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## Remarks at InfoVest 21 Breakfast Presentation: On Outsourcing Legal and Compliance Functions and the CCO Role

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Good morning.

When I starting consulting in the early 1990s, it was not because I had a lot of grey hair or had become tired of life on the inside. I simply thought it would be more fun and more challenging, and would provide me with the kind of economic opportunities I wanted, as well as opportunities to really learn how the industry works, through exposure to different types of firm. Consulting did all of that for me. My first consulting assignments included providing a mutual fund organization board with synopses of country risk for the board's annual foreign custody review, along with some basic registration work for several other clients.

At the time, there were only a few firms and people doing what I was doing. I was fortunate in that I was able to ride a wave of opportunities that attended certain banking scandals that had taken place, including those of BCCI and Lavoro, having to do with money laundering and illegal lending of one type or another,<sup>1</sup> as well as a decision by then SEC Chairman Richard Breeden to make the US financial markets

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<sup>1</sup> This surge in foreign banking has been accompanied by a variety of questions and concerns on the part of the public, legislators, regulators, and U.S. bankers. Many of these concerns have been addressed by the passage of the International Banking Act of 1978 (IBA), which tightened federal and state control over foreign bank operations in the US. International bank scandals, most notably the closure of the worldwide operations of the Bank of Credit and Commerce International (BCCI), illustrate the disastrous effects of deficient supervision of the international banking system. The Federal Reserve responded to the corruption with the [promulgation](#) of the Foreign Bank Supervision Act of 1991 (FBSEA). The FBSEA greatly expanded the supervisory authority contained in the International Banking Act of 1978 and placed the bulk of this authority in the hands of the Federal Reserve Board. As a result of this act, the entry of foreign banks in the US slowed down considerably in the early 1990s. In 1992, for example, no foreign bank opened a new branch, agency, or representative office anywhere in the US. This was attributed to administrative delays in processing the applications required to be submitted to the Board of Governors of the Federal Reserve System for such offices. \*

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easier to access by foreign players. Among other things, the referenced banking scandals caused the Fed to slow the application processes for foreign banks looking to do business in the US, forcing these foreign banks to come into the US in a de-banked form, or as a mere rep office, or not at all. Many of these banks opted to enter the US as operating entities, but in de-banked form. That is, they dropped lines to newly established US subsidiaries which, instead of registering under the US banking laws, became broker-dealers and investment advisers, not subject to Fed scrutiny – or the Fed’s lengthened application process. DMA picked up a lot of this registration work, and attending compliance work, especially from Latin America (most notably Brazil) and Europe.

This was a rather interesting time for US securities and money management regulation. In 1996, partly in an effort to help internationalize the US securities markets, President Clinton signed into law The National Securities Markets Improvement Act (NSMIA). That bill became law and extensively amended various provisions of the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act, and pre-empted key areas of state securities or blue sky law. This removed certain redundancies and conflicts between state and federal laws as regards broker-dealer and investment adviser registration issues, among other issues. DMA was in the thick of these changes, helping clients understand and navigate them.

The compliance consulting “industry” began to grow rapidly since about the late 1990s. After the adoption of new compliance rules 206(4)-7 under the Advisers Act and Rule 38a-1 under the Investment Company Act, just a few years ago, which required registered investment advisers to have Chief Compliance Officers, codes of ethics and comprehensive written compliance policies and procedures, and given the relatively low salaries, high level of bureaucracy, and limited career opportunities available at the SEC and self-regulatory agencies, many former regulators, who parlayed their years as regulatory insiders into new consulting boutiques, joined the accountants, lawyers and former compliance insiders getting into the consulting business. Now, in just about every part of the country, there are people holding out as compliance consultants. One survey I came across a few years ago indicated that of 40 large U.S. investment management firms interviewed by Cerulli Associates Inc., more than half outsourced at least part of the compliance function. In another survey of 450 registered investment advisers, more than a quarter of the surveyed advisers said they outsourced compliance functions the previous year. Of course, as indicated in the handout that you received, **time** and **money** are the key reasons for outsourcing this function. Given these factors, and the intention of the Obama administration to revamp securities and investment management regulation, there will likely be more opportunities for new boutiques to come on-line, as well as more fees for firms already established, including, I

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hope, DMA. Thus it is time for those of us who have been around for a while to distinguish ourselves from what may now be called "the pack."

More than unbundled administrative activities are being outsourced. Depending upon the level of risk the service provider or consultancy is willing to absorb, certain consultancies, such as DMA's, will also provide for outsourcing of the CCO role mandated under Rule 206(4)-7. Rule 206(4)-7 and Rule 38a-1 under the Investment Company Act require investment advisers and mutual funds to adopt and implement formal compliance programs, and both rules require that firms have designated CCOs.

(Incidentally, not long afterwards, the NASD/FINRA also required broker-dealers to appoint CCOs with appropriate qualifications, something I had been advocating for years.)

There is a lot we could talk about concerning the types of things that can be outsourced, but I will focus on two – the CCO outsourcing and outsourcing the legal function, just raising some questions for discussion. Let me take a few minutes to talk about the CCO role and whether outsourcing makes sense for certain firms. From the SEC's perspective, the CCO is to be someone who is "competent and knowledgeable regarding the Advisers Act, and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm" and "should have a position of sufficient seniority and authority within the organization to compel others to adhere to compliance policies and procedures." Often, and from a de jure perspective, it is sometimes hard to put these two requirements together. From a de facto perspective it is often equally hard, as someone serving in the CCO role who is also, say, the firm's president, will lack the appropriate knowledge to do the CCO job, and the person with the knowledge to do the CCO job will not have the appropriate stature or clout within the firm. Having a less senior employee do the CCO job can raise issues of both clout and knowledge, and can be seen as a sham effort to simply "check the box" in order to fulfill the regulatory requirement to have a CCO – a quite risky choice for a variety of reasons. So some advisors solve the problem by outsourcing the role of CCO as that role is defined under the Advisers Act. The firm gets the requisite compliance knowledge, can often get the clout, and gets to save a substantial compensation expense.

As reported by the law firm Goodwin Procter, at one conference that took place about the time of the adoption of the referenced rules, a staffer from the SEC's Office of Compliance Inspections and Examinations raised concerns about "outsourcing" the CCO function. In the mutual fund context, considering whether to approve a third party CCO, (the staffer said) fund boards will need to consider whether such a CCO can

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effectively implement and monitor a compliance program when or if (a) the CCO is handicapped by geography or (b) the CCO services more than one fund complex. The SEC staffer also suggested key factors that should be used to judge the effectiveness of a CCO. These include: (1) whether the CCO is administering a compliance environment that not only addresses and supports the goals of the federal securities laws, but [and note this] **also the intent of those laws**; (2) whether the compliance program is structured to and does in fact prevent, detect and correct violations; (3) whether the program supports open communication between fund service providers and those with compliance oversight; and (4) whether the program is proactive, *i.e.*, whether it seeks to identify potential risks, rather than being merely reactive. These same questions are relevant to any registered adviser, not only mutual fund advisers, but because of the public and retail nature of mutual funds, the standards are somewhat higher.

Note, however, that outsourcing the function of CCO is not at all ruled out by the SEC, even in the mutual fund context. The question remains one of when outsourcing is appropriate and whether the independent contractor can do the job as required. As mentioned in the handouts, this depends upon the facts on the ground – the size of business, its complexity, its ability to absorb costs, the independent contractor's bandwidth, and other factors.

I have served as CCO for several firms, and still do. While clients or investors make inquiries, my being primarily attached to my consulting business or serving in similar capacities for other firms has never been a significant issue during due diligence. I think there may be several reasons for this that should neither lull consultants or independent contractors like myself into a false sense of security, nor lull firms into a similar false sense of security.

First, it is unclear that investors or clients understand the importance or nature of the compliance function within an organization. The function admittedly is not the most interesting one, and it is rather far removed from investors' or clients' interests (which tend to be alternatively focused on portfolio related considerations, including risk and operations). In my experience, most hedge fund investors, for example, using DDOs to perform their own reviews of targeted hedge funds, ask only superficial questions about regulation and compliance – often limited to how the firm handles employee trading and how and when portfolios are reviewed from a compliance perspective. More sophisticated investors also ask about the allocation of trades, conflicts of interest, and trade error policies. But that's about it. Second, clients and investors may simply assume that since outsourcing the job of CCO can be done, it must be alright to do so in the **given** situation.

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Given this, in my view it is up to the adviser or fund and to the CCO to make sure that the outsourcing engagement makes sense for the firm, and should be prepared to explain themselves to the investor or client. From the point of view of the CCO independent contractor, he or she should not accept an engagement that will provide too many challenges, which challenges can include everything from geographical challenges, lack of familiarity with products and services, lack of band width, or just challenges presented by the firm's culture – which in some cases is actually hostile to compliance and ethical practices, or sees business ethics and compliance considerations as nuisances. What I am saying here, in part, is that the outsourced CCO, regardless of questions of remunerations, has to listen for the signs that it is time to go, either because the firm has outgrown him or her, or because the culture is too unwieldy.

We can come back to CCO-related issues shortly, if you like. Let me talk briefly about outsourcing legal work.

In my view, most small firms do not really need internal legal staff other than for targeted or specific types of work, and I dissuade them from hiring a lawyer as a sort of safety blanket. There are of course situations when in-house counsel at small shops can be useful. For example, a CLO shop that is reviewing lots of loan documentation may benefit from having an experienced lawyer on staff to assist with loan documentation reviews, but when of my present clients even outsources this function, having struck a deal for a flat fee on loan doc reviews. Again, for the most part, smaller firms do well with having their legal work farmed-out to competent outside counsel. In terms of cost, in my experience, bringing in a General Counsel, for example, will not necessarily result in reduced legal costs, contrary to the reasoning of firm principals. Often, legal costs increase, as the in-house lawyer allows review creep to set in, and starts to consult with outside counsel on more and more matters, rather than fewer and fewer matters. This need not happen, but it is not unusual. To be fair, sometimes the additional cost is a function of the firm's growth and not a GC's decision to go liberal with the use of outside counsel. A good GC will, of course, be ready to explain this.

As mentioned in the hand outs, there is no requirement for a registered adviser, mutual fund complex or broker-dealer to have a Chief Legal Officer, or in-house legal staff. What is required in all of these contexts, however, is a Chief Compliance Officer. I have nothing against in-house lawyers. Quite to the contrary, having the right one around adds a very beneficial – if often unappreciated – dimension of business analysis to organizational decision-making processes, largely do to the training and kinds of experience lawyers have. Good, experienced lawyers can help a firm see over the hill, so to speak, at the issues and problems with which the firm may be faced should

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certain decisions be taken. However, firms should always be able to answer three questions when it comes to hiring legal staff, in my view: (1) What will our own lawyer or legal team do that can't be done by outside counsel? (2) Does the lawyer add to better management decision-making overall? (3) Are legal costs reasonable and under control?

Not all lawyers are the same, of course. Smaller firms cannot afford to bring in lawyers with a check-the-box mentality, but should engage lawyers with probing minds, a very good knowledge of the business in general, and who have the ability to be pro-active and serve as good problem solving resources for the entire management team.

One of the drawbacks with outside counsel is the question of fees, and this is what often drives firms to think about building an internal legal team. There can be reluctance on the part of a firm's employees to bounce matters off of outside counsel for fear of generating large bills. But often, especially with start-ups, this sort of free association is precisely what is needed to avoid bad or even ruinous decisions. New firms need the insight of their outside lawyers at this critical time, since it is at this time that very bad and painful decisions can be made. Of course, proper engagement agreements can mitigate some of this worry, dictating that billing would not take place for certain types of consultation, but I have too often seen lawyers run away with a list of questions that only pertained to a potential new product or potential new service, generating thousands or tens of thousands of dollars in fees. Conversely, I have seen situations where inquiries about new products or services have been responded to with only curt replies from outside counsel, adding little value to the decision-making process, since management was unable to properly and thoroughly analyze all of the legal and regulatory variables with the simple curt replies from its outside counsel to its own conjured, and sometimes misguided, questions. Often, managers don't actually know what questions to ask, and it is up to the lawyers to get a good understanding of what is on the table and to fill in the blanks for the client.

Last on this point, which we can open up for discussion, I think that the decision as to whether to internalize the legal function should be based upon a clear set of criteria and expectations regarding the function the lawyer is to play and the value the lawyer must bring to the role. If a firm can afford an internal General Counsel, if there is sufficient general legal work to address, if having that General Counsel will control legal costs in the long run, and if the General Counsel helps to contribute to management decision making in general, then it is probably prudent to hire rather than to turn always to outside counsel. In fact, I recently recommended to a prominent valuation and pricing firm that it hire a General Counsel, in the face of its management's reluctance to do so. The firm recently hired a GC, partly based upon my input, or so I am told.

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Having said that, nothing I am saying should be construed to suggest that having inside counsel means that a firm should cut its relationships with outside law firms. Outside counsel will always be useful for complicated transactional matters, tax matters, and other matters outside of the general expertise of the inside lawyer or lawyers. So I suppose that, given that this is a breakfast discussion about outsourcing, the answer to the question “When should I outsource my legal work?” can be answered as follows: **Always**. The question is not whether legal work should be outsourced, but when and how a firm should start to bring the legal function in-house. Obviously, for large firms with many employees and a large mix of products and services, an in-house legal department is almost always required. It is the smaller firm that has the conundrum, and it is the small firm about which I am speaking, primarily.

A more convoluted answer seems to be required when it comes to the question of outsourcing compliance, especially since “compliance” can mean a lot of different things. That is, the answer to the question “When should I outsource my compliance work, including the CCO role?” has to be answered, “**It depends.**” It depends on the particular compliance function under consideration. Certain compliance functions can also be outsourced to law firms. For example blue sky services and certain federal registration services can be sent over to outside counsel. Alternatively, such functions can be outsourced to compliance consultancies with no legal staff whatsoever. The decision is one that is more like art than science.

My colleague Jeff Rathgeber will soon take over and talk about outsourcing due diligence and certain operations functions. But before he does, I just wanted to make a few targeted remarks, and we can perhaps talk about them during Q and A, if time permits:

- Firms might do well to view or frame compliance as a component of enterprise risk. Seeing things this way does not mean that one should take a cynical view, but if compliance is looked upon as an attempt to ward off certain risks which can threaten the enterprise, such a perspective can be useful in also warding off apathy about the compliance function. The risk that your firm is trying to mitigate is, quite simply, *regulatory risk*. Conceptualizing or framing compliance management as a risk management function can be quite useful and can change how compliance management is viewed and handled within the firm.
- There are both optical and substantive dimensions to compliance. It is not a good idea to see the latter as the place where “serious” compliance takes place, and the former as but a cynical attempt at window dressing. The optics of

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compliance (generating attractive and useful reports rather than ones that look as if no thought went into them, including compliance-related information in internal newsletters, and generating user-friendly compliance related internal communications) can demonstrate an interest in compliance within the firm. That is one of the reasons that DMA has created its CompliPort reporting mechanism, which allows managers to generate substantive, date-stamped, and attractive reports on a wide variety of compliance matters. We can help with the optics and well as the substance of compliance, which helps to demonstrate an interest in compliance at client firms.

- DMA recommends the broker-dealer approach to compliance. We help our clients establish decentralized compliance policies and procedures, along the lines of those required by broker-dealers. This entails training specific managers concerning the specific obligations of their areas of firm supervision.
- DMA believes that business ethics should be rolled-in to the firm's compliance program, instructing clients' staffs as to the underlying principles that drive regulation – just as the SEC staffer, quoted a earlier, suggested. This oblique rather than direct approach informs the entire compliance program with a normative dimension that is often lacking in check-the-box approaches to compliance management. There is a substantial overlap of compliance, business ethics, and public policy. If this understanding can be infused into the culture of the firm, employees themselves become more proactive, rather than merely reactive as regards compliance.
- DMA, drawing on its many years as a consultancy to mutual funds, registered advisers, broker-dealers and hedge funds, is expanding into overall enterprise risk consulting, which includes assisting small firms with governance and policy from a vantage point above the basic compliance, HR and operating policies of the firm – including reviews of lines of authority, insurance coverage, compliance with the firm's own governing documents, the facilitation of proper internal communication, on-going monthly reviews of the firm's entire operation one segment at a time, and constant reviews of all internal policies and procedures that create points of impact from an enterprise risk point of view. This sounds arcane, but it is really the performance of constant reviews of the firm's practices, asking lots of questions about operations, procedures, products, and people, removing the assumptions and gaining clarity and certainty. We insist that risk management is not merely quantitative but is also qualitative, as should be painfully obvious given recent market events. I mentioned before that firms

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like DMA must begin to distinguish themselves from “the pack.” This is how we intend to do it.

Over the next several years, we will see increasing, targeted regulation that will require smarter risk management, compliance and corporate ethics programs. We hope to offer all the services we have always offered, but want to take a more holistic approach in our consulting, so that we can be the extra set of experienced eyes, ears and hands that our clients will need. Someone has to rise to take a 5000 foot view of the business, and that’s precisely the perspective we would like to take of our clients’ businesses on their behalf. For we see portfolio risk, operational risk, regulatory risk, reputation risk and other risks as overlapping concerns, **not as silos**. Since our experience with regulation and our many years of helping new firms establish themselves has required us to see organizations broadly, it is only natural for us to expand into governance and enterprise risk consulting. It is for this reasons that I asked Jeff Rathgeber, Marc Groz (a mathematician with both a qualitative and quantitative approach to risk) and others to join DMA. So on that note, I hand off to my colleague, Jeff Rathgeber.