CONVERGENCE

OPTIMAL PERFORMANCE

"Reducing your Chances of Being Victimized by Bad Behavior- Recognizing Red-Flags and Risk in an Asset Manager's Business."

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Merrill Lynch recently admitted to misleading customers about how it handled their orders and agrees to pay a $42M penalty. Merrill Lynch admitted to a practice called "masking," when it tells customers that it executed millions of orders internally but had actually routed them for execution at other broker-dealers, including proprietary trading firms and wholesale market makers, according to the SEC order. Masking entails reprogramming Merrill's systems to falsely report execution venues, altering records and reports, and providing misleading responses to customers. By "masking" the broker-dealers who had executed customers' orders, Merrill Lynch made itself appear to be a more active trading center and reduced access fees it typically paid to exchanges," the SEC statement said. Even after Merrill stopped masking in May 2013, it took additional steps to hide its past practice, says the SEC.

Why do investors continue getting deceived by their financial intermediaries? Were these deceptions perpetrated by a rogue individual who cleverly found a crack in the manager's control armor or the result of a highly complex business environment that failed to establish and/or maintain the appropriate controls over high risk conditions? Convergence believes avoidance and prevention is a function of recognizing risk signals in a manager's business model and asking the right questions!

"Seeing the Signals"

Convergence studied 100 actions taken by the SEC against investment advisers for a variety of wrongdoings against institutional, high net worth and individual investors. Wrongdoing includes, and is not limited to, financial injury to investors caused by manager fraud, misrepresentation and/or disclosure failures. Our goal was to determine if investors **could have detected** red-flags, or risk signals, in the manager's business model that they might have considered **before** making their investment or identified during post investment ongoing due diligence.

The answer in both cases is "Yes." We saw high risk business conditions in the adviser's business model leading-up to and during the wrongdoing that if detected may have helped investors avoid or limit the financial and reputational harm they suffered.

“Detecting Risk Signals”

Convergence tracks 61 business conditions in a manager’s business model that create non-investment risk. These business conditions fall into 4 risk categories, including operational, compliance, regulatory event and vendor. Our study concluded that most managers subject to the enforcement actions had several high-risk business conditions (HRBC) in their business that could be linked to what they did and that a high correlation existed with certain factors. Meaning, they existed in 67% of the SEC actions we studied. This paper focuses on one often-debated risk factor that we believe all investors should avoid.

“The Challenging Role of Today’s CCO”

A quality compliance effort is a team, not spectator sport. Portfolio Managers, Traders, Operations, Accounting and investor relations staff all play a key role in supporting the CCO’s effort to ensure regulatory filings are made on time and are accurate and complete. The Chief Compliance Officer in today’s asset manager has a tougher job and faces more personal risk than at any time in recent memory. The CCO and the principles of the firm face civil and criminal penalties for making regulatory filings that contain material errors and omissions and misleading statements. At one time these filing required a “best efforts” basis. Thus, to fully limit personal and professional risk, they need to take greater efforts to understand and defend the data they use to complete their filings.

The scope of the CCO role has expanded. They take an influential seat at the product development and fund-raising table. Think about the challenges the CCO has working with the aggressive personalities of today’s alpha-male/female portfolio managers or traders. All driving toward more growth and improving returns. You might wonder why any asset manager, or its CCO for that matter, would underwrite the material risks that are clearly obvious when a CCO also performs CFO, COO, CRO, CIO and CEO duties? The condition violates the very basic segregation of duties principle and raises many questions.

Limited Partners in funds adviser expect CCO’s to be independent and the ultimate steward of the firm’s regulatory culture. While the culture of compliance starts with the “tone-from-the top”, todays Compliance Officer stands at the intersection of a crowded and fast-moving investment highway.

“The Multi-Functional CCO (MFCCO)-Does it Matter?”

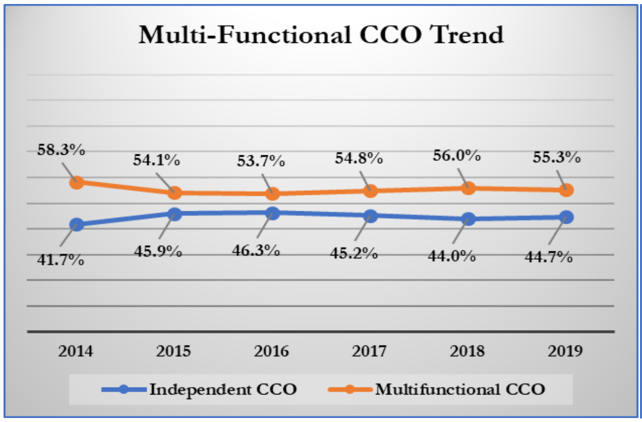
We considered the SEC’s and other expert’s comments on the MFCCO subject. While the SEC has commented publicly on the challenges it creates, they have essentially left the ultimate decision on whether it is “good/bad” to investors. Privately, investment consultants, audit firms and administrators we spoke with expressed concern. Unfortunately, large and small investors are not equipped to make the “good/bad” determination because little research exists to guide them on making the decision.

Most CEOs and CCOs interviewed by Convergence on the topic recognize the benefits of an independent CCO yet offered several practical challenges as to why it still exists. They fall into three categories, their founder’s ability and willingness to pay for it, 2) their ability to effectively manage it and 3) the impact on the MFCCO compensation. While Convergence does not argue these points, we offer an alternative and data driven view on why separating the function makes good business sense.

We studied three business conditions to help us define “good/bad” for asset managers, service providers and investors; 1) the trend in independent and MFCCO, 2) the asset growth in managers with independent and MFCCO models and 3) SEC enforcement actions taken against managers for investor wrongdoing. We selected a sample of 3,000 asset managers who were 1) active during the 2014-2019 study period and 2) advised private funds. Private funds include Hedge, Private Equity, Venture Capital, Real Estate, Securitized Assets and Other Funds.

1. **The MFCCO Trend and the Cumulative Asset Growth of Managers**
   - In all three size bands listed below, the number of independent CCOs increased
   - Their assets **<u>grew faster</u>** than those with a Multi-Functional CCO model in place.

Table 1a: Advisers <$100MM AUM



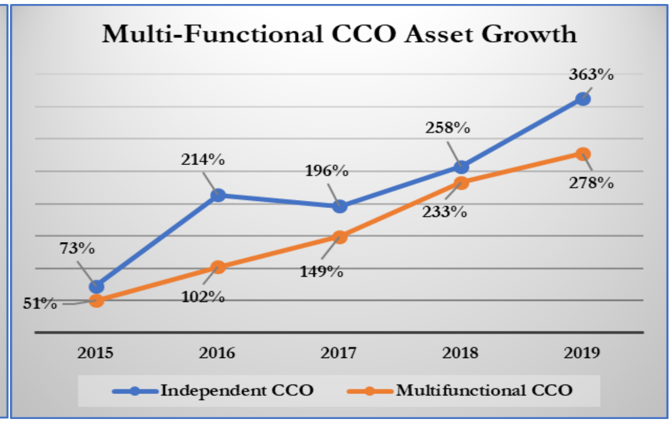
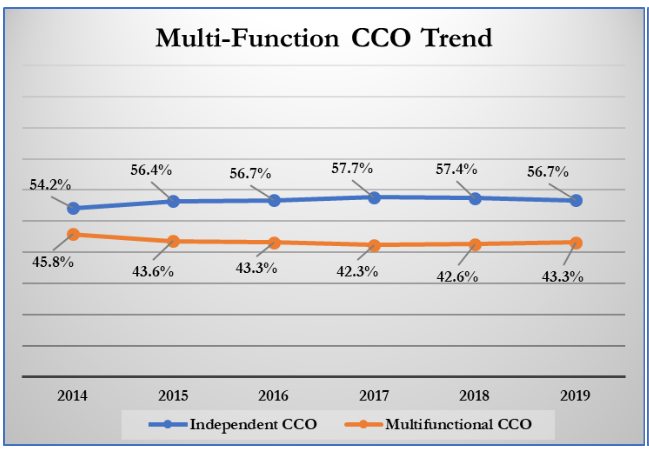


Table 1b: Advisers >$500MM<$1BN



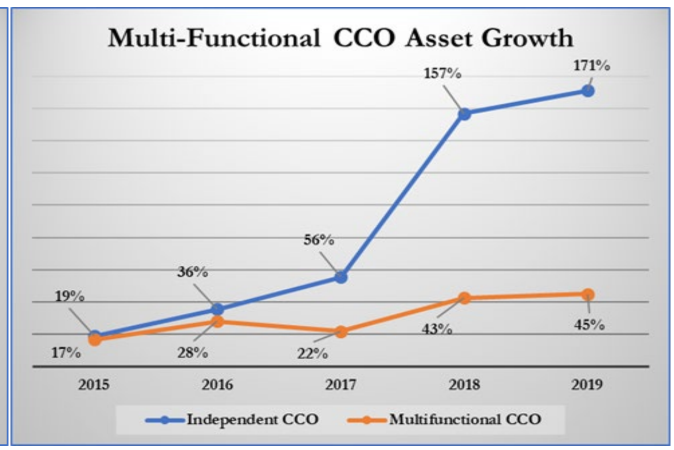
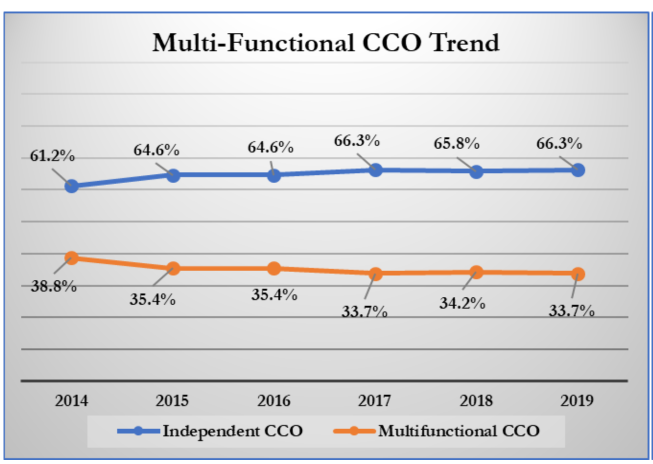
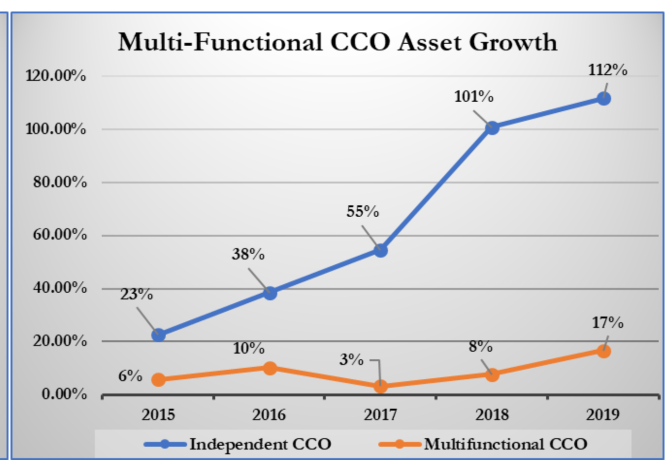


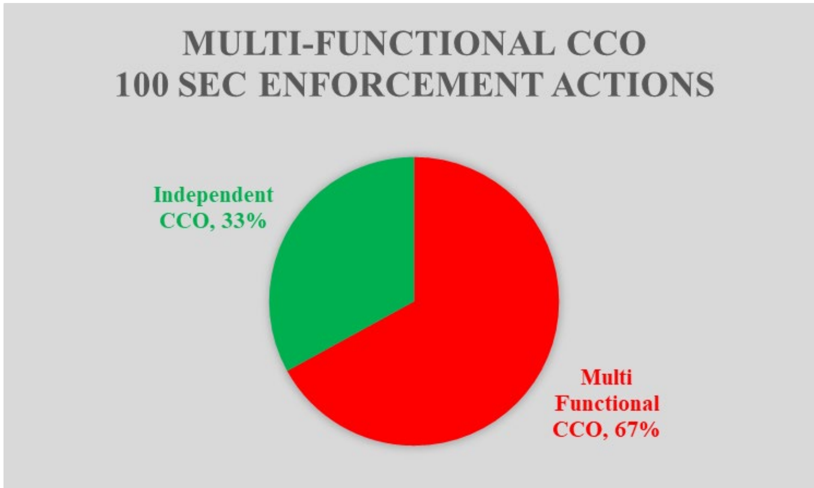
Table 1a: Advisers with $1BN<$5BN in AUA





2. **MFCCO in SEC Wrongdoing Actions**
   - The Multi-Functional CCO existed in 67% of 100 SEC Enforcement Actions Modeled

Table 2: Percentage of Advisers Cited in SEC Actions with a MFCCO



The MFCCO condition creates various conflicts of interest and additional work burdens because of the control roles and work required of the same person. Convergence studied 100 SEC enforcement actions involving wrongdoing, defined as actions that financially injured the investor. The MFCCO model existed in 67% of the cases during the time period leading up-to or during the period the wrongdoing action occurred. In these cases, the MFCCO was either a direct participant in the action or was unable to prevent the action from occurring.

We find this statistic compelling. Reading these cases is a sad yet eye-opening experience when you consider the financial and reputational losses that investors **might have avoided** had they 1) known about the condition and 2) if they knew about it and took action to ensure that additional checks and balances existed in the organization to avoid compensate for the condition.

And, yes, we expect MFCCOs to be outraged by this implication. We are not impugning their integrity as many are hard-working an honest. Yet we simply cannot ignore the facts. And while we hear the arguments that "I am a MFCCO, but I have outsourced work to an independent Compliance firm that serves as a check and balance and " I have someone working for me that is really the CCO", the reality is simply the risk is clear and the regulatory cases support the view. Yet, we respond to the first question by suggesting that "the nuances of how asset managers run their businesses and the dynamic nature of compliance renders third-party Compliance firms less effective in spotting day-to-day MFCCO conflicts. And to the second question we respond by suggesting that "unless your direct report has a reporting line to an independent third-party, their ability willingness to report potential issues without your knowledge is limited and in our opinion suspect. Many have said that they are less willing to report activities that may influence their status or compensation and more willing to try and work-out the situation.

Regulatory and Investor Sentiment on MFCCO[1]

[1] Todd Cipperman, April 30, 2019, "5 reasons to just say no to having a part-time CCO" https://www.financial-planning.com/opinion/sec-intensifies-scrutiny-on-doubled-up-compliance-officers

The MFCCO has more work to do than their independent counterparty. The SEC has raised questions about the MFCCO's ability to meet their compliance requirements and has a message for your firm: when it comes to compliance, "do your job."

The commission will bring enforcement actions against firms with inadequate compliance programs, even in the absence of other regulatory violations or client harm. This in the wake of investment firm employees or executives acting as chief compliance officers, on top of other responsibilities. In most cases, such two-hatted executives do not have the time or knowledge to ensure completion of required compliance activities.

In 2017, the SEC's Office of Compliance Inspections and Examinations issued a Risk Alert naming weak compliance programs as one of the top five most frequently identified compliance deficiencies, resulting in another upsurge of enforcement actions against compliance programs and CCOs. The SEC often cites the dual-hat model as a prime reason for the alleged inadequate compliance program.

To steer clear of this snare, investment advisors must allocate proper resources to compliance and enforce a separation of powers between the compliance officer and other management. Through risk alerts, speeches and enforcement actions, the SEC has outlined guidelines for an adequate compliance program. They include drafting policies and procedures conducting testing, training, reviewing marketing materials, consulting with management and reporting.

In one case, the SEC censured, fined and barred from practicing the general counsel/chief compliance officer of an investment advisor accused of making unauthorized investments and then misleading a client. The SEC maintains that the CCO is a regulatory officer whose job is to implement policies and procedures reasonably designed to prevent violations of the securities laws, and to report on the compliance program, not to be a zealous advocate for management.

Double exposure

In the event of a compliance deficiency, a dual-hatted CCO faces personal liability and sanctions, including fines and potential bars from the industry. If that executive is also a firm principal, an enforcement action naming them personally often means the end of the business itself, especially where the SEC imposes an industry bar.

At one asset management firm, the CCO with limited compliance experience pleaded for more compliance resources, but his boss ignored him saying he would deal with any issues after an exam occurred. Ultimately, the SEC charged the firm with underfunding the compliance program.

A dual-hatted CCO may also have potentially troubling ties to management and its financial interests. Having a compliance officer who also works as a senior executive creates conflicts of interest and inadequate supervision. A general counsel who also serves as CCO may have relevant experience and compliance knowledge, but part of a lawyer's job is to advocate for the client, and that includes an absolute obligation to keep information confidential to preserve attorney-client privilege.

The SEC will also challenge firm leaders who serve as CCO because of the inherent conflict of interest. In one such case, the SEC fined and censured an IA/BD for failing to supervise its CEO/CCO, who was ultimately convicted on criminal charges of stealing from clients. The SEC charged the firm for failing to implement reasonable policies and procedures to review the consolidated reports, which, according to the SEC, would have quickly uncovered the obvious scheme.

Firms must ensure that the CCO has significant independence from management and the revenue-producing function. If not, the dual-hat structure virtually guarantees a lack of proper supervision.

Institutional Investors are increasingly passing on making investment in firms with the MFCCO condition in place. "It's just not worth the hassle of staying on top of the natural challenges this condition creates," cited one large state pension plan official. In fact, the data supports what we are hearing in the market. They are investing less often with managers with the MFCCO.

Solutions

First and foremost, investment advisors must allocate enough resources to the compliance function. Based on our experience and industry benchmarking, firms should spend no less than 5% of revenue or 7% of operating budget on compliance, with most SEC-regulated entities spending between 7% and 20% of total operating costs.

Of course, some firms may be able to justify a lesser amount if the business is relatively uncomplicated, while emerging firms might spend up to 20% or more as they put their compliance ducks in a row. Too little spent is a red flag to regulators that the firm does not take compliance seriously. Firms looking to avoid an SEC enforcement action and stabilize their compliance programs have one of two options: 1) hire an in-house compliance officer, or 2) hire an outsourced compliance officer.

Both in-house and outsourced CCOs help guarantee that the proper time will be dedicated to the program by an expert who understands regulatory policy and compliance. However, it is still essential that firm management provides adequate funding, as well as ensure CCO independence from the revenue-producing team.

The SEC will look underneath the hood of a compliance program to investigate whether a firm actually implements effective policies and procedures. Just having policies and procedures and identifying a CCO won't satisfy compliance obligations anymore. Firms must retain a competent and dedicated CCO either by hiring a full-time employee or by retaining the services of an industry-recognized outsourcing firm. Nothing less than the reputation and success of the firm is at stake.

The quality of your regulatory filings reflects directly on your compliance culture. Investors often ask about your commitment to maintaining a strong compliance culture. Sloppy regulatory filings may cost you more and are indicative of other weak internal processes. The quality of your regulatory data also impacts the cost of doing business. Filings that are wrong require amendments which costs the firm additional money. CEOs at the minimum should want to know what their quality scores look like and if they are weak, why?

The Market for Chief Compliance Officers

It is no surprise that competition for quality CCOs is fierce. There are over 35,000 SEC and State registered advisers offering advisory and other services to investors. Turnover in the CCO function has ranged from 3-6% over the study period.

Summary

Convergence believes there are good business reasons for having an independent CCO. More managers are listening to these reasons and our data shows that the percentage of asset managers with independent CCOs continues to increase. These managers understand that the independent CCO is good for their business. Their control environments are better, they growth their assets faster and the quality of their regulatory filings are better than their peers.

For additional research on this topic please contact George Gainer at 203-956-4824 and to discuss how Convergence can help you find a CCO, please contact Eileen Cleary, President of Convergence Talent Management @ 908-672-3011.