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EMPLOYMENT

Is Your Legal and Compliance Team Ready? How Recent Developments Will Drive Demand for In-House Staff and Increase Regulatory Scrutiny (Part One of Two)

By William V. de Cordova, *Hedge Fund Law Report*

Numerous changes have affected the regulatory arena – including the transfer of power to the new Presidential administration and changeover of many high-level staff at the SEC – and fund managers must anticipate the potential effects of those developments on their businesses. Specifically, fund managers must ensure that their legal and compliance staffs are adequately prepared for increased regulatory scrutiny, particularly given recent risk alerts issued by the SEC Division of Examinations (Examinations) – formerly the Office of Compliance Inspections and Examinations, or OCIE.

To examine those issues and their impact on the market for legal and compliance staff, the Hedge Fund Law Report recently spoke with David Claypoole, founder of Claypoole Executive Search. This article, the first in a two-part series, sets forth his insights on the factors driving increased demand for in-house staff; the anticipated effects of the Biden administration on the private funds industry; the likelihood of increased regulatory scrutiny of fund managers; and the need to ensure that legal and compliance staff has adequate resources. The second article will explore recent changes to the SEC and their potential impact on the industry; the regulator's and industry's performance during the coronavirus pandemic; and trends in compensation of and demand for legal and compliance personnel.

For further commentary from Claypoole, see our two-part series: "How Have Industry Developments Affected the Value of Legal and Compliance Staff?" (Feb. 2, 2017); and "Will Industry Deregulation Affect the Value of Legal and Compliance Staff?" (Feb. 16, 2017).

HFLR: What do you expect to see with respect to the market for legal and compliance staffing in the coming year?

Claypoole: Over the next 18 to 24 months, the industry is going to see a demand for legal and compliance talent at alternative asset managers that is equal to – or perhaps even greater than – the demand that was seen in 2005 and 2006, during the run-up toward enforced registration of hedge funds prior to the decision in Goldstein v. SEC.

[See "To Regulate or Not to Regulate" (May 6, 2008).]

HFLR: What do you think is driving that increased demand?

Claypoole: I see three things that are happening all at once – two of which are absolutely unique and the other of which occurs every four to eight years.
That first, non-unique factor is simply the replacement of one presidential administration with another. When a Republican administration is replaced by a Democratic administration, the incoming administration generally installs much more aggressive regulators into the SEC, the DOJ, the Department of the Treasury (Treasury) – essentially anyone that oversees the alternatives industry. Those regulators are more likely to look for targets on funds' backs, whereas the regulators installed by a Republican administration generally deal more lightly with managers.

Over the last three or four years, demand for legal and compliance personnel has been relatively slow in the private funds space – and that slowdown hit well before the coronavirus pandemic. Once my team noticed that, we began thinking about the reasons for it, and the conclusion I came to – which has been borne out by many discussions I've had with industry practitioners – is that nobody has been really scared of the SEC, DOJ or Treasury under the Trump administration.

[See "BakerHostetler Panel Analyzes the Trump Effect on the SEC's Initiatives and Enforcement Efforts" (May 4, 2017); and "How the Trump Administration's Core Principles for Financial Regulation May Benefit the U.S. Funds Industry (Part One of Two)" (Feb. 16, 2017).]

Meanwhile, as early as the beginning of 2017, when President Trump came into office, we started to receive calls from people who had been working in the Division of Investment Management and the Division of Enforcement (Enforcement) at the SEC, telling us that they were looking for new jobs, after having been very quietly laid off. At the same time the SEC was weakening itself, a bunch of U.S. attorneys were leaving without being replaced – or, to the extent they were being replaced, those replacements were very pro-business.

[See "WilmerHale Attorneys Detail 2016 CFTC Enforcement Actions and Potential Priorities Under Trump Administration" (Feb. 16, 2017).]

In general, when a Democratic administration replaces a Republican one, there is an expectation that there will be more enforcement of the securities laws. People are expecting a great deal more enforcement from the incoming administration.

About three or four months ago, when people started anticipating Biden winning the election, we started seeing an uptick in demand for legal and compliance personnel. In the first two weeks of this year alone, we have gotten five new job openings. This is a reaction to the expectation of the incoming administration as a lot more aggressive.

HFLR: Do you really think there is that much of a difference between the perception of the SEC under the Trump administration and how the SEC will be viewed under the Biden administration?

Claypoole: People used to be scared of the SEC under former Chair Mary Jo White or Enforcement Director Robert Khuzami, but they have not been scared of Jay Clayton's SEC. To use an analogy, you can get hit by a hammer, or you can get hit by a pillow. The perception that managers had of the SEC under the Trump administration was that the Commission was much softer than a hammer; nobody was afraid of getting hit that hard. As a result, certain managers made the choice to forgo hiring dedicated CCOs, GCs or directors of compliance, figuring that they could save millions of dollars in compensation at the risk of a fine by the SEC if its staff shows up. Managers are often willing to make that gamble when the only thing they stand to lose is money.

If, however, a manager thought that the consequence of that action could be Enforcement showing up, with the DOJ and FBI in tow – not to mention news cameras from all of the media outlets – that would have been a completely different story. If there is a risk of having its business destroyed and receiving jail time, a manager is much more likely to be motivated to hedge against that risk. With the new administration coming in, the perception is shifting back toward that end of the spectrum – to the SEC as a hammer.

HFLR: Returning to the increased demand for legal and compliance personnel, what is the second factor that is helping that push?

Claypoole: As I mentioned, this is a very unique situation. For years, private equity (PE) managers have essentially ignored the spirit of the regulations, particularly Rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act) – the so-called "compliance rule." Although the need to empower a CCO has always been understood, other than the giant PE shops such as Carlisle, KKR and Blackstone, most PE managers have not put as many resources into their legal and compliance functions.

Instead, the bulk of PE managers – those with $2 billion to $8 billion under management, that have been running for 10 years and that have closed 40 deals – have relied on outside counsel and service providers, as they had done before the Dodd-Frank Act (Dodd-Frank) introduced the requirement in 2012 that they register under the Advisers Act. When Dodd-Frank's registration requirement became effective, we expected PE funds to do the same thing that hedge funds had done in 2005 and 2006 – *i.e.*, hire a GC/CCO and build a legal and compliance function around him or her. In reality, most didn't; they simply continued outsourcing the legal and compliance functions and slapped the CCO title on someone who was dual-hatted.

[See our two-part series "A Decade of Dodd-Frank": Why and How the Regulations Brought Private Funds Into Compliance (Dec. 3, 2020); and Enforcement, the Volcker Rule and a Report Card on Its Efficacy in Hindsight (Dec. 17, 2020).]

In November 2020, Peter Driscoll, the head of Examinations spelled out what Examinations is going to be seriously examining going forward. Basically, what he said is that the CCO needs to be empowered, be senior and hold authority – and he discouraged dual-hatted CCOs. To paraphrase Driscoll, his message was, "You have not been complying with the spirit of the law, so I am here to tell you today what that spirit is. And, when you leave here, please take a copy of Examination's risk alert (Risk Alert), which covers our concerns about your inadequate compliance resources."

Now, the SEC is saying that they will not only go after managers if they violate the securities laws; there will be serious consequences even if a manager has no issues with the underlying laws, if its CCO is not a senior person who is empowered; has access to and the backing of senior management; and is appropriately compensated as a C-level executive responsible for one of the largest risks that a manager can face.

[See our two-part series on why fund managers must adequately support their CCOs and compliance programs: "Failures Lead to SEC Enforcement Action" (May 9, 2019); and "Six Valuable Lessons From Enforcement Actions" (May 16, 2019).]

HFLR: And the third factor?

Claypoole: The third – also unique – factor is that there is going to be a huge amount of churning in the industry unrelated to job creation. As a result of the pandemic and the success the industry has witnessed with virtual arrangements, there is going to be a massive reshuffling of where and when people work.

While I suspect this will take about 18-24 months to shake out once widespread vaccination is achieved, there will be three main working arrangements:

1. All staff are back in the manager's office, just as they were pre-pandemic.
2. All staff are working from home, and the manager eliminates its office altogether.
3. The manager institutes a hybrid model, such as what I've heard of as the "3-2-2" model where staff spend three days in the office, two days at home and two days off.

Thus, people are going to change jobs simply to get to their preferred arrangement, and that gives me, as a recruiter, another carrot to offer. In the past, I would never call the associate GC of Credit Fund X and offer him or her the exact same job at Credit Fund Y across the street for $100,000 less in overall compensation. Now, however, I can say, "You can do the job from your condo in Miami where you pay no state taxes and are in your condo in Miami." That will generate a lot more positive response.

Related to this factor is the fact that a lot of positions are likely to start opening up in the industry for another reason. After speaking to hundreds of professionals over the last nine months, I can tell you that many people are seriously reconsidering what they are doing with their lives in terms of work-life balance. So, people are going to be vacating large positions in this industry far sooner than they otherwise would have if they hadn't had the opportunity for this "self-inventory" during which they decided that they want to spend more time with their families; spend more time doing things they enjoy; and spend less time striving for the next dollar or promotion. That is also going to create some movement in the industry.

[See "HFLR Webinar Explores Legal and Compliance Employment Trends, Including Compensation, Staffing, Diversity and the Pandemic's Impact" (Oct. 15, 2020).]

HFLR: You mentioned the Risk Alert earlier. One of the things that was highlighted in the Risk Alert is the SEC's distaste for dual-hatted CCOs. What effect do you think that may have on a fund manager that currently has a dual-hatted GC/CCO? In other words,

should a fund manager with a single GC/CCO look to add staff and split the legal and compliance function between two individuals?

Claypoole: That decision is going to depend on the size of the manager. You almost always start out with a GC/CCO, and when the SEC examines an emerging manager, it will likely be fine with that arrangement, as long as there is an appropriate level of resources available to that GC/CCO. After all, until a manager has sufficient revenue to employ a competent professional as its standalone CCO, it makes sense for the GC to wear that hat. As the manager grows, however, that is not going to remain the case. One of the things that came out in Driscoll's talk and stood out in the Risk Alert is that when the SEC sees advisers that have grown significantly in size and complexity but have not increased their legal and compliance resources or headcount to address those changes to their organizations, that's when dual-hatting is likely to be a problem.

Thus, a long-short equity fund with $2 billion in assets under management (AUM) that has a GC/CCO who has been provided with sufficient resources, the SEC is probably going to be absolutely fine with that. If the manager grows to $5 billion or $7 billion dollars – or if the manager starts adding trading strategies – the Commission is likely going to have a problem with the dual-hatted GC/CCO at that point. It really is tied to AUM and complexity.

[For more on dual-hatted CCOs, see "Benefits, Challenges and Recommendations for Persons Simultaneously Serving As General Counsel and Chief Compliance Officer of a Hedge Fund Manager" (May 10, 2012); and "Who Should Newly Registered Hedge Fund Managers Designate As the Chief Compliance Officer and How Much Are Chief Compliance Officers Paid?" (Feb. 25, 2011).]

HFLR: You've mentioned the importance of ensuring that legal and compliance has appropriate resources. What are some of the key resources with which a fund manager should expect to supply its legal and compliance staff?

Claypoole: Personnel is the most important resource for a manager's legal and compliance staff, especially as the manager grows in any significant way – meaning with respect to employees, investment professionals, AUM, jurisdictions in which it operates, strategies, etc. My firm has been conducting a survey of legal and regulatory compensation in the alternatives space for nearly 20 years, and we realized that, as part of that study, we have been capturing the size of legal and compliance departments. That is something that managers are very interested in – whether their legal and compliance departments are the right size – so, we analyzed those numbers.

After reviewing over 180 managers, each with more than $1 billion in real AUM (not regulatory assets under management), we determined that complex hedge fund managers in multiple jurisdictions generally require about one legal and compliance professional per $1 billion under management. Private equity assets and simple hedge fund strategies require less than that.

Other than staff, resources that legal and compliance should have include:

- up-to-date software and compliance tracking programs;
- support of and cooperation with accounting and finance personnel to address valuation issues;
- ability and resources to hire appropriate consultants;

- authority and resources to contact regulatory counsel at a qualified law firm; and
- any other industry information service or resource.

I mentioned before that there is likely to be movement in the industry, as people will be willing to change jobs for reasons other than money (such as work-life balance). Two things that professionals have been changing jobs for other than money since I started recruiting in the field are better resources and a stronger commitment to a culture of compliance by advisers' management.

HFLR: Besides what you mentioned earlier, what other effects do you expect the incoming Biden administration to have on the legal and compliance space?

Claypoole: First, as mentioned before, there is going to be a greater emphasis by the administration – and thus the SEC and DOJ – on the securities laws and managers' compliance with them. That is the main thing that will affect individual managers with respect to the administration.

In addition, if you look at where the Democratic party is currently and consider the people who are taking the lead – such as Elizabeth Warren and Alexandria Ocasio-Cortez – you can anticipate a vocal call for increased regulation. Thus, the private funds industry as a whole may need to attempt to counter that – either through industry organizations, such as the Alternative Investment Managers Association or the Managed Funds Association, or by having regulatory personnel spend more time with the press or in Washington, D.C.

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EMPLOYMENT

Is Your Legal and Compliance Team Ready? How Recent Developments Will Drive Demand for In-House Staff and Increase Regulatory Scrutiny (Part Two of Two)

By William V. de Cordova, *Hedge Fund Law Report*

The private funds industry continues to feel the effects of various factors that have impacted it over the past year, such as the coronavirus pandemic, as well as the blurring of the lines between hedge funds and private equity (PE). As fund managers come to terms with those changes, they must ensure that their legal and compliance departments are prepared – and sufficiently staffed – to meet the challenges that lie in the road ahead.

To examine these issues and their impact on the market for legal and compliance staff, the Hedge Fund Law Report recently spoke with David Claypoole, founder of Claypoole Executive Search. In this second article in a two-part series, Claypoole explores recent changes to the SEC and their potential impact on the industry; the regulator's and industry's performance during the coronavirus pandemic; and trends in compensation of and demand for legal and compliance personnel. The first article set forth his insights on the factors driving increased demand for in-house staff; the anticipated effects of the Biden administration on the private funds industry; the likelihood of increased regulatory scrutiny of fund managers; and the need to ensure that legal and compliance staff has adequate resources.

For further commentary from Claypoole, see our two-part series on the market for in-house compensation at hedge fund managers: "What Is the Value of Legal and Compliance Staff?" (Mar. 12, 2015); and "Trends in Legal and Compliance Hiring and Staffing" (Mar. 19, 2015).

HFLR: The SEC has undergone significant changes in personnel in the past few weeks – including the departure of Chair Jay Clayton, Director of the Division of Enforcement (Enforcement) Stephanie Avakian and Director of Corporate Finance William Hinman. In addition, Dalia Blass, Director of the Division of Investment Management, and Paul G. Cellupica, Deputy Director and Chief Counsel of that Division, were slated to depart by the end of January. What effect do you anticipate that having on the SEC and its interactions with fund managers? In other words, how much of a "knowledge vacuum" do you think these departures will leave, which managers will have to overcome when dealing with the Commission?

Claypoole: On both a macro and micro level, I don't think that there is going to be a significant effect on managers. First, on the macro level, Clayton and the other people who are at the top of the SEC are going to be replaced by people who are similarly competent and knowledgeable in the space. For example, Gary Gensler – Biden's pick to replace Clayton – was the head of the CFTC from 2009 to 2014 and a former banker with Goldman Sachs.

Even if there is a period of transition and adjustment as the senior people at the SEC turn over, the rank-and-file staff at the SEC who are on the ground with the funds every day and actually conducting the examinations are not turning over. There would be much more concern for fund managers if the lower levels at the SEC started leaving, but I don't see that happening.

I remember back when hedge funds started being examined by the SEC in 2006. Examiners would come in who did not understand what the managers were doing. As a result, managers had to do a lot of hand holding.

Pay increases and other factors at the SEC over the years have led, however, to a more highly educated baseline of career SEC staff. Plus, many of them have been there since 2005, so they have 15 years' experience examining managers. So, the rank-and-file SEC staff who are coming in and conducting the exams and audits know their stuff.

HFLR: Enforcement's Annual Report, released in November, showed that the total number of cases brought by Enforcement was down only 17 percent from the prior year, despite the challenges wrought by the coronavirus pandemic. What do you think can be inferred from those statistics and what that means for legal and compliance staff at fund managers?

Claypoole: The drop in enforcement actions makes perfect sense. The industry missed a beat when the pandemic broke out, and that beat was 6-8 weeks. Once everybody got rearranged and knew where they were, the industry kept operating better than almost any other that I can think of. That 17-percent reduction lines up almost exactly with the amount of time that the SEC spent trying to figure out how it was going to function during the pandemic.

By nine weeks into the pandemic, we had already placed someone in a new position virtually – *i.e.*, without any in-person interviews – which shows how quickly everyone had adapted.

[See "SEC Annual Report Highlights Pandemic Response, Enforcement Focus Areas and Whistleblower Program Success" (Dec. 10, 2020).]

HFLR: Speaking of the pandemic, the regulators and the funds industry moved quickly to remote work. How has that affected the role of legal and compliance, and what changes do you think will be made by fund managers with respect to legal and compliance staff as a result?

Claypoole: There is a huge diversity of opinion on this issue. Many people think that everybody being separate – with everything being done electronically – makes compliance easier because there is going to be more of an electronic trail, allowing CCOs to monitor everyone's behavior. As a result, it will be harder for a staff member to take action that is outside what is considered proper because everything is "on tape"; no one can be whispering to a buddy or giving insider information at the water cooler.

On the other hand, others think it is much harder to monitor what anyone is doing when he or she is not physically in the same location, which will lead to more inappropriate behavior.

Personally, I think the biggest downside of a more virtual-heavy work environment is that the CCO is less able to develop the kind of relationship that will promote compliant behavior. The best and most successful CCOs are those who are well-liked by the investment professionals and legal folks; are present; walk across the trading floors; stop at people's workstations, look at their monitors and notice their trading; talk to them; ask what they are doing; and develop relationships with the staff. Thus, when it is time for those CCOs to do their jobs, their advice is welcomed rather than resisted. It is more difficult for the CCO without that personal connection.

[See "OCIE Risk Alert Highlights Concerns Associated with Coronavirus Pandemic" (Sep. 10, 2020); and "Companywide Work From Home: Six Cybersecurity Considerations" (May 7, 2020). See also our two-part coverage of the HFLR's webinar on the coronavirus pandemic: "Manager and Regulatory Flexibility" (May 7, 2020); and "Business Issues" (May 21, 2020).]

HFLR: What effect do you expect all of the above to have on compensation of legal and compliance personnel going forward? Do you see legal and compliance personnel being regarded as more valuable by fund managers – and compensated accordingly – or regarded as yet another in a sea of rising expenses?

Claypoole: If I'm correct about the three prongs of increased demand for people in the space, it's Economics 101 – supply and demand. If you all of a sudden have a thousand investment advisers coming to market looking for a CCO at the same time, it can do nothing but drive up the compensation.

Compensation might be driven up more at the top layer – *i.e.*, for the CCO and deputy CCO – and remain flat or even trend downward slightly for those at the bottom. Although it seems counterintuitive that increased demand for compliance staff would drive down compensation, as compliance becomes more important and managers want to have more control over it by conducting more of the function in-house, they will start hiring staff to do more of the clerical work – email review, restricted trading lists, etc. – at the bottom. If managers start hiring inexperienced personnel for those clerical positions and training them accordingly, it could cause a slight slide at that level.

[For more on compensation, see "Majority of In-House Counsel Satisfied With Compensation, but Gender Gap Remains, Survey Finds" (Jul. 23, 2020); "BarkerGilmore Survey Benchmarks Compliance Personnel Compensation by Company Type, Revenue, Gender, Education and Industry" (Aug. 29, 2019); and "RCA Compensation Trends Panel Discusses Strong Market for Private Fund Compliance and Legal Personnel" (Jan. 25, 2018).]

HFLR: How, if at all, do you think the PE industry has been affected differently by the above factors?

Claypoole: It's really hard to tell today who is what. It used to be, back in the old days, the difference between a hedge fund and a PE fund as far as the Commission is concerned is that PE funds tied up money for more than two years and hedge funds did not. I had hedge fund clients that would set their redemption periods to two years if they could get away with it, even though they were clearly hedge funds, simply so they could avoid registration. Now, the lines are much blurrier. Hedge funds and PE funds have mated; most of the top managers are running both types of strategies – many of them split straight down the middle, with equal amounts of assets under management in PE and in hedge funds. Meanwhile, on the west coast, PE is mating with venture capital (VC) and technology.

[See "Structural and Operational Considerations for Hybrid Funds" (Jan. 14, 2021); and "Sidley Panel Discusses Operational and Tax Challenges of Hybrid Funds" (May 23, 2019).]

I do think that most of the increase in demand is going to be driven by managers that identify as PE sponsors coming to market to put together their legal and compliance staffs from scratch. The cross-pollination between the industries is pervasive. If you imagine hedge funds, PE funds, VC funds and tech funds as different colors of sand and pour them all into a jar, doing so one at a time will create bands of colors. If you pour them all in at the same time, however, all of the colors mix together, and you get brown. That's where I think the industry is right now.

HFLR: Despite the blurring of the lines, if most of the demand is going to be driven by managers identifying as PE sponsors, how much risk do hedge fund managers face that their legal and compliance staff could be poached by PE sponsors?

Claypoole: That is a major risk for hedge fund managers. When registered investment advisers (RIAs) started putting together legal and compliance functions back at the beginning of the century in response to enforced regulation or the feeling that it was on the horizon, a lot of the folks that you first saw come in on the compliance side were people that had done registered investment company (RIC) work traditionally – the closest thing that was out there. No one had done RIA work, so a RIC was the closest analogy and we hired people from RICs.

Clearly, if I'm a PE fund, I can hire a private deal lawyer from a Kirkland, Latham, Simpson or Debevoise that knows very little about regulatory work. If my goal is to hire someone who knows his or her way around regulatory issues and private deal transactions, the best place to find that person is in a hedge fund – just like the way hedge funds found those people at RICs 20 years ago.

As I said earlier, however, the asset management space is all brown sand – not bands of different colored sand – and that cross-pollination can drive demand even further. For example, if the hedge fund culture of dealing with legal and compliance – which went from the idea that no lawyers were necessary in 2003 to the concept in 2011 of "Hey, we just decided to get into structured products as a new segment of our business, so we need to get a new structured products lawyer!" – pervades the newly browning private funds space, that will increase the demand for legal professionals who are entirely outside the asset management groups of traditional law firms.

HFLR: The industry has also seen an explosion of interest in the private credit space – which had previously been considered a "niche" area. Are managers seeking legal and compliance personnel with specific private credit experience, and if so, can people with that experience expect to command a premium when it comes to compensation?

Claypoole: Let's start off by imagining every fund manager as a house. The front door of the house represents the investors, and the back door represents the investments.

With respect to direct lending – managers making middle-market loans to businesses that, for one reason or another, cannot access credit from traditional sources – the compliance issues have much more to do with the front door than the back door. Compliance issues regarding fundraising dwarf those regarding the loans themselves, which mostly require having strong underwriters. At the front door, where the manager is raising money, the issues require traditional, hedge fund regulatory experience around fundraising – anti-money laundering, know your customer, etc.

[See our three-part series on hedge funds and direct lending: "Tax Considerations for Hedge Funds Pursuing Direct Lending Strategies" (Sep. 22, 2016); "Structures to Manage the U.S. Trade or Business Risk to Foreign Investors" (Sep. 29, 2016); and "Regulatory Considerations of Direct Lending and a Review of Fund Investment Terms" (Oct. 6, 2016).]

On the other side, if you're talking about a private credit manager that is investing in debt, I also don't see a need for special skills on the legal and compliance side that will command a premium. The product issues are not complex enough to put the specific knowledge ahead of what I would call the RIA knowledge – that is much more where the focus of those hires lies. Most managers are unconcerned with legal and compliance staff having specific product knowledge when it comes to the staff they are hiring.

HFLR: Previously, you've said that the "right" amount of legal and compliance staffing seems to be approximately one legal or compliance person per billion dollars under management for complex multi-jurisdictional hedge fund assets. How realistic a benchmark is that for fund managers to use to determine whether they have the appropriate levels of staffing in place?

Claypoole: I don't expect the top – when you're looking at the complex, multi-jurisdictional hedge fund manager – to move. I don't see any world where we get to a place where it's more than a 1-to-1 relationship. There are many other strategies and many other structures, however, that I think are understaffed if you look at the industry numbers in the aggregate, and I expect that to change. Organizations with staffing levels well below those of the privately held complex multi-jurisdictional managers we have been discussing should probably be reassessing their staffing. The SEC is watching!