When Should You Hire Your First Compliance Officer?

It may be sooner than you think

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Prologue

"When should we hire our first compliance officer?"

This perennial question arises at regulated firms frequently. If it has not yet crossed your desk, it is probably only a matter of time.

And now is probably a good time.

This guide is designed to be a tool to lead you through the key issues to be considered when assessing compliance resourcing. Recognising that every firm's risk profile is different and there is no one-size fits all solution, we have provided a framework to facilitate and inform internal discussions.

The present guide has been created in collaboration with compliance expert Oliver Lodge, Director of **OWL Regulatory Consulting** and ex-Regulator at the Financial Services Authority (FSA) and the Investment Management Regulatory Organisation (IMRO).

Main Options & *Key Deciding Factors*

A firm will usually look at three different options when it is time to build its compliance function. The present guide will detail and analyse each of these options, based on major deciding factors.

As a key decision maker within the business, you must establish which of the three options below suits best your needs and current situation:

- Hire a full-time Chief Compliance Officer (CCO)
- Hire a part-time Compliance Officer
- Get the compliance function outsourced to a firm of regulatory consultants

Based on the above, how can you make a sound decision that will mitigate your regulatory risks? What factors should you take into consideration to properly assess your current - and future - business needs?

It is tempting to suppose that the selected option depends solely on affordability. After all, having a compliance function may be mandatory, but it is infinitely scalable: shouldn't you then just do what you can afford?

The answer is no: when regulation is concerned, cost isn't the sole deciding factor. Telling the SEC that you can't afford adequate compliance resources will get you nowhere. This is why the question needs to be properly considered, rationalised and recorded.

No matter how the compliance function is structured, having the right quantity and quality of resources are both crucial: after all, having a function that lacks sufficiency isn't good. Can all key compliance qualities and skills be found in one person? Is one individual enough for the firm? Is the CCO in effect the commissioner of the experts? Is it preferable for the Senior Management Functions to be held by a Senior Director?

Let's take a deeper dive into the key factors that will determine the outcome of your decision process.

The Factor

Credibility (general/product specific - ESG)

With ESG becoming such an important area of investment activity, your credentials may depend to some extent on the credibility of your CCO. You must also bear in mind the firm's credibility with the regulator - they can be sure to take an interest in the composition of the compliance function. Will the ones concerned be looking for a reassuring constant CCO presence, or alternatively a known external name?

FIRST OPTION: EXTERNAL CONSULTANTS

While the choice of external consultants may be entirely logical and defensible, it will also tend to raise questions, no matter how misguided such questioning might be. The greater the weight placed on compliance in client-facing documentation, the greater the difficulty in taking this approach.
Nevertheless, the external compliance function is capable of providing a range of specialists able to express dispassionate observations, uncluttered by internal relationships.

SECOND OPTION: PART-TIME COMPLIANCE OFFICER

Although some of the same issue as with the external solution apply to the part-time compliance officer option, it is likely to be less prominent, especially to clients/investors. However, professional investor due diligence may well enquire about the scale of the control functions.

THIRD OPTION: FULL-TIME CCO

This solution usually provides the strongest credibility, whether it should or not.

The Factor

AuM & Complexity of business or funds

Although perhaps an obvious differentiator between firms, AuM is seldom a good guide to compliance needs. Generally, complexity or wide range of strategies presents greater challenge than pure quantity. The consideration highlighted in this area is whether a special strategy, unlikely to attract substantial AuM, is worth the compliance resource that it requires.

FIRST OPTION:
EXTERNAL CONSULTANTS

While pure scale in terms of AuM may not require much by way of additional resource, complexity or a range of activities/strategies is likely to have resource implications. Where quantity of resource is the issue, the external solution is seldom the most advantageous, but it may be invaluable where specialism is key (see next factor - *Need for specialist knowledge*).

SECOND OPTION:
PART-TIME COMPLIANCE OFFICER

In this context, the question is one of pure quantity. Rules of thumb in relation to AuM mean little. One option for evaluating the need is to start small and review periodically the adequacy of the outcome. Alternatively, a consultant may be able to evaluate the need.

THIRD OPTION:
FULL-TIME CCO

The CCO solution is actually no more than 'somewhere on the quantity scale'. If one FTE is what is needed, that is the simple solution, but the right answer may be less or more than one.

Somes thoughts
on Private Equity

Hedge funds have a lot more stringent and liquid compliance requirements where you are mandated to have a compliance officer to literally check things, or build programmes for things that happen on a daily basis. You need them day-to day. You call them a CCO because there is one of them but in essence you could hire a compliance manager and tick that box – you need that person much earlier.

In the Private Equity world, there are far fewer daily things that need to be done, and those things could be outsourced to a consultancy. It is a much more discretionary decision whereas going in-house typically is related to either having different strategies, multiple funds, fund raises, different offices and different licensing requirements.

It really is more business complexity than anything, as opposed to the foundation of the work. Whether it is day 1 or day 100, or trade 1 or trade 100, there needs to be that minimum requirement in the hedge fund space. In Private Equity, however, when the founder or management team decides that there is just too much going on and that the risk is not acceptable to be outsourced, that is when a discretionary decision needs to be made.

Typically, you will probably see it go hand-in-hand with regulatory licenses first. If you are going through the UK, and then open up a second one, you will for sure be looking for an individual to manage the situation. All of a sudden, you open up a new frontier you have no idea about: you don't even know who to outsource it to. Jurisdiction is therefore a big one then, because of registrations.

Fundraising is another big one. If you've seeded and spun out a Private Equity fund and you've got the capital locked in for one fund, you can get away with it. If you are going out seeking additional external capital for fund 2, or if part of your model is to go and get a broad range of investors, it would be very difficult to get away with that without a dedicated compliance officer – just because fund raising itself has so much regulation and the investors need it.

Gary Wong, Director at Softbank and ex-CCO at Bain Capital

The Factor

Need for specialist knowledge

How specialist is specialist, when you have a range of funds with different approaches, objectives and investors? If your range is too wide to expect a single CCO to be able to deal with it, the external provider, with its cohort of experts, may have the advantage. But don't assume that that makes it less costly.

FIRST OPTION: EXTERNAL CONSULTANTS

Where the firm's activity presents significant challenges in terms of range of specialisation, the external solution can have significant advantages, given the scope for input from several specialists, even where the required quantity of compliance resource is comparatively modest.

SECOND OPTION: PART-TIME COMPLIANCE OFFICER

If a wide specialist range is needed, it would be a fortunate firm that found a part-time CO who genuinely held all the necessary knowledge. Inadequate understanding by compliance has been the cause of several high-profile disasters.

THIRD OPTION: FULL-TIME CCO

With a CCO, there are similar problems to that of the part-timer in this respect. However, the main difference will be the inclination to invest in necessary training to ensure that the CCO is fully up to speed.

The Factor

Scale of risk

Being truly dispassionate, where do you believe the regulator places your firm on its risk spectrum and where do you believe the main risks lie? Will those risks be better controlled by a good CCO or by a well-advised and supported COO who definitely devotes time and attention to compliance matters? Consider here the clout needed to challenge and restrain.

FIRST OPTION: EXTERNAL CONSULTANTS

This is an area where generalising can be dangerous and inappropriate. If the risks relate to complexity, the external solution is usually to be preferred. The same may be said if the issue is, or has been proved to be, that a lone compliance officer is unable to hold his own.
The external solution, reporting to an engaged senior manager may be right.

SECOND OPTION: PART-TIME COMPLIANCE OFFICER

Generalising dangerously, the part-time solution is usually only appropriate in relatively low risk businesses. If that case can genuinely be made, so be it, but be cautious about allowing cost to become too big a factor, overwhelming careful consideration about risk.

THIRD OPTION: FULL-TIME CCO

Where the risk is largely in the eye of the regulator, the CCO solution will usually be the answer that is expected. But it is seldom all about satisfying the regulator, especially where senior managers are extensively exposed.

The Factor

Indications from the Risk Register of dependence on mitigating controls

Risk Registers do funny things to people. The temptation to look only at the eventual outcome is strong, but the whole document needs to be considered to determine where the attention of the control functions needs to be focused. Look keenly for areas with high inherent risk and much lower residual risk and ask yourself whether the mitigation that achieves that transformation is well and reliably applied. If the compliance and other control functions are too thin to deliver the assurance needed, look for ways of reinforcing.

FIRST OPTION:
EXTERNAL CONSULTANTS

Where the Risk Register is clearly showing that the security of the firm relies significantly on a number of key controls that mitigate high risks, the occasional presence of external compliance is unlikely to suffice.

SECOND OPTION:
PART-TIME COMPLIANCE OFFICER

While expertise may be an issue in understanding the essential controls, the most probable issue is quantity of resource and sufficiency of visible compliance presence. A careful assessment of the resource required will be needed, unless trial and error is tolerable in the circumstances (not recommended).

THIRD OPTION:
FULL-TIME CCO

The situation of high dependence on identified controls is likely to justify the constant presence of a CCO.

The Factor

Incidence of material breaches

You will know the extent to which you have been exposed to shocks and nasty surprises. What has that suggested about the current compliance arrangements? Are they properly robust or is it quality or quantity that is lacking? Might the external contributors not know enough about what is really going on? The constant presence is valuable where risks have been known to crystallise.

FIRST OPTION: EXTERNAL CONSULTANTS

Incidents speak louder than words. They tend to suggest that current arrangements are not sufficient or appropriate in one respect or another. While breaches are seldom the fault of compliance, the right compliance arrangements should be able to reduce the incidence of them. External structures tend to suggest limited quantum, which may be the problem. But equally external expertise may be the solution.

SECOND OPTION: PART-TIME COMPLIANCE OFFICER

If material breaches have become a theme, change is required following a review of the insufficiency that is causing the failure to pre-empt the breaches. The firm is likely to need either enhanced quantity of compliance monitoring resource, or enhanced skills, robustness or specialist knowledge.

THIRD OPTION: FULL-TIME CCO

Whatever structure has not worked well, the firm may be moving towards or away from a CCO. It may, alternatively be forced to conclude that a single compliance officer is not enough.

The Factor

Remoteness of activity

Where the business is all comfortably based in a single office space, however old-fashioned that might seem today, control is more readily achieved than when dealing with dispersed activity, whether working at home, agents on the road, appointed reps or regional offices.

FIRST OPTION: EXTERNAL CONSULTANTS

Remote working of whatever kind is likely to require more time commitment for compliance than business based in a single office. The external solution in such situations is seldom the best, even if an external supplier can offer a regionally structured arrangement. There needs to be strong coordination of the compliance effort, usually better provided by dedicated compliance travelling to remote work sites.

SECOND OPTION: PART-TIME COMPLIANCE OFFICER

Although clearly a question of degree, any significant remote working that requires travel to remote work sites is unlikely to be adequately covered by a part-time CO.

THIRD OPTION: FULL-TIME CCO

Usually this situation calls for a CCO who will go wherever required to advise, review and report.

The Factor

Headcount

There is a long-standing rule of thumb suggesting that the compliance function should represent 2% of the firm's headcount. To describe that as simplistic is a great understatement. Nevertheless, a larger business is inevitably going to require greater resource on control functions, including compliance.

FIRST OPTION:
EXTERNAL CONSULTANTS

For a small firm, an external solution may work well and may be cost-effective. However, if the other factors allow, the likelihood is that the limited quantity required is necessarily not best found from external providers. For larger firms, an in-house team is usually inevitable.

SECOND OPTION:
PART-TIME COMPLIANCE OFFICER

Where scale is the only significant factor, the flexibility of part-time arrangements may fit well.

THIRD OPTION:
FULL-TIME CCO

Moving to a CCO will be the logical direction of travel as the business grows. But one FTE is not a magic number and the requirement may move swiftly towards more resource.

The Factor

Comments from SEC

However irritating the regulator may be, if you are pressed by them to enhance your compliance function, declining to do so can only be described as a high-risk strategy. One material breach later and your hand will be forced.

FIRST OPTION:
EXTERNAL CONSULTANTS

If the identified need is for greater expertise, the external solution is favoured, either on its own or in support of in-house compliance. Either way, there must be sufficient focus in-house on what is being generated by the external resource.

SECOND OPTION:
PART-TIME COMPLIANCE OFFICER

The advantage of part-time arrangements is usually the flexibility to fine-tune the quantum. If the regulator is demanding more (they seldom demand less!), it may be possible simply to add fractions of an FTE.

THIRD OPTION:
FULL-TIME CCO

A decisive move to a CCO may be just the commitment that the regulator is looking for. If it seems OTT at the moment, comfort yourself with the thought that positive business growth will use up any slack and the move may produce a much better relationship with the SEC with whom you have live.

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