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ACA Insight

The weekly news source for investment management legal and compliance professionals

"The Commission needs to be especially cognizant of the messages it sends ... to CCOs of investment advisers."

Gallagher Criticizes SEC Pursuit of CCOs and Calls for Guidance

Chief compliance officers are being unfairly targeted in enforcement actions by the SEC. If it's not stopped, it could lead to less compliant advisory firms.

That, at least, is the view of SEC commissioner **Daniel Gallagher**, who on June 18 issued a public statement in the wake of two recent settlements that he voted against. The settlements, he said, "fly in the face of my admonition" to "tread carefully when bringing enforcement actions against compliance personnel."

"Both settlements illustrate a Commission trend toward strict liability for CCOs under Rule 206(4)-7 (the Compliance Program Rule)," he said. "Actions like these are

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Examiners on Site: Make the Visit a Success

The big day has arrived. SEC examiners will shortly walk through your front door for what will hopefully be no more than a two-to-three day visit. Are you and your advisory firm ready?

The SEC does not examine all that many firms. Even with added funding, only approximately one in seven will be examined each year, according to the agency's FY 2016 budget request (*ACA Insight*, 4/27/15). Further, the SEC has made a point of targeting never-before-examined advisers, those with a history of past violations, and those engaged in certain activities, such as the management of alternative investments.

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Advisory Contracts: Don't Cut Corners on the Approval Process

The advisory contract process for mutual funds is meant to be followed. Advisers and board members cannot ignore parts they don't like.

That's one takeaway from the June 17 settlement between the SEC and an investment adviser, the adviser's principal, and three board members of two mutual funds. All were charged with violating what is known as the 15(c) process, referring to the section of the Investment Company Act that covers evaluation and approval of mutual fund advisory contracts.

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Gallagher Criticizes

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undoubtedly sending a troubling message that CCOs should not take ownership of their firm's compliance policies and procedures, lest they be held accountable for conduct that, under Rule 206(4)-7, is the responsibility of the adviser itself. Or worse, that CCOs should opt for less comprehensive policies and procedures with fewer specified compliance duties and responsibilities to avoid liability when the government plays Monday morning quarterback."

"The Commission needs to be especially cognizant of the messages it sends to the compliance community, and in particular to CCOs of investment advisers," Gallagher said. "To put it bluntly, for the vast majority of advisers, CCOs are all we have." The role of adviser CCO takes on added weight when one considers that there are nearly three times as many registered advisers as there are broker-dealers, but that the SEC divides its examination resources "roughly" equally between each group. "Given the vitally important role played by compliance personnel, I am very concerned that continuing uncertainty as to the contours of liability under Rule 206(4)-7 will disincentivize a vigorous compliance function at investment advisers."

> *"The Commission must take a hard look at Rule 206(4)-7 and consider whether amendments, or at a minimum staff or Commission-level guidance, are needed."*

The Compliance Program Rule

Gallagher attributed "much of the blame" for the Commission's pursuit of CCOs to Rule 206(4)-7, which he described as "not a model of clarity." The rule "offers no guidance as to the distinction between the role of CCOs and management in carrying out the compliance function." In addition, the SEC has not issued any guidance about how to comply with the rule in the 11 years since it was adopted, leaving only enforcement actions to provide insight into agency thinking – and in some cases these actions "have unfairly contorted the rule." Enforcement actions should not be used to resolve any uncertainty as to what the rule means, he said.

"On its face, Rule 206(4)-7 speaks directly to the responsibility of the adviser, but all too often, the Commission interprets the rule as being directed at CCOs," he said. "The rule expressly states that the firm must designate a CCO to *administer* [emphasis Gallagher] its compliance policies and procedures. At the end of the day, ultimate responsibility for *implementation* [emphasis Gallagher] of policies and procedures rests with the adviser itself."

"The Commission must take a hard look at Rule 206(4)-7 and consider whether amendments, or at a minimum staff or Commission-level guidance, are needed to clarify the roles and responsibilities of compliance personnel under the rule so that these individuals are not improperly held accountable for the misconduct of others," Gallagher said. "The status quo will simply not do."

Other voices

Stroock partner and former SEC Division of Investment Management deputy director **Robert Plaze** took a different point of view. "If the SEC had attempted to write a rule then stating what the CCO was to do in each case, I suspect commissioner Gallagher would be giving a speech saying that it was too intrusive and complicated."

In any event, he noted, Division of Enforcement director **Andrew Ceresney** did provide guidance as to when CCOs would be prosecuted in a May 2014 speech. In that address before a Washington, DC audience of legal and compliance professionals, Ceresney said that action would be taken against CCOs "when the Division believes legal or compliance personnel have affirmatively participated in the misconduct, when they have helped mislead regulators, or when they have clear responsibility to implement compliance programs or policies and wholly failed to carry out that responsibility."

"At the end of the day, though, legal and compliance officers who perform their responsibilities diligently, in good faith, and in compliance with the law are our partners and need not fear enforcement action," Ceresney said.

Plaze also noted that members of the Commission may vote against a staff settlement with an adviser if they disagree with it, as Gallagher did in these two cases. "But other members of the Commission voted differently," he said.

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Willkie Farr partner and former SEC Division of Investment Management director **Barry Barbash**, on the other hand, said that "Gallagher makes a point to a degree. Rule 206(4)-7, from the get-go, including during the comment period, was critiqued by the industry as vague." Nor, he said, did the rule as originally adopted seem to contemplate "holding CCOs, trustees and directors, as opposed to registered investment advisers, liable for the implementation of compliance policies and procedures."

While new guidance for Rule 206(4)-7 that provided more specificity to the responsibility of CCOs might be helpful, "it is not likely to happen," he said, as "it could be viewed as a limitation on the SEC's ability to bring cases. The breadth of the rule as now written is an important enforcement lever."

"Investment advisory firms need to be able to attract the best and brightest to the CCO position," said **Investment Adviser Association** president and CEO **Karen Barr** after reading Gallagher's statement. "While it is certainly appropriate to pursue enforcement action if the CCO is involved in misconduct or misleads regulators, the Commission should take care not to send the wrong message to CCOs with actions that could be perceived to be second-guessing or singling out CCOs as solely responsible for firm violations. The SEC should support CCOs in carrying out their critical functions."

The settlements

The two cases that Gallagher said spurred his negative vote and statement were a June 15 SEC settlement with **SFX Financial Advisory Management Enterprises** (*ACA Insight*, 6/22/15) and an April 20 settlement with **BlackRock Advisors** (*ACA Insight*, 4/27/15).

In the SFX settlement, the agency alleged that the CCO caused the firm's failure to implement its compliance policies, which it said would have detected the alleged theft of client assets by the firm president over several years. The CCO was also charged with failing to conduct the annual review of the firm's compliance program. The CCO was censured and agreed to pay a $25,000 civil money penalty.

In the BlackRock Advisors settlement, the agency claimed that the CCO caused certain of the fund's violations in connection with its failure to adopt and implement policies and procedures to address how the outside activities of firm employees would be assessed for conflicts of interest. The SEC also alleged that the CCO did not disclose these problems to the fund's board of directors. The CCO paid a $60,000 civil money penalty to settle the case.

Gallagher noted that in both of these case, the SEC stated that the CCO was responsible for the implementation of the firm's policies and procedures, rather than their administration. Implementation would be the responsibility of the firm itself, he said.

Plaze said he found Gallagher's dissent from the BlackRock Advisors settlement a bit odd, as that case prominently alleges violations not only of Rule 206(4)-7, but of provisions of Investment Company Act Rule 38(a)1, which he said specifically requires the CCO to inform the board of a mutual fund of certain material compliance matters, which the SEC alleged the BlackRock CCO failed to do. "This was not a case with a lot of ambiguities," he said.

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Small firms and more

Should the trend of holding CCOs liable continue, Gallagher said, the impact may fall particularly hard on small advisers. "It appears that many such advisers have just one set of policies and procedures covering both compliance and business functions," he said. "At these firms, there is a significant risk that by taking ownership of the implementation of the policies and procedures, CCOs could unwittingly also be taking ownership of business functions, subjecting them to strict liability whenever there is a violation of the securities laws."

> *"Rule 206(4)-7, from the get-go, including during the comment period, was critiqued by the industry as vague."*

While saying that there are, "of course," situations when a CCO should be held accountable for violations, the SEC should try to avoid the "perverse incentives" that come with targeting compliance personnel who "are willing to run into the fires that so often occur at regulated entities. This includes exercising restraint and discretion even at the investigation stage."

"The psychological impact, and in many cases reputational damage, that can come with months or years of testimony, the Wells process, and settlement negotiations can be just as chilling as the scarlet letter of an enforcement violation," he said.

Examiners on Site

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If your firm does not fall into a target category, your chances of being examined are even less.

But you never know. You may get that document request letter tomorrow. The last thing any chief compliance officer wants is to be unprepared. And if your firm has never been examined or falls into a targeted risk area, all the more reason to make sure you're ready.

How many examiners will arrive and how long will they stay? That depends on a variety of factors, including the size of your firm, what the exam staff wants to investigate, and what they find during the investigation. Typically, two to three examiners will arrive, but there may be more, said **Wilmer Hale** partner **Matthew Chambers**. The visit can last from one day to several weeks.

Preparatory best practices

Use the suggestions below to maximize the chances for a successful on-site examination:

- **Choose a point person.** This person, who will be the main interlocutor with the examiners, is typically the CCO. "If you choose not to have the CCO as your point person, there better be a good reason. Otherwise it may cause examiners to think there is some problem with your CCO," said Chambers. Small firms may not have a standalone CCO, but someone at the firm will have that responsibility and should be the main contact. The point person should sit in on all interviews that examiners have with other employees – nothing should be done without the CCO present. If examiners ask employees for information when the CCO is not there, those employees should tell the examiner to check with the CCO.
- **Provide a good, comfortable room for the exam team.** This is their private room, where the examiners can talk, exchange ideas, review documents and more. The room should be within your firm and not at some remote location, but make sure it is not located near a site where employees group and talk, like the lunch room or the front reception area, said **Mayer Brown** attorney **Adam Kanter**. "You don't want examiners to feel like they're off in Siberia, but nor should they be right in the thick of things where they can overhear idle chatter from personnel."
- **Replace nervousness with calm competence.** Staff will be understandably nervous when examiners arrive, but "it's very important to make a good first impression," said **Day Pitney** counsel **Eliza Sporn Fromberg**. The best way to handle this is to make sure all employees are well-versed in what their depart-

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ments do and how they comply with any regulations affecting their departments, she said. For instance, "receptionists at the front desk should show, if asked, how they track who comes in and out of the building."

- **Don't volunteer unnecessary information.** Make sure employees who may be interviewed understand this. "Answer what is asked, nothing more," said Chambers, who said he has seen a long deficiency letter result after a portfolio manager spoke too much.
- **Tell the truth**. Sometimes employees think they are helping the firm by shading an answer a certain way or by providing misleading information, said Fromberg. That will actually hurt the firm when examiners later discover an employee was less than honest. Train all employees to answer questions honestly. If there are any issues that the CCO may not yet know about, make sure the CCO finds out about them prior to the on-site visit.
- **Highlight compliance during the introductory meeting.** Most onsite examinations begin with an introductory meeting, during which the CCO lets examiners know about the corporate structure and perhaps provides an organization chart. Use this meeting to demonstrate that your firm is compliance-oriented and has a good tone at the top, said Fromberg. "Provide an overview of your compliance program and resources. Highlight any new additions, such as new compliance positions or programs," she said. Department heads should also attend, with perhaps each taking a few minutes to explain what their departments do. "Their presence will show that they take compliance seriously, since they took time from their busy schedules to attend," Fromberg said. Chambers suggested that, to prevent inadvertent comments, it is best that the comments by the CCO and all other firm personnel attending be scripted. But make sure the scripted comments are not too long nor give the impression of being too rehearsed, said **ACA Compliance Group** senior principal consultant **Kimberly Daly**, "That would be annoying to the examiners, many of whom prefer to control the meeting and ask questions based on their agenda, not what the adviser wants to present."
- **Prepare a document action team.** Examiners typically send firms a document request list prior to their visit, but that doesn't mean they won't request more documents on site. In fact, odds are that they will. So prepare a team whose job it will be to find requested documents, said Kanter. With so many documents in the firm, how can you possibly anticipate which ones they will ask for? By reviewing any deficiency letters your firm received as a result of past examinations, and by reviewing the annual priority list published by the SEC's Office of Compliance Inspections and Examinations, Fromberg said. Whatever topics are listed in those two documents will likely be the focus of examiner attention.
- **Keep track of everything examiners ask for.** "If you can't find something, let them know," said Fromberg. "Don't let it just hang there and think it will go away." Assume that the examiners are keeping track of their requests – and will note that your firm was not forthcoming if you did not either provide the requested information and did not offer an explanation as to why it was not provided.
- **Do not have outside counsel on site.** "It sends the wrong message, that you have something to hide, or that you expect things to get confrontational," said Kanter. Instead, after the examiners leave each day, conduct a daily debrief with your outside legal team. Let them know what happened that day and get their advice for the next day.
- **Avoid arguments at all cost, but correct factual errors.** You want examiners leaving with the belief that your firm was cooperative and a partner with them in helping your firm stay in compliance. If an examiner mentions that there seems to be a problem, don't immediately respond and don't become defensive, said Chambers. "Calmly tell the examiner that you will study the situation and get back to him." If, on the other hand, an examiner makes a factual error because he perhaps missed something, you should point that out in a helpful way. You don't want to see an issue cited in a deficiency letter that is inaccurate because an examiner had an incorrect understanding of how your firm works.

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- **Listen during the exit interview.** This is where the exam team, at the end of the visit, will summarize what it found. The best strategy here is to simply listen, Chambers said, calmly speaking up only when you need to correct any factual errors. "Sometimes, believe it or not, the SEC is wrong."

Advisory Contracts

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The adviser, **Commonwealth Capital Management**, allegedly provided incomplete or inaccurate information to the two mutual fund boards, and the adviser's majority owner, **John Pasco III**, allegedly caused those violations. The three board members were charged with moving forward on advisory contracts without having all the information they had requested. An attorney representing Commonwealth Capital Management and Pasco did not respond to a voice mail and email seeking comment.

Under Section 15(c), it is illegal for a registered investment company to enter into or renew an advisory contract unless the terms of the contract are approved by a majority of the fund's independent directors. "As part of the approval process, Section 15(c) imposes a duty on the directors to request and evaluate, and a duty on the adviser to furnish, such information as may reasonably be necessary for the directors to evaluate the terms of the adviser's contract," the SEC said.

Commonwealth Capital Management was part of a turnkey mutual fund platform providing services to small to mid-sized mutual funds, according to the SEC's administrative order instituting the settlement, and advised various fund series within two larger fund entities, World Funds Trust (WFT), set up as a trust, and World Funds Inc. (WFI), set up as a corporation. The three board members charged served as trustees for WFT and as independent directors for WFI.

While the Commission collectively fined the adviser, Pasco and a subsidiary mutual fund administrator $50,000, each of the board members was fined only $3,250. Yet the words of SEC officials in the agency's litigation release focused on the role of the board members, particularly in terms of their roles as trustees at WFT.

"As the first line of defense in protecting mutual fund shareholders, board members must be vigilant," said SEC Division of Enforcement director **Andrew Ceresney**. "These trustees failed to full discharge their fund governance responsibilities on behalf of fund shareholders."

"The advisory fee typically is the largest expense reducing investor returns," said the Enforcement Division's Asset Management Unit co-chief **Julie Riewe**. "The [parent fund of some of the funds'] trustees fell short as the shareholders' watchdog by essentially rubber-stamping the adviser's contract and related fee."

"The case is a reminder to fund advisers that the contract renewal process is a vital exercise, and advisers are obligated to provide boards with the information boards need to carry out their responsibilities," said **Mutual Fund Directors Forum** president and CEO **Susan Wyderko**. "The SEC is clearly focusing on this issue, and here took action when the adviser provided incomplete and inaccurate information to the fund boards."

"Asking the correct questions and requesting the correct documentation is only half of what's required of mutual fund boards," noted **Zaccaro Morgan** partner **Nicolas Morgan**. "The board must also receive and evaluate the information before approving an adviser's contract."

"The obligations of investment advisers and investment company boards under Section 15(c) of the Investment Company Act are a priority for the SEC Enforcement Division's Asset Management Unit," said **Mayer Brown** partner **Matthew Rossi**. "I would not be at all surprised to see the SEC bring additional enforcement actions like the Commonwealth case in the future."

Requests and responses

The WFT board of trustees evaluated and approved advisory contracts for its funds with Commonwealth Capital Management and a sub-adviser on October 1, 2008. The WFI board of directors evaluated and approved advisory and sub-advisory contract renewals with Commonwealth Capital Management on August 27, 2009.

Prior to the WFT approval, according to the SEC, WFT trustees requested certain materials and information from Commonwealth Capital Management and its sub-adviser as part of the 15(c) process. These included a copy of the adviser's and sub-adviser's most current Form ADV, compliance manuals, code of ethics, and current financial statements. WFT also requested that the adviser and sub-adviser complete a questionnaire prepared by an independent counsel regarding their operations, compensation and compliance procedures.

The adviser compiled information into a "board book" and, following a review and certification of the questionnaire responses by Pasco, delivered it to WFT in advance of the October 1 meeting, at which the board reviewed it, the SEC said.

But Commonwealth Capital Management did not, in fact, provide the board with all the information requested, the agency charged. Specifically, the trustees had requested that the adviser and Pasco submit comparative fee information – fees paid by comparable funds – along with the completed questionnaire. "There is no documentary evidence [Commonwealth Capital Management] furnished information regarding the fees paid by comparable funds," the agency said. In addition, the adviser provided incomplete responses about the nature and quality of the services the adviser provided versus services provided by the sub-adviser and administrator.

"Notwithstanding the fact that [Commonwealth Capital Management] failed to provide the requested comparative fee information, the trustees approved the advisory contracts because they considered the proposed advisory fees to be within an appropriate range," the SEC said.

Wyderko noted that the SEC said it found no documentary evidence that fee information was provided to the board. "It's a reminder to fund boards of the importance of memorializing important aspects of the board's deliberations in the minutes," she said.

The agency, in its order instituting the settlement, described a similar set of circumstances involving the approval of the advisory contract with WFI, with Commonwealth Capital Management providing WFI's board with a book of information. As with WFT, the book provided to WFI allegedly did not provide all the requested information.

"Commonwealth Capital Management supplied a fee chart containing inapt comparisons and erroneous information while omitting other details," the SEC charged. "The firm additionally failed to provide certain information about profitability and an expense limitation agreement that had been in place to limit the relevant fund's expenses. Commonwealth Capital Management also informed the WFI independent directors that the fund had appropriate breakpoints when, in fact, breakpoints were omitted from the advisory contract."

"In this environment, advisers must be particularly careful to ensure that the information they provide to fund boards during the Section 15(c) process is complete and accurate, particularly when that information includes the nature and quality of the adviser's services and the fee structures for comparable funds," Rossi said. "Moreover, when providing the information on fee structures for comparable funds, an adviser must make sure that those funds are in fact comparable. Obviously, fund boards must also request and carefully consider this information and all other necessary information when approving investment advisory contracts for registered investment companies."

The WFI board, after approving the advisory contract renewals in 2009, held its next annual 15(c) review on August 25, 2010, when it again approved the advisory contracts, according to the administrative order. But also again, the information provided was incomplete, the SEC said. "The performance and fee comparison charts provided by [Commonwealth Capital Management] had the same comparisons and deficiencies as the 2009 charts. [Commonwealth Capital Management] provided a table of fees and expenses so that the board could evaluate the adviser's profitability, but [Commonwealth Capital Management] again did not fully explain its entries or its methodology for allocating expenses and provided only a single year's financial statements."

Note to Readers

The next issue of *ACA Insight* will be dated July 13, 2015. Have a safe and enjoyable Fourth of July weekend.

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