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Dear CCO: The SEC Has Its Eyes on You

The importance of understanding CCO liability in the investment management industry.

BY FIZZA KHAN

The role of any chief compliance officer is multifaceted. In the investment management space, responsibilities include ensuring all investment activities are in compliance with applicable regulations to engaging with financial regulators to answer questions and address concerns. This is a tall order for even the most experienced of CCOs—and has arguably become even taller as many have been forced to maintain sound compliance processes and controls across decentralized, remote work environments.

While the exact regulatory and cultural changes that may roll out under the new leadership of the Securities and Exchange Commission remain uncertain, the list of responsibilities and critical function of a CCO to an investment adviser are always evolving. At a national seminar held by the SEC last November, the commission outlined points for how investment companies and advisers can model a regulatory compliance program to prevent violations and mitigate operational and regulatory risks, as well as focused on the importance of the CCO's role in achieving this. So important, of course, that the CCO can be held personally liable if the firm is subject to an enforcement action.

In one recent case, the SEC levied a $1.7 million fine against the investment adviser Gilder Gagnon Howe & Co. for violations of Section 206(4) of the Advisers Act and Rule 206(4)-7

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U.S. Securities and Exchange Commission seal in Washington, D.C. January 5, 2019.

thereunder, and found that the CCO "willfully aided and abetted GGHC's violations." These rules require a registered investment adviser to, among other things, "adopt and implement written policies and procedures reasonably designed to prevent violation" of the Advisers Act and its rules. However, GGHC failed to meet this requirement despite being warned by FINRA in late 2016 that they had not done enough "to establish and enforce an adequate supervisory system as it related to the supervision of trading activity and failed to evidence that it was actively monitoring turnover rate, cost-to-equity ratio, and in-and-out trading."

This is an illuminating example of a CCO being held personally liable for a lack of supervision and engaging in fraudulent activities uncovered during the course of a routine SEC examination.

In announcing the decision, the SEC fined the CCO $45,000 and barred her from the securities industry.

While this enforcement action may give some compliance professionals pause, it is worth remembering that the SEC's standard for "liability" is a high bar. CCOs should take comfort in knowing that regulators are not out to play "gotcha." Instead, each enforcement action should be treated as an important learning opportunity for how to improve compliance.

Following are four areas in which CCOs should pay careful attention to lower their risk of potential liability:

- **Inclusion in E&O/D&O insurance:** Errors and omissions insurance and directors and officers insurance are specialized liability insurance programs designed to protect against business losses not covered by traditional liability insurance. While the former provides protection for any representatives of the company, the latter specifically protects directors and officers against legal liability. A CCO, as both a representative of the company and a senior officer, should be covered by both of these policies.

- **Appropriate delegation of responsibilities:** The SEC knows that there is only so much a single person can do. There is a general expectation that the CCO will take on a wide range of responsibilities, but delegate specific items to other compliance professionals on staff (or to a third-party expert). Implicit in this arrangement is that the CCO is providing the necessary support to his or her team to ensure that investment managers are meeting their fiduciary duty.

- **Proper supervision:** The popular saying "the buck stops here" offers a helpful reminder of how CCOs should think about their role. While the CCO should have a direct line to senior management or be a regular part of management decisions, it is ultimately the CCO's responsibility to oversee compliance. Of course, there is not necessarily a right way to supervise a compliance program, but there are definitely many wrong ways. A few of the warning signs that SEC officials look for include: lack of written policies and procedures, limited training sessions, inconsistent reporting and disclosures, and minimal changes to the compliance program over a long period of time, especially if the business is growing.

- **Compliance in all aspects of business:** Investment firms often view compliance as a "necessary evil" because they are under the jurisdiction of the SEC and other regulators. CCOs should not be relegated to only "compliance functions"—they need to have a voice in the investment, operations and compliance departments of a firm. The SEC has demonstrated that its reach goes well beyond what are in the four corners of rules and regulations of the Advisers Act, Exchange Act or other pertinent regulations. CCOs need to construct programs that effect policies and procedures that address not only the "typical compliance areas," but each facet of a firm's business that could be under review by a regulator and ensure, in their supervisory capacity, they address and mitigate potential risks of the firm.

The common theme across each of these four areas is proactive compliance. In other words, do not give regulatory agencies reason to further scrutinize during a routine examination. The SEC has tried to be transparent in communicating what types of issues could be cause for an enforcement action. Investment advisers and their CCOs would do well to listen to those signals in designing and maintaining a thorough compliance program.

***Fizza Khan** is founder and CEO of Silver Regulatory Associates, which provides regulatory compliance, ESG and due diligence advisory services to the investment management industry. Visit www.silverregulatoryassociates.com for further information.*