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TERRANCE J. O'MALLEY
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The Fall of Legal and Compliance
In the Private Fund Space

By Terrance J. O'Malley
Principal, TJO Management LLC

Terrance O'Malley is available to consult on regulatory and compliance matters.
He can be contacted at terrance@tjomanagement or (646) 470-6461.

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The Fall of Legal and Compliance in the Private Fund Space

A decade ago, legal and compliance issues stood at the top of the priority list on the operational-side of most private fund firms. Wide-ranging interviews with leading industry participants, surveys of Chief Operating Officers and other anecdotal evidence, however, suggests that may not be the case today. And it seems the U.S. Securities and Exchange Commission – with its recent risk alert and added expertise – might be taking notice.

This paper looks at the state of the legal and compliance function. It begins with a review of some key moments over the past two decades that impacted the role of legal and compliance, then discusses potential reasons for the role's declining priority. Next, the paper considers how the SEC might be refocusing its efforts to oversee the private fund industry. The paper concludes with some observations on what the future could hold and a set of questions that can be used to assess the importance of the legal and compliance function at any private fund firm.

The Rise Before the Fall

Up until the mid-2000s, private fund firms enjoyed an exemption from SEC registration as investment advisers. As long as a firm managed 14 or fewer funds and didn't publicly advertise, the firm was off the SEC's radar. Some firms nevertheless implemented robust legal and compliance programs. Others did not.

Private funds, as entities, also enjoyed a registration exemption as long as a fund maintained a 100-investor limit. Moreover, Congress had recently expanded the exemption in 1997 by adding Section 3(c)(7) to the Investment Company Act that allowed private funds to have an unlimited number of "qualified purchaser" investors. That change (and an average annual return for the S&P index of just over 28% from 1995 to 1999) led to huge success, tremendous wealth creation, and of course regulatory scrutiny.

The additional scrutiny resulted in a 2003 milestone report issued by the SEC staff, "Implications of the Growth of Hedge Funds." The report laid the groundwork for the SEC to soon change its rules and require the registration of private fund firms.

At the same time, the SEC was busy on other fronts. These initiatives included:

- Adopting the "Compliance Rule" mandating that registered firms have a chief compliance officer and a compliance manual;
- Proposing another rule to require that registered firms have a written code of ethics; and

- Ramping up its compliance reviews with a new emphasis on emails, particularly in the wake of the mutual fund market-timing scandal.

The SEC's next step was to pull the registration trigger for private fund managers in 2004. In effect, the SEC changed its rules so that private funds were no longer counted as a single client. Instead, firms had to look-through all of their funds and register if they had 15 or more investors on an aggregate basis. The net result: firms had to register, hire or designate a CCO, draft a compliance manual, and get ready for an SEC compliance inspection. In short, the SEC move accelerated a trend in the private fund industry to staff up on legal and compliance talent and also to dedicate resources for legal and compliance programs.

The SEC's rule change was later challenged in court and thrown out in 2006. But by that point, a large percentage of the hedge fund industry had already registered and decided to remain so.

As an aside, the hedge fund industry generally supported the registration requirement, while the private equity industry opposed and successfully fought it. The result was a registration rule that omitted the "look-through" for funds with at least a two-year lock up. That meant private equity stayed out of registration, as did those hedge fund firms who could command a two-year lock-up from investors.

By the mid-2000s, the private fund industry was rocking. But as the decade came to a close, the industry experienced a number of hugely impactful events. The 2008-2009 financial crisis – including the collapse of Lehman Brothers – crashed down on the industry and saw regulators implement a series of emergency legal requirements, like short selling bans and enhanced reporting. The Madoff scandal led to expanded requirements for custody of client assets and generally greater industry scrutiny. Then came the implementation of the Dodd-Frank Act. Collectively, these events justified making legal and compliance the top operational priority for private fund firms.

Dodd-Frank settled the debate about registration. Every private fund firm (or at least over a certain minimum AUM size) had to register with the SEC by early 2012, and this time, it included private equity firms. Dodd-Frank also enhanced the SEC's inspection authority – another concern for existing and newly-registered firms. Finally, the SEC adopted Form PF, which also went live in 2012.

This tempest of regulatory activity – and it wasn't limited to just the SEC – might be seen as the modern high-water mark for legal and compliance in the private fund space.

Causes for the Fall

The private fund industry didn't collectively wake up one morning and say "Hey, legal and compliance isn't as important anymore." Rather, there were a number of factors that went into the declining priority over the past decade. The most significant factors are described below.

1. The industry figured it out. The rationale most favorable to the industry is that firms simply figured it out, and that the resources needed to maintain a legal and compliance program aren't as significant as those needed to create one. That's not a bad argument. It is easier to periodically review and tweak a compliance manual than to draft one in the first place. Extrapolate from there.

2. Nothing to see here. The industry hasn't had any major public blowups in about 10 years. At worst there have been a few enforcement cases (primarily involving - ironically - private equity managers who didn't know what their fee disclosures said). So after 10 years, people can get complacent or sometimes forget things - like the SEC is real and that even word of an enforcement investigation can be bad.

3. Apprehension over SEC examinations subsided. Substantially. There's nothing like the threat of a full on, inside out, upside down regulatory exam to keep everyone in line. But on an industry-wide basis, it never happened. There weren't knocks on every firm's door by teams of 6'4" square-jawed regulators with advanced degrees in data analytics and mental telepathy. Instead when examiners did show up, they were regular, smart professionals trying to do a conscientious job – sometimes finding things and sometimes not.

4. Compliance fatigue. People got tired of hearing about legal and compliance. The business team didn't want legal and compliance telling them what to do, nor the cost center. Colleagues on the operational side maybe grew a bit uncomfortable with the enhanced status of legal and compliance. Even legal and compliance teams got a bit weary of the routine. And regulators – after the intense period of implementing Dodd-Frank mandates – started looking beyond the private fund business. It was no longer the shiny new penny.

5. Competing issues. Other operational issues arose to compete with legal and compliance. There is of course cybersecurity (though it has a legal and compliance component). And worthy social causes like ESG. There are also financial considerations that have grown more acute in a low-return, fee-compression era. Firms also have grappled with implementing new technology, and whether, when and where to outsource.

6. Investor expectations. Finally, a decade ago, investors seemed far less tolerant of any reputational risk coming from the operational side of the managers they invested with. But for some of the same reasons described above, reputational risk from the legal and compliance side has dropped down the investor priority list, particularly when the returns are there. As a result, having a best-in-class legal and compliance program (not to mention the entire operational side of the business) is no longer viewed by many investors as a substantial differentiator.

The Way Forward

The march of progress can change some things forever. But in the financial services field, some things are just cyclical.

In that context, the SEC staff put out a "risk alert" in June 2020 targeting the private fund industry. The alert identifies a number of deficiencies cropping up at private fund firms. Meanwhile, the SEC is also adding senior personnel with exceptional knowledge of the business. Many have been asking what this all means. The answer is: look at the big picture.

The deficiencies enumerated in the recent alert aren't new. They have all been highlighted before, if not in the private fund context, then certainly in context of mutual funds and separate accounts. And, they're mostly common sense to any firm that makes thoughtful decisions based on putting investors first – some call that fiduciary duty. Meanwhile, the SEC adding senior personnel with private fund expertise should be viewed as a related event, not a coincidence. So one of the big picture messages is: "No backsliding on legal and compliance."

Repeating the Message

If the SEC is redirecting some of its focus back on the private fund space, consider that it might not be immediately apparent. The SEC can take some obvious steps, like enforcement actions and rule adoptions. And the staff can issue more risk alerts and interpretive letters, make speeches, or initiate compliance examination sweeps.

The SEC also can engage in less formal and more subtle outreach initiatives throughout the industry. Who might the SEC staff meet? First, there are legal and compliance professionals. That's important, but it's also preaching to the choir. So the impact is limited. On the other end of the scale, there are the Founders/PMs. As a group, however, they aren't always easy to reach. In between, there are the investors/allocators (the ones who write the checks, often with the oversight of a board). And there are other important intermediaries such as consultants, including investment and operational due diligence teams.

So the SEC staff could take a number of routes to get the message out, including some that are not so obvious.

Final Thoughts – Through the Eyes of Legal and Compliance

Technical compliance with applicable laws is necessary, but so is meeting their spirit and putting investors' interests first. Otherwise, small problems stack up and become big ones.

Assessing a firm's list of priorities can prove difficult, particularly in a short amount of time. Looking at a firm through the eyes of the legal and compliance function, however, can offer

some valuable clues. Here's a list of questions that can help identify the status of the legal and compliance role. None are fatal; few firms have all the best answers.

- Does the firm have an individual whose sole role is legal/compliance? If not, how does that compare with peer firms?
- If the CCO is dual hatted, what other role(s) does the CCO perform? Does the dual-hatted CCO have meaningful compliance experience? What efforts does the dual-hatted CCO take to stay informed about regulatory developments? Does the individual list their CCO title first or last?
- Who does the general counsel and/or CCO report to (i.e., who hires/fires and determines annual compensation)? The Founder/PM or some intermediary? If to an intermediary, what is the Founder/PM's rationale? And if to an intermediary, does the firm claim some sort of "dotted line" reporting?
- How much does the GC and/or CCO get compensated, and how does that compare to peer firms, as well as to other senior personnel within the firm?
- Where does the GC and/or CCO sit, literally? Next to the Founder/PM, down the hall, on another floor, or in another building?
- How often does the Founder/PM meet with the GC and/or CCO, and do they meet one-on-one?
- Does the GC and/or CCO participate on all significant firm committees?
- Does the GC and/or CCO make the decision on hiring outside counsel and/or compliance consultants? Or is that authority retained by someone else?
- In the event of turnover at the GC and/or CCO level, how "promptly" has the firm informed the SEC by amending its Form ADV, and did the firm inform its investors, also promptly?

About the Author

Terrance J. O'Malley is a leading practitioner and authority on the operational side of the investment management industry. Over a 25-year career, he has focused on legal and compliance, organizational structures, senior executive functions, and corporate communications.

He currently leads his own consulting firm, TJO Management LLC. Most recently he served as a chief administrative officer, general counsel and chief compliance officer at Blue Ridge Capital, a hedge fund firm that managed $9 billion at its peak. His additional experience includes positions as Partner at the law firms of Schulte Roth & Zabel and Fried Frank, as an enforcement attorney for the U.S. Securities and Exchange Commission, as a capital markets adviser to foreign governments in Russia, Ukraine and India, and as a consultant at PricewaterhouseCoopers.

Terrance also "wrote the book," twice. He is co-author to two influential industry books: *The Insider's Guide to Hedge Funds: Successfully Managing the Middle and Back Office* (Wolters Kluwer, 2018) and the *Investment Adviser's Legal and Compliance Guide* (Wolters Kluwer, 2004 – 2019).

Terrance hosts Operational Leaders, a podcast that discusses operational issues for executives tasked with "the business of running an investment management business." The podcast features conversations with some of the biggest names in the investment management industry. In addition, he is a frequent speaker at industry conferences and has published dozens of articles for top publications on industry trends and best practices.

For additional information about Terrance and TJO Management LLC, please visit **the firm's website**.