% of all enforcement actions were against CCOs.

The backing of your firm

A supportive corporate culture that understands the relevance and importance of compliance can provide crucial assistance to a CCO.

"A culture of compliance is incredibly important," says John Roth, CCO Venor Capital Management. "The message that compliance is important, and its subsequent impact on culture, truly has to come from the top of the firm."

According to a report from the Office of Compliance Inspectors and Examinations (OCIE), a firm willing to provide its compliance professionals with sufficient backing in terms of communication, resources and empowerment is more likely to avoid falling foul of the regulatory authorities.

"A CCO… must be empowered with sufficient knowledge and authority to be effective," OCIES' report reads. "Each registrant is ultimately responsible for adopting and implementing an effective compliance program and is accountable for its own deficiencies."

In the event of enforcement action, the regulatory authorities are also more likely to support a CCO if their firm has failed to provide them with the relevant support.

In the case of investment advisor Pekin Singer in June 2015, the SEC found the firm and its president had failed to provide sufficient staff, guidance and financial support to its CCO, significantly contributing to the firm's compliance failures. The SEC suspended for 12 months and fined Pekin Singer's president $45,000, ultimately taking no action against the CCO.

However, as one partner of a New York-based law firm that advises hedge funds told *HFMWeek*: "In some hedge funds there may be situations where the CCO could easily be a scapegoat and the first line of defence to protect the principles of their firm."

Being held responsible

While the majority of compliance violations are not caused by the CCO, failure to perform their duties to their firm, stakeholders and the stability of financial markets can see the person being held legally responsible.

In June 2015, the president of SFX Financial Advisory Management Enterprises was found to have stolen around

$670,000 from clients over a five-year period. The SEC charged the firm's CCO Eugene Mason, finding he had caused compliance failures by not performing an annual compliance review and neglecting conduct reviews of cash flows in client accounts, as required by the firm's compliance policies.

Similarly in April 2015, the SEC fined BlackRock CCO Bartholomew Battista after the firm failed to disclose a conflict of interest relating to a portfolio manager at the firm. The securities regulator found Battista had caused the funds' failure to report a "material compliance matter" and forced him to pay a $60,000 penalty.

What about whistle blowers?

The whistle blower programme came into effect as part of the 2010 Dodd-Frank reforms, aiming to incentivise people to report violations of the Securities Exchange Act. Today the SEC typically pays out 10% to 30% of monetary sanctions collected, awarding eight whistle blowers approximately $38m in total in 2015.

For CCOs the whistle blowers programme can be both a helping hand and an additional burden.

On the one hand, the programme brings an increased level of scrutiny that can lead to severe enforcement action against a CCO's firm and possibly the CCO themselves. On the other hand, the programme helps nurture a culture of compliance and can be used to protect compliance professionals.

Cordium's Shea says the programme has had an influence across the board for "well-intentioned firms".

"It's part of training, it's part of policies, it's part of contracts with individual employees," he says. "Firms are making sure that everyone in their organisation understands whiste blower policies and where to turn, internally or externally, with their concerns."

Cyber awareness

As cyber security concern has grown, it has become an increasingly important part of a CCO's suite of responsibilities.

Not only are firms under pressure from investors to keep vital data secure, such as client identities and banking details, but the SEC has reaffirmed its commitment to ensuring a cyber-secure alternative investment industry on multiple occasions, issuing official guidance in April 2015 and announcing greater examination of controls in November 2015.

Perhaps the most high profile case of enforcement after a cyber breach, was in September 2015 when RT Jones Capital Equities Management was fined $75,000 after the personally identifiable information of around 100,000 individuals, including thousands of the firm's clients.

An obvious difficulty with ensuring sufficient best practice in cyber security, thereby avoiding enforcement action, is the fact the majority of CCOs are not technical experts in this respect.

"If you're in a role where you've got responsibility for a discipline that you're not an expert in, it really is incumbent on you to seek out the necessary expertise internally or to use external resources," advises Nekton Partners' Haas.

"There's an understanding that it's difficult for someone with a purely operational or compliance background to have all the necessary technological expertise, and the SEC has helpfully provided CCOs with a lot of clarity and guidance on this," says Cordium's Shea. "But in most instances, to enhance the detail of written policy and quality of programme, there's a need for in-house or third-party expertise."

Responsibilities, risk, reward

According to survey data from recruitment firm Parks Legal Placement, the average US-based hedge fund CCO earned around $802,000 in 2014, with the top quarter of earners bringing in between $1m and $2.5m.

Parks Legal founder and president David Claypoole says there is a correlation between CCO wages and the rising amount of regulatory risk funds face.

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"15 years ago compliance was an administrative function. It was about checking boxes," he says.

"Increased regulation over that time means that firms need to hire people with more experience and better training. People who intellectually have more firepower, because the regulations are complex and need to be interpreted at a level that was unnecessary prior to all this regulation.

"The people who are CCOs at the largest hedge funds now, could be partners at top law firms. They need to be paid competitively with those firms as a result."

Claypoole says wages have also been impacted by the level of personal and professional risk compliance professionals face.

"There is real personal liability now, although CCOs aren't typically going to jail, you could lose your entire career and you need to be compensated for that," he says. "It's hazard pay."

However, a barrier to further financial reward for the extra workload and risk taken on by a CCO is the simple fact that the value added by a CCO is not always clear.

"When a CCO is doing a great job, the evidence is that nothing happens and nobody notices what you're doing," says Claypoole.

The future of the CCO

"CCOs are starting to take a greater and increasingly visible, more important role at the boardroom table," says Venor's Roth. "And the role inevitably changes as a result."

Roth believes that for CCOs to keep their seat at that table, they're going to have to play an active role in resolving their firms' concerns.

"The most valuable CCOs will not only identify issues and inform the appropriate personnel within the firm, but help be part of the solution," he says. "We need to be more than the person who says 'no you can't do it', We need to be wanted at the boardroom table." ■