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Chief Compliance Officers

Developing a 2018 Compliance Budget: How Investment Advisers Can Make the Most of Limited Resources

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In the face of ever-increasing regulatory demands and a challenging fee environment, compliance departments are frequently being asked to do more with less. A recent presentation by ACA Compliance Group (ACA), entitled "Planning Your 2018 Compliance Budget," offered timely insight on how chief compliance officers (CCOs) and compliance personnel can approach the compliance-budgeting process, obtain buy-in from senior management, avoid common pitfalls and stretch limited resources. The program featured Lee Ann Wilson, ACA senior principal consultant; Sean McKeveny, ACA consultant; and Kara J. Brown, counsel at Sidley Austin. This article highlights the portions of the presentation most relevant to fund manager compliance staff, particularly those who may be currently immersed in the process of seeking approval for their budgets.

For additional ACA insights on budgeting, see "ACA 2016 Compliance Survey Covers SEC Exams; Compliance Staffing and Budgeting; Annual and Ongoing Compliance Reviews; and AML/Sanctions Compliance (Part One of Two)" (Jan. 19, 2017).

Budget Planning

An initial step in planning for a compliance budget is to consider the following, Brown explained:

- the adviser's most recent risk assessment;
- its previous annual compliance reviews;
- any regulatory changes that affect the firm;
- any changes to the existing business, new business lines or new personnel that could introduce additional compliance obligations; and
- any other changes during the course of the year that might give rise to additional compliance work in the coming year.

Compliance should also consider any recent SEC examinations of the adviser and the results of those examinations, Brown continued. If there were any noted deficiencies, the SEC will expect the firm to have resolved them. If the firm has not done so, it should ensure that a portion of the budget is allocated to that purpose.

It is also helpful to look at the exam priorities articulated by the SEC and regulatory pronouncements from other regulators. Compliance departments will want to have a budget sufficient to address those priorities. If a firm has identified other risks but has not yet addressed them, it should also factor those costs into its budget. The SEC and other regulators will ask about a firm's risk process.

The CCO of an adviser that is subject to the jurisdiction of other regulators, such as the CFTC and FINRA, will also need to consider any exams, exam findings and interactions with those regulatory bodies, Brown added. The SEC may consider how an adviser has responded to deficiencies noted by other regulators as part of its evaluation of the firm's overall culture of compliance.

Finally, CCOs should consider whether there are responsibilities currently being handled by the compliance group that can potentially be shifted to other departments in the firm, Brown suggested. For example, cybersecurity is a hot topic in compliance but may also fall within the domain of the firm's information technology (IT) group. Compliance should coordinate with other departments to allocate responsibilities and budget appropriately.

See "DLA Piper Compliance Survey Offers Perspectives to Hedge Fund Managers on CCO Liability and Compliance Program Benchmarks" (May 26, 2016).

Getting Buy-In for the Budget

To make a case for the requested budget and to obtain buy-in from the firm, it is important to understand the pressures associated with compliance budgeting. Position compliance as "a partner to the business and not just . . . an outlying non-profit center," Wilson suggested.

Advisers face pressure from investors. For example, investors have been asking for adoption of policies and procedures on cybersecurity and anti-money laundering. There are also increased regulatory pressures, such as Regulation S-ID. Advisers may also have additional overhead and operational costs, such as those arising out of an expansion or a move to a new location.

Speaking the right language is key to being effective in the budgeting process, Wilson said. Be visible and transparent about the responsibilities that compliance has. One good way to cultivate internal support is for members of the compliance group to participate in various committees throughout the firm. "It is very important to have a seat at the table," she said. This allows compliance to see where the business is going and anticipate how that will affect compliance. It also allows others to understand the work that compliance does.

Start the budget process sooner, rather than later, Wilson continued. Consider staffing requirements and the various options for meeting those requirements. Assess how technology can streamline workflows and tasks. ACA surveys can provide helpful metrics in discussing budget needs, Brown said. They can also provide a sense of industry best practices, Wilson added.

It is better to approach budget issues as they arise throughout the year rather than to request a significant increase at year-end, Brown explained. Compliance teams should try to demonstrate to both clients and regulators that they are staying on top of regulatory changes and trends. Ongoing training and attendance at compliance conferences can demonstrate that commitment. Compliance professionals can also participate in peer-to-peer forums and similar events.

Use of Technology

Technology can streamline workflows and tasks, and investment in technology can result in long-term savings. Advisers, however, often balk at the substantial initial outlay, Wilson said. Prior to any investment in technology, an adviser should conduct appropriate vendor due diligence. It should also understand the limitations of the technology solution and the onboarding process.

See "How Fund Managers Can Develop an Effective Third-Party Management Program" (Sep. 21, 2017); and "How Managers Can Identify and Manage Cybersecurity Risks Posed by Third-Party Service Providers" (Jul. 27, 2017).

Technological solutions can help compliance shift resources from testing to monitoring. Process automation is another way that technology can foster savings, Wilson noted. Although automation can eliminate human error, there should still be appropriate monitoring as part of the compliance process. That monitoring cost should be considered in budgeting.

Many clients have automated systems, but "it doesn't always appear that they are on top of those systems," Brown observed. If an asset manager represents to regulators that it is using technology, for example, it must understand the technology and use it properly.

When considering a new solution, it is a good idea to get at least three proposals. This will help evaluate whether paying more for a service will be better for the firm in the long run than a less expensive service. Compliance should involve other firm stakeholders in those discussions, Brown added. For example, IT can help evaluate a new technology and identify issues that the technology could pose, such as incompatibility with regulatory reporting systems.

See "Advertising Compliance Series: Ten Best Practices for a Fund Manager to Streamline Its Compliance Review (Part One of Three)" (Sep. 14, 2017); "Hedge Fund Managers Are Advised to Build Robust Infrastructure" (Mar. 3, 2016); and "How Hedge Fund Managers Can Use Technology to Enhance Their Compliance Programs" (Nov. 17, 2011).

Employment Issues

Employment costs represent a significant portion of many compliance budgets, and advisers should consider staffing requirements along with the options available to them in the marketplace, McKeveny said. This will help in allocating resources efficiently when staffing decisions are made.

"Hidden" Employment Costs

If compliance is budgeting for a new employee, it should factor in a number of costs, in addition to salary, that might otherwise be overlooked, McKeveny cautioned. Those include:

- the cost of bonuses, retirement contributions and other benefits being offered;
- "supervisory overhead" – the additional cost of supervising the new employee;
- employee recruitment and onboarding costs;
- the time and expense necessary to bring the employee up to speed;
- the costs of continued training and professional development; and
- the cost of space and equipment used by the employee and the general increase in overhead associated with increased headcount.

Use of Rotations

To deal with headcount constraints, some advisers have a "rotational program" that exposes compliance personnel to a variety of different tasks and provides additional training, noted McKeveny. It also helps to keep them engaged and may help an organization retain talent. Broadening exposure of junior personnel can take some tasks away from more senior personnel, freeing them up to focus on more complex matters.

In a rotational program, a new compliance staffer may first deal with code of ethics administration and email reviews. Later, that person could move into chaperoning consultations or trade surveillance.

Compliance may also add personnel from other departments – for example, operations or accounting – into the mix, McKeveny said. This broadens internal awareness of the importance of the compliance program and its day-to-day operations.

Subject matter experts are important, but rotational programs are valuable and can provide the added benefit of individuals spotting issues that might not otherwise have been noticed, Brown noted. Rotations also help retain employees with significant expertise in one area but who want to be doing more and have greater responsibility. Ask team members what other areas they are interested in and devote some time and resources to exposing them to those areas, she suggested.

"Cross-training is always a benefit," Wilson added. The SEC, for example, does not want the CCO to have to bring in several other people to answer a question about what is going on at the firm. That is why it is good for the CCO to also be exposed to the inner workings of other firm departments.

Compliance should not function "in a vacuum," Brown observed. It must coordinate with other areas of the organization. Many advisers operate with a relatively small compliance staff. Sharing responsibilities outside the group can ease the compliance burden. It is also important that other groups have their own procedures, because investors and the SEC will want to know what other groups in the organization are doing and what their processes look like.

For example, one task that occupies a lot of compliance personnel's time is tracking down documents, Wilson noted. Compliance can help other areas develop processes that facilitate putting together documents requested by regulators. "Regulators will take notice" if an adviser is slow to produce documents, Brown added; it will detract from the adviser's credibility. To prepare, compliance can review sample exam requests with the other departments where commonly requested documents may reside.

See our two-part series on a roadmap to maintaining books and records: "Compliance With Applicable Regulations" (Nov. 2, 2017); and "Document Retention and SEC Expectations" (Nov. 9, 2017).

Finally, foster a "culture of communication" on the compliance team, Brown recommended. Personnel should be willing to speak up when issues arise so that concerns can be addressed timely and efficiently. Junior compliance personnel with ideas should be encouraged to bring them to senior personnel.

Staffing Levels, Temporary Support and Outsourcing

Another important budget consideration is deciding whether to have staffing levels that are sufficient for "normal" work volumes or to maintain a staffing level that can handle "peak" workloads, McKeveny said. Staffing based on peak loads could leave people underemployed at times. On the other hand, staffing based on normal workloads could lead to unhappy, stressed employees at peak times, as well as increased turnover.

The SEC does not want to hear from an adviser that there are "not enough hours in the day to keep up with all of that [compliance] work," Brown said. It expects advisers to keep up with demand. Compliance should seek a budget sufficient to address the adviser's regulatory burdens.

One way to address this dilemma is to develop the ability to pull in staff from other departments or from outside the firm at peak times, McKeveny said. Using external support could be more cost-effective because those individuals may require less training and less direct supervision. It also eliminates the hiring and termination process. A firm may also want to avoid having junior staff reviewing what may be sensitive firm emails, Brown noted. Finally, outside assistance can mitigate key person risk by offering "a larger and deeper bench," McKeveny added.

See "The Role of Outsourced Compliance Consultants in the Hedge Fund Compliance Ecosystem" (Jun. 27, 2014).

As organizations grow, it becomes harder to apply consistent practices, McKeveny said. One way to do that is by centralizing testing units. A centralized unit can help in sharing best practices and in developing the most effective workflow. If a firm has multiple locations, the unit could be located in one of the lower cost locations.

See "Challenges and Solutions in Managing Global Compliance Programs" (Oct. 5, 2017); and "Most Small and Emerging Managers Expect Headcount to Increase in Next Three Years: AIMA/GPP Study Explores Viability, Key Business Terms, Outsourcing and Growth Prospects" (Jul. 27, 2017).

Budgeting for the Unexpected

A number of things may happen during the course of the year that can affect a compliance budget, Brown explained. A budget may build in a buffer for some or all of those possibilities. For example, there has been a noticeable uptick in the number of SEC exams since Jay Clayton took over as SEC Chair. He committed to a 20 percent increase in investment adviser exams in fiscal year 2017, with an additional 5 percent increase in fiscal year 2018. Exams require significant resources for document production, preparation for interviews and additional work from outside counsel.

See "SEC Chair Clayton Details Eight Guiding Principles for Enforcement and Agency Strategies for Their Implementation" (Aug. 10, 2017).

Staff, whistleblower or investor complaints can also impose an additional drain on a compliance budget, but they nonetheless must be taken seriously. The SEC expects advisers to investigate and address complaints; failing to do so will become an exam issue.

Additional unanticipated costs can also arise from the unexpected departure of an employee, a new business line for the adviser – particularly where compliance is brought in at the last minute – and issues identified through compliance testing that require additional resources to address.

It is important to think about budgeting throughout the year and to keep apprised of intra-year changes that affect the budget, Brown said. In one recent enforcement action against a hedge fund manager, compliance had asked for additional resources, but senior executives refused. The SEC faulted the senior executives, not the compliance personnel. Compliance should "think creatively" about how to get the attention and support of senior executives, she suggested.

See "SEC Enforcement Action Shows Hedge Fund Managers May Be Liable for Failing to Adequately Support Their CCOs" (Jul. 23, 2015).

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