

The Combined Role of General Counsel and the Chief Compliance Officer – Opportunities and Challenges

By Edward T. Dartley

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, it not only presented the investment management industry with a set of new regulatory challenges far beyond anything previously seen by the industry, but also invited several thousand private equity fund and hedge fund managers into the world of SEC-adviser registration. For investment managers, the resulting business challenges of the last few years have been multi-faceted: increased regulatory oversight, increased regulatory requirements, increased investor demands for compliance excellence, and a shrinking pool of potential investor dollars.

For newly-registered managers, SEC registration meant, among many other things, the requirement that the firm appoint a chief compliance officer. For both managers that were registered prior to the passage of Dodd-Frank and those that were not, striking the balance between meeting demanding new regulatory requirements and running an efficient business has meant examining the pros and cons of combining the role of CCO with that of another position within the firm—sometimes the CFO, sometimes the COO, but most often the CCO role is combined with that of the general counsel.

There is no shortage of media coverage of the practical issues surrounding the effective implementation, monitoring, enforcement and improvement of the compliance programs of financial institutions. Here we take a look at the challenges and opportunities (yes, opportunities) of running an investment management firm with a dual-roled general counsel and CCO.

While investment advisory firms registered with the SEC are required to have a compliance program that is reasonably designed to prevent violations of the federal securities laws, the nature, scope, and specifics of the program are highly dependent on the nature of the advisory services offered, the size of the firm, and the character of the firm and the people who run it. There simply is no one-size-fits-all compliance program, even as among investment advisers that might be of similar size and that offer similar services.

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In many instances, economics alone will drive the choice of whether to combine the CCO and general counsel roles. Many, if not a majority of, investment managers are of a size where having a separate general counsel and chief compliance officer—or even having a general counsel at all—is simply not financially viable option. In cases where the economics do not drive the decision, there are a number of factors to consider in making the determination as to whether to split or combine the functions of GC and CCO.

Take for instance a hedge fund manager with an events-driven strategy and with \$300 million under management, versus a private equity fund manager with the same amount of assets under management and that invests across numerous sectors. The day-to-day legal and compliance issues faced by the firm will be different in many respects. For the hedge fund manager, active trading will give rise to periodic compliance issues that will arise more frequently than legal questions. The manager’s need for a separate GC and CCO is less acute, and having one individual serve in both roles brings with it the advantage of having both legal and compliance perspectives on any one issue (as well as potential protection of the attorney-client privilege, as discussed below). Alternatively, the manager may well make the decision that an experienced CCO is more valuable—and from a compensation perspective, more affordable—than hiring someone with a law degree and with legal practice experience to fill the role.

The private equity manager, on the other hand, will have less day-to-day trading-related issues, but will face a wider range

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of legal issues, such as interpretational questions concerning the private equity fund’s limited partnership agreement and other governing documents, legal due diligence that must be conducted on potential new private equity investments, and specific legal questions which may arise at the portfolio company level. These and other issues are legal in nature and may well lead the manager to conclude that having separate individuals fill the roles of general counsel and CCO is the best course of action, or alternatively, that the one person to fill both roles should be an attorney.

Whether to combine the roles of general counsel and chief compliance officer will depend upon many factors. While

some of these factors are firm-specific, other factors flow out of the nature of the roles of legal and compliance, and the ways in which they overlap, as well as the ways in which they do not.

Advantages to the Combined Role of General Counsel and Chief Compliance Officer

There are distinct advantages to consolidating the roles of general counsel and chief compliance officer. As mentioned above, for firms that find that in-house counsel is a necessity rather than a luxury, combining the positions of general counsel and CCO provides an obvious economy of scale. One person serving in the dual role of general counsel and CCO means a single compensation package, and if the investment manager is willing to pay market rates for in-house legal talent, then making that person the CCO as well will reduce the firm’s operating expenses and keep the headcount low (provided of course that the positions allow sufficient bandwidth for both to be done well).

Another advantage to combining the two roles is the ability to bring legal judgment to specific compliance challenges. Experienced compliance professionals are well-equipped to handle a wide range of compliance issues and problems that are presented by the increasingly complex regulatory landscape. At the same time, however, legal training involves distinct skillsets that often are required for non-routine compliance matters. On the one hand, amending the investment firm’s Part 1 ADV to update the firm’s regulatory assets under management typically would not require legal training. On the other hand, determining whether an affiliate of an investment firm can file as a “relying adviser” under the Securities Exchange Commission’s (“SEC”) January 18, 2012 No-Action Letter, and thereby avoid the additional expense and resources of filing its own Part 1 and 2 ADVs, may well require a legal interpretation of the SEC’s No-Action letter and an evaluation of the specific circumstances to determine whether the firm can take that position.

Another advantage to combining the functions of legal and compliance arises out of the status of the general counsel within the corporate structure of the investment manager. An in-house counsel at an investment firm wears multiple hats within the general counsel position itself. He or she

is a legal advisor, and at times a business advisor as well, as there are many instances where legal advice bleeds into or is inextricably intertwined with business considerations. The in-house attorney is also at times a negotiator—again, often-times on a business level, where for instance the negotiation of contractual provisions involves the negotiation of business terms. And in-house counsel is of course also an advocate for the firm, interpreting the law and the regulations in a manner that will achieve the dual goals of adherence to the law and achievement of business objectives.

Each of these job functions, separately and combined, can serve to place the general counsel at a senior level in the corporate structure of an investment firm. In those firms where the general counsel occupies such a position, combining the general counsel role with the chief compliance officer position can serve to elevate the compliance function to a more senior level than it might otherwise occupy. Senior management at investment management firms vary widely in their perspectives on the role of compliance and the CCO within the firm. Many firms view the compliance function as an essential component of the operations of the firm. At other firms, compliance is acknowledged as a necessary component of doing business as an SEC-registered investment manager that is accepted, but not necessarily embraced at the most senior level.

Regardless of perspective, combining the legal and compliance function into a single GC/CCO role promotes access to senior management and a consistent role in the business and strategy decisions that guide the firm. Having the chief compliance officer in a senior position augments his or her authority both in the senior corporate hierarchy and within the firm at large, thereby helping to ensure that the CCO has sufficient stature at the investment manager in order to effectively perform the compliance function. Put another way, perceived senior status can enhance respect for the position of compliance within the firm, which in turn enhances the requisite level of corporate power to do the job effectively and with the greatest benefit for the firm.

Another advantage to having the GC/CCO functions combined into a single senior position is the ability to “issue-spot” potential compliance landmines before they detonate. If the GC/CCO is involved in, or at least informed of, matters such as strategic business decisions, discussions of potential new lines of business, significant investor relations issues, and the like, he or she can bring the compliance perspective and

depth of experience into the conversation at the earliest possible juncture. As a result, the investment management firm obtains more complete advice at an earlier stage, and reduces the risk that business decisions will need to be revisited or modified in order to deal with regulatory considerations that weren't apparent to the business decision makers.

All of this suggests another benefit to combining the roles of GC and CCO—namely, the ability to make the business of compliance and the business of the business run efficiently together. Over the last decade, regulation has proliferated in an unprecedented pace. Many of the regulations under the Investment Advisers Act and other regulatory initiatives applicable to the asset management industry are not black-and-white rules, but rather are “principles-based” rules which often leave open to the investment manager multiple avenues for achieving regulatory compliance. For instance, while Rule 206(4)-7 requires SEC-registered investment advisers to have a compliance program that is “reasonably designed to prevent violations of” the Act, the rule does not provide specific requirements, and the adopting release offers only general guidance that “at a minimum” should be included as part of a registered investment adviser's compliance program. Accordingly, the selection of policies and procedures that a firm must have, and the selection of policies and procedures that are advisable for a firm to have but are not required, are subject to judgment calls. These judgments must be informed by a combination of business, legal, market, and regulatory considerations, as well as what might or might not be standard practices, or “best practices”.

While decisions on specific compliance matters may be guided and informed by SEC no-action letters, enforcement settlement orders, and the like, as well as industry practice, in many instances there is no one pathway to effective and compliant solutions to any specific regulatory question. Again, put simply, compliance is not one-size-fits-all, nor should it be. Ideally, the goal of both the in-house attorney and the CCO should be to find the optimal solution among several potential options that will harmonize the dual goals of effective investment management and compliance with applicable regulation. Achievement of those multiple goals is facilitated where the GC/CCO has access to and involvement with the business processes of the firm, and works as a partner with the other senior managers of the firm.

Another potential benefit of having a dual GC/CCO is wider protection afforded by the attorney-client privilege and

the work-product doctrine. If properly structured, an in-house counsel's communications and advice are typically afforded protection under the attorney-client privilege similar (though not identical) to that afforded to outside counsel. When it comes to the subject of compliance, specific problems or questions can fall into one of three categories: non-legal issues, legal issues, and mixed questions where there are legal and non-legal components (which may or may not be distinct or capable of compartmentalization).

For those compliance issues that implicate one or more legal questions, having a dual GC/CCO facilitates the protection of communications and work product at the earliest stages of consideration, thereby promoting a candid and open internal dialogue. For those compliance matters where the question is mixed, or unclear, having a chief compliance officer who is also an attorney enhances the ability of the adviser to invoke the attorney-client privilege in appropriate circumstances. Compliance issues often have a legal component to them, especially if the compliance question is a potential regulatory problem for the firm that requires an analysis and interpretation of applicable regulatory authority. As an example, an institutional investor in a hedge fund may request confirmation that the investment manager has complied with the firm's political contributions policy. If the matter is handled by a CCO who is also the hedge fund manager's general counsel, then the firm has the ability to claim that communications made in the course of the investigation required to respond to the investor's request are protected by the attorney-client privilege (at the same time, however, caution should be exercised in this area, as the SEC and other governmental agencies have been taking increasingly aggressive positions on privilege in recent years).

Combining the role of general counsel and chief compliance officer also addresses a practical reality that investment managers face more and more frequently as regulation becomes more complex and regulators become more demanding: the blending of compliance and legal questions. There are a host of issues that do not fit neatly into the categories of purely compliance or purely legal. For instance, who should be involved when there is a question regarding the allocation of an investment opportunity among several of the investment manager's clients—is it a CCO question, is it an in-house counsel question, or is it both? The same question can be asked on matters such as valuation questions, allocation of expenses between the investment manager and the funds that

it manages, and a myriad of other questions. If the general counsel and CCO roles are filled by one individual, the investment manager can consolidate the decision-making process and avoid overlap in job responsibilities, thereby enhancing management efficiencies and achieving economies of scale.

Potential Challenges in Combining the Role of General Counsel and Chief Compliance Officer

As many benefits as there may be to consolidating the roles of general counsel and chief compliance officer, there are as many challenges. One of the core challenges has as its root the divergent role of the attorney versus that of the chief compliance officer in an asset management firm. The asset manager stands as the client of the in-house attorney. In that role, the in-house counsel, like any attorney, functions as an advocate for his or her client. The in-house counsel provides guidance to the manager on regulatory and compliance matters, but as an advocate. The role of the investment manager's general counsel is to provide advice to the manager that will strike the balance between compliance with the regulatory framework in which the manager operates, and at the same time allowing the manager to make money for its clients and run a profitable business. In those cases where the rules are not black-and-white, reasonable interpretations can allow a manager to take one of several courses of action, each of which has different levels of legal and regulatory risk. The in-house attorney's role is to balance the business objectives against what is legally permissible, advise the manager on the optimal path to take, and then be prepared to defend that decision and to offer judgment and advice where the question is a close one. In these circumstances, in-house counsel works with senior management to assess and decide on the course of action that presents an acceptable level of risk.

The role of the chief compliance officer overlaps in some respects but diverges in a very important one. Like in-house counsel, the CCO's job responsibilities include providing the firm with guidance on following the regulations that govern the investment manager's activities. In this role, the CCO is responsible for building and maintaining the firm's compliance program, and implementing changes and improvements to the program as regulatory developments warrant. The CCO is also responsible for administering the compliance program. When specific compliance questions

arise, the CCO, like the in-house counsel, is responsible for providing guidance to the firm on choosing the appropriate course of action that balances oftentimes-dueling compliance and business considerations. In many cases, however, this guidance and interpretation also translates into decisions concerning enforcement of the firm's procedures with respect to the investment management firm and its personnel.

This is where the roles of general counsel and CCO can diverge. Whereas both roles seek to interpret and guide the firm, finding the right balance between regulatory compli-

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ance and business needs that will minimize both corporate and regulatory risk, the general counsel's role is to protect the investment manager and advance its interests within the boundaries of the law. The chief compliance officer's role, however, is not that of an advocate. The CCO's responsibilities include administration of a compliance program that will detect and prevent compliance violations. Where there are shades of grey or questions as to whether a particular practice creates regulatory risk, or constitutes a compliance violation, the CCO's role is not to function as an advocate for the firm. Rather, the CCO's role is to offer—and where necessary, insist on—solutions that will allow the investment manager to address the problem and to deter future conduct that could give rise to regulatory violations.

By its nature, the position of the chief compliance officer's responsibilities when faced with a regulatory issue can implicate competing interests of protecting the firm and administering an effective compliance program. Take, for instance, a situation where a hedge fund is trading in the securities of a company while in possession of non-public information about the viability of one of the company's suppliers and it is unclear whether the information is "material." In that scenario, the in-house lawyer's role is to examine the issue and determine from a legal perspective whether the information is non-material such that the firm can continue to trade. In making that determination, the general counsel will weigh arguments for why the information is or is not material, and advise the manager on the relative risks of a potential future regulatory challenge to that decision. The general counsel becomes part of the senior management decision-making process.

The chief compliance officer, however, plays a different role that can lead to a different approach and conclusion. While the CCO ostensibly would perform a similar analysis, there is an additional dimension to the CCO's function—ensuring the administration of the firm's compliance program and acting as a form of "gatekeeper" when it comes to determining whether there has been a compliance violation. This function requires a degree of objectivity and independence on the part of the individual who serves as chief compliance officer that is fundamentally inconsistent with the role of advocate

that an attorney plays. Accordingly, in the example above where the firm needs to make a determination as to whether it is in possession of material non-public information, the role of the CCO is not

to advocate for positions as to why the information is non-material, but to assess the facts from a compliance perspective and make a determination as to whether the insider trading policies and procedures of the firm are implicated, and if so, what course of action may be warranted.

Thought of another way, the chief compliance officer seeks to understand and assess how the firm's compliance program performs in terms of detecting and prevent violations of the federal securities laws. In essence, the compliance officer frequently asks "how are we doing?" from this perspective. The general counsel seeks to advance the interests of the firm as far as possible, consistent with applicable federal securities law, given the factual context in which the firm finds itself, regardless of the answer to the compliance officer's question.

So what does this mean for those individuals who take on the dual roles of general counsel and chief compliance officer? It means that there will be instances in which there is an unavoidable conflict between the responsibilities of a combined GC/CCO to the firm. In the inside trading example, for instance, what are the responsibilities of the GC/CCO? Is it to provide legal advice to senior management with respect to the arguments available to the firm that will allow it to conclude that the information does not constitute material non-public information, and therefore allow the firm to trade? Or is it to make a compliance determination as to whether the firm can under its insider trading policy trade while in possession of this information?

Furthermore, what happens if senior management is willing to take an aggressive position on whether the information constitutes material non-public information, and is willing to

take on a higher regulatory risk in order to achieve the firm's investment management goals? In-house counsel's role in this circumstance is to advise senior management as to the degree of risk and the arguments that may be advanced if the matter is eventually questioned in the firm's next regulatory exam. The CCO's role, on the other hand, is to make a determination as to whether an aggressive position may be taken consistent with the firm's compliance program and the regulatory rules, and also whether the firm *should* take on this additional regulatory risk. One can see in this example the conflict that this dual role can produce.

As many benefits as there may be to consolidating the roles of general counsel and chief compliance officer, there are as many challenges.

Recent commentary from the SEC on the Commission's expectations for chief compliance officers exacerbates the potential conflicts that can arise for individuals who serve as both in-house counsel and chief compliance officer. The SEC has made it clear that it expects chief compliance officers, and attorneys as well, to play a gatekeeping function. For instance, in a recent speech, Commissioner Kara Stein pointedly remarked that the SEC's "focus on gatekeepers will empower securities professionals, compliance officers, accountants, and lawyers to actively look for red flags, ask the tough questions, and demand answers."¹ As to chief compliance officers, the SEC's expectation is that the CCOs will play a watchdog role, seeking out potential violations and making tough inquiries of management. Attempting to fulfill that role when the CCO is also in-house counsel to the firm creates an inescapable tension with the GC/CCO's dual function of acting as an advocate for the asset manager as well.

Notwithstanding the potential for conflicts, there are thousands of SEC-registered investment advisers that have a dual-hatted GC/CCO. Given the potential benefits for combining these roles, there is no reason to believe that will be a near-term trend away from this combined function. However, with the ever-increasing complexity of regulation, combined with an increasingly vocal and proactive SEC demanding that CCOs act as watchdogs for their firms, there is a strong incentive for proactively finding solutions that will ameliorate or eliminate potential conflicts when they arise.

A compliance committee is one such solution. The formation of a compliance committee, consisting of the GC/CCO and other members of senior management, such as the CEO and the CFO, can be an effective mechanism for addressing situations where the firm is presented with "close call" compliance questions that require substantial advice from both the legal and compliance perspectives. In such circumstances, the GC/CCO, wearing the in-house counsel hat, can advise senior management on the range of options available to the firm, the arguments available to support different courses of action, and the relative degree of risk associated with such courses of action. The matter is then assessed from a compliance perspective by the firm's compliance committee. The GC/CCO, in the role of CCO, advises the compliance committee and seeks the input of other members, and senior management as participants on the committee reach a consensus regarding the appropriate course of action. By diffusing responsibility for the compliance analysis in this manner, the potential conflict that the GC/CCO would otherwise face in specific situations is alleviated.

Another mechanism for reducing or eliminating potential conflicts is the use of outside advisors. In circumstances where the in-house counsel who also serves as CCO is faced with a situation where the particular issue requires both advocacy and compliance analysis, turning to outside counsel for an assessment of the legal options available to the firm can free up the GC/CCO to then weigh in more comfortably on the compliance component of the question. Alternatively, the GC/CCO may choose to evaluate the legal questions implicated by the issue, and turn to a compliance consultant for advice on the compliance determination (although this approach will be less effective if the consultant lacks sufficient knowledge about the adviser's specific compliance policies and practices). In either case, the involvement of a third-party advisor can create a layer of protection for the firm that can assist in reducing the potential for conflict with in the role of the GC and CCO.

Challenges in the Protection of the Attorney-Client Privilege

Another area of challenge for the firm that has a dual-hatted GC/CCO is the protection of the attorney-client privilege.

When in-house counsel also serves as the firm's chief compliance officer, he or she must routinely ask which role is being played when it comes to analyzing compliance issues and communicating with others about them. Sometimes it can be relatively straightforward to parse out when the GC/CCO is advising as in-house counsel and advocate, as opposed to chief compliance officer. Often, however, it is not so easy, and there are many grey areas.

The combined role requires particular vigilance when it comes to email communications. Care needs to be taken by the in-house lawyer who initiates emails on compliance issues. In each case, he or she must read and re-read the email and ask the question: am I providing legal advice, or am I functioning in the role of the chief compliance officer, reporting on a compliance matter and providing a recommendation as to how the firm should proceed to address it. Where the advice is legal in nature, there should be an appropriate designation that the information is privileged and confidential. At the same time, if the communication is clearly not legal advice, and accordingly not privileged, then the in-house counsel should avoid a privileged designation. Blanketing every communication as privileged runs the risk that such determinations will be challenged by, for instance, examiners in an SEC regulatory exam. Wholesale privilege designations could also lead to the question as to whether the GC/CCO was devoting a sufficient amount of time to the compliance function.

Other members of the firm must also be sensitized to the fact that the firm's GC/CCO has two distinct functions. In this electronic age, emails and texts are the norm for communicating within the four walls of investment management firms, even when colleagues are a few doors away from each

other. There is a strong and completely understandable propensity for portfolio managers, research analysts, and other investment professionals to fire compliance questions or concerns in an email to the GC/CCO. Where an investment manager has a dual-hatted GC/CCO—and even in firms where these roles are performed by separate individuals—it is important for the manager and the GC/CCO to educate and advise personnel as to when in-person or telephone communication of issues is preferable to emails or other forms of electronic communication.

Conclusion

The last five years have seen a perfect storm in the investment management industry—an explosion in financial services regulation and the SEC-registration of thousands of investment managers that have never had to deal with SEC regulations. At the same time, these managers have experienced downward pressure on fee structures from an increasingly sophisticated and demanding investor base. For those asset managers that are sufficiently large and/or complex in their business operations to warrant the need of in-house counsel, there is a strong financial incentive to combine that role with that of the chief compliance officer. Firms which choose that course—and there are many that do—can reap substantial benefits as long as both the firm and the GC/CCO are cognizant of and meet the potential challenges presented by that combination.

ENDNOTE

- ¹ February 21, 2014 Speech, found at http://www.sec.gov/News/Speech/Detail/Speech/1370540830487#.U0igg_PD_LY

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