

COMPLIANCE IS HERE TO STAY. HIRE, OUTSOURCE OR DELAY?

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How do we implement a compliance program?

Should we hire somebody? How?

Should we utilize an outside firm? Who?

How much should we spend?

Every firm registered under the Advisers Act has been wrestling with these questions since the SEC adopted the compliance rules back in 2005, and Dodd-Frank made them applicable to private fund sponsors last year. The Advisers Act's compliance rule (206(4)-7) doesn't say much. Through releases, enforcement actions, speeches, and industry best practice pronouncements, we have learned that an adequate compliance program includes a few key elements:

- Senior management must demonstrate a significant compliance culture and tone;
- The compliance function must have adequate resources;
- The policies and procedures must be customized and implemented;
- Ongoing training of staff is required;
- The annual review requires periodic testing and in-depth analysis;
- The CCO must be competent and knowledgeable about the Advisers Act; and
- Maintaining adequate books and records is critical.

Not surprisingly, ensuring an adequate compliance program costs money. Based on our many years of experience in the industry including conversations with the regulators and trade groups, a firm must spend a minimum of 5% of its revenues (or 2 basis points of assets under management) on compliance. Firms with a passable compliance program view the compliance function like any other business function such as finance, marketing, operations, and legal.

Confronted with all the required compliance activities and their associated costs, an adviser has three alternatives:

1. Retain a reputable compliance services firm (aka outsourcing);
2. Hire a competent employee to serve as the CCO (aka insourcing); or
3. Do the bare minimum until the SEC forces a change (aka delaying).

DELAYING

Firms delay the implementation of a realistic compliance function in many ways: buy a canned compliance manual online or from a vendor, adopt policies and procedures but decline to implement their requirements, tell the CFO he/she is now the Chief Compliance Officer, promote an administrative assistant to CCO, allocate minimal resources to compliance, etc. We also see delaying disguised as rationalization: "We do the right thing." The compliance rule does not require a firm to do the right thing. It requires the firm to adopt, implement, and test policies and procedures reasonably designed to achieve compliance with the Advisers Act and its rules.

Delaying doesn't work as a business strategy. A firm may suffer significant enforcement actions and penalties, which can include fines and personal liability including industry bans. Firms should also consider the potential reputational costs. Enforcement actions are available on the web to be forever cited by clients, competitors, potential employees, and regulators. Delaying also will not work with institutional clients. Most public plans, fund-of-funds, mutual funds, and other institutional investors perform significant due diligence on a firm's compliance program in addition to investment and operational due diligence.

Todd Cipperman is the founding principal of both Cipperman & Company (CipCo) and Cipperman Compliance Services (CCS). CipCo provides a wide range of legal services, including regulatory advice, product development, distribution arrangements, and client and vendor agreements, to investment managers, investment advisers, broker-dealers, mutual funds, hedge funds, and technology providers. As Principal of CCS, Todd manages ongoing business operations, directs strategy and has built a team of experienced professionals whose careers have been focused exclusively on the investment management industry.

OUTSOURCING VS. INSOURCING

We will now turn to the real debate of whether to insource or outsource. What follows is a list of factors to consider when determining whether to insource or outsource your compliance and a scorecard for easy reference:

	Outsourcing	Insourcing	Winner
Regulatory Knowledge	A reputable compliance services firm with a decent-sized staff (e.g. more than five) should give an adviser the breadth of knowledge necessary to implement an effective compliance program. A group of experienced professionals will have more regulatory knowledge than any one person a firm could hire.	If the firm can find that unique person with the specific experience necessary, it may make sense to hire a person.	Outsourcing
Depth	A group of professionals work together to support a firm's compliance needs. They can draw on each other's experience and knowledge. Also, their knowledge is not firm-specific. A team can utilize cross-industry and multiple firm intelligence to serve each client. A firm also retains an adviser's institutional compliance knowledge even if personnel turn over.	If a firm can find the perfect person with the perfect knowledge, hiring may make sense. Unfortunately, a firm loses its compliance knowledge once the in-house CCO moves to a new job.	Outsourcing
Business Knowledge	A compliance services firm will have broad industry experience and apply it to the particular issues facing the adviser.	Although an in-house resource may not immediately know the adviser's business, he/she should become expert in the adviser's business over time.	Push
Management	When a service issue arises, the client can appeal to management for corrective action. A firm, unlike a person, does not take vacation or sick days or ask for a promotion. Also, should an adviser wish to make a change, it does not become the same type of emotional decision as firing an employee.	Management of an internal compliance resource has become a cross-industry problem. Faced with a limited career path, many compliance officers leave after a few years to make more money or to experience a different type of firm. Then, the adviser must go through the decision-making and hiring process all over again.	Outsourcing
Control	Firms can control the service offering by written agreement and through its relationship with the service provider's management.	An in-house CCO must report to senior management that determines pay and tenure. An in-house CCO must be mindful of the impact of his/her reports and adjust the message accordingly.	Insourcing
Leverage	Compliance firms execute agreements to perform a specified list of compliance services.	Many in-house CCOs perform multiple roles including providing legal services or assisting with operations.	Insourcing
Independence	A compliance services firm brings an independent perspective to the compliance function. Institutional clients and regulators value this independence and often give more weight and credibility to a compliance review prepared by an outside party rather than somebody reporting to senior management.	An in-house CCO is in an inherently difficult position. Detecting a serious compliance deficiency only creates problems. In many cases, the CCO gets blamed because senior management views the CCO as the cause and not the solution. Unlike an outside firm which has many clients, an in-house CCO faces significant disruption if a compliance breakdown fractures the relationship with management.	Outsourcing
Cost	Based on our experience, utilizing a compliance services firm usually costs between \$50,000 and \$150,000 per year. Of course, the fees vary widely depending on the firm engaged as well as the adviser's activities and risk profile. An adviser can also vary the services utilized to meet its budget constraints. Utilizing a compliance firm avoids the fixed cost (including benefits) and commitment of hiring an employee.	To hire a competent compliance officer generally costs at least \$150,000 in salary plus benefits. The price tag goes up for larger, more complex advisers and may require hiring multiple people. Costs obviously vary depending on the market, but an adviser should compare the available talent against the personnel offered by a compliance firm. Hiring an employee also involves a fixed commitment of resources including head count, benefits, and management.	Outsourcing
Liability	In the event of a compliance problem, an adviser can look to the compliance services firm and its contractual service commitments. The Agreement may provide for a cause of action and/or indemnity for significant failures.	The only remedy against an employee would be termination.	Outsourcing
Regulators	Periodically, we hear rumblings that regulators may frown upon outsourcing. That has not been our experience. We have managed several SEC exams where we either served as CCO or provided a full outsourcing service. The SEC has indicated that what matters is an adequate compliance program. The SEC will criticize an adviser that demonstrates lack of commitment to compliance by spending too little (see metrics above), outsourcing to a firm that does not provide the necessary resources and services, or failing to empower the compliance services firm.	What matters is not that a firm has hired a CCO, but that the firm hires the wrong CCO. While a firm can show a degree of commitment by hiring an employee, several enforcement actions have alleged that an in-house CCO lacked the appropriate training, skills, or background.	Push

CONCLUSION

Hiring an internal employee may make sense where a firm needs to leverage employees into multiple roles and has concerns about controlling the compliance function. However, firms should understand the significant benefits of outsourcing: a deep team, avoiding the fixed costs and management issues of hiring a full-time employee, demonstrating a degree of compliance independence, sharing liability, and lower costs.

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