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EXAMINING AND MANAGING RISKS ASSOCIATED WITH OUTSOURCING COMPLIANCE FUNCTIONS

Outsourcing compliance functions is a growing practice at financial services firms. In this article, the authors describe the reasons for outsourcing, and the risks of the practice for investment advisers and broker dealers. They then turn to liability risks for internal and outsourced chief compliance officers and for financial services firms using outsourced companies. They conclude with notes on managing such risks.

By Daren R. Domina and Timothy J. Piscatelli *

In 2003, the U.S. Securities and Exchange Commission adopted Rule 206(4)-7 under the Investment Advisers Act of 1940, frequently referred to as the "Compliance Rule"[1] for SEC-registered investment advisers.[2] In more recent years, the financial services industry has faced increasing regulatory oversight from the SEC enforcing compliance with the Compliance Rules, as well as self-regulatory bodies like the Financial Industry Regulatory Authority, Inc. ("FINRA") enforcing compliance with their respective versions of such rules.[3] Financial services firms incur significant costs ensuring compliance with the wide variety of intricate regulatory requirements to which they are subject. In an attempt to help alleviate their regulatory burdens, certain financial services firms are increasingly utilizing outsourced compliance firms to some degree.

Whether financial services firms should keep compliance functions in-house or outsource certain tasks has come to the forefront of industry conversations, as financial services firms grapple with the potential benefits and shortcomings of utilizing firms. While recognizing that there may be significant benefits to utilizing outsourced compliance firms, a financial services firm must also consider that it retains the ultimate responsibility for delegated services, and that violations of rules and regulations can result in significant penalties and other negative repercussions for the firm.

[1] Rel. No. IA-2204 (2003); Simultaneously, the SEC adopted parallel Rule 38a-1 under the Investment Company Act of 1940 (Rel. No. IC-26299 (2003)), often referred to together with Rule 206(4)-7 as the "Compliance Rules."

[2] Given that the matters discussed herein generally can be applied to both investment advisers and broker-dealers, this article shall often use the generic reference of "financial services firm."

[3] For example, current FINRA Rules 3110, 3120 and 3130.

* *DAREN R. DOMINA is a partner in the Investment Management group in the New York office of Haynes and Boone, LLP and the head of the firm's Broker-Dealer Regulatory Practice Group. TIMOTHY J. PISCATELLI is an associate in the Investment Management group in the New York office of the firm. Their e-mail addresses are Daren.Domina@haynesboone.com and Timothy.Piscatelli@haynesboone.com.*

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This article summarizes certain recent trends and risks in outsourcing compliance functions, the awareness of which may assist financial services firms in potentially managing and mitigating the risks associated with utilizing outsourced compliance firms.

GENERAL BACKGROUND TO OUTSOURCING

The compliance team of a financial services firm is primarily responsible for overseeing and managing regulatory compliance issues within the organization. After appointment of a Chief Compliance Officer ("CCO"), compliance is typically tasked with a number of responsibilities, such as (1) developing a compliance framework tailored to the firm's business; (2) developing and implementing policies and procedures for the financial services firm to meet its regulatory requirements; (3) monitoring the firm's business and assessing compliance risks; (4) investigating and taking corrective action regarding noncompliance and misconduct; and (5) reporting compliance status and issues to senior management.

Although outsourcing compliance functions was relatively new at the time of the Compliance Rules adoption in 2003,[4] Lori A. Richards, Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") signaled some of the staff's concerns in a 2004 speech, *The New Compliance Rule: An Opportunity for Change*: "While the rule does not preclude outsourcing, let me caution you . . . [i]t would be logical to infer that a reasonable amount of time would have to be spent not only overseeing the structure of the compliance program but its implementation as well. Because of this, I am wary about whether a compliance 'rent-a-cop' could really be up to the task."[5]

Over the ensuing years, financial services firms increasingly looked to engage outsourced compliance firms and/or to outsource certain compliance functions. Regulators took notice. In 2005, the National Association of Securities Dealers (now "FINRA") recognized the increasing occurrence of outsourcing in general and in reminding member firms of their overall responsibilities, such as monitoring and due diligence, cautioned that a member firm retained ultimate responsibility for supervision and may never contract its supervisory and compliance activities away from its direct control.[6] Subsequently, in 2009 FINRA was among the first regulators to formally indicate that outsourcing would be a priority area of review during FINRA examinations.[7] In 2015, OCIE launched an Outsourced CCO Initiative that culminated in its published "*Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers*" risk alert (the "OCIE CCO Risk Alert").[8] In addition, a survey conducted in 2016 about the cost of compliance found that, of more than 300 financial services firms surveyed worldwide, 25% of firms outsourced some or all of their compliance functionality.[9] The outsourcing trend has generally continued to today, with the 2020 edition of the same survey indicating that, of more than 750 financial services firms surveyed worldwide, 34% of firms outsourced some or all of their compliance

[4] Other than, for example, use of outsourced Financial and Operations Principals ("FinOps") by small- to mid-size broker-dealers or the outsourcing functions a clearing broker performs.

[5] Lori A. Richards, Director of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations, Speech *The New Compliance Rule: An Opportunity for Change* (June 28, 2004) *available at* https://www.sec.gov/news/speech/spch063004lar.htm.

[6] NASD *Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers*, Notice to Members 05-48 (July 2005) *available at* https://www.finra.org/rules-guidance/notices/05-48.

[7] FINRA *2009 Regulatory and Examination Priorities Letter* (March 9, 2009), *available at* https://www.finra.org/rules-guidance/communications-firms/2009-regulatory-and-examination-priorities-letter.

[8] OCIE, *Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers*, National Exam Program Risk Alert (November 9, 2015) *available at* https://www.sec.gov/files/ocie-2015-risk-alert-cco-outsourcing.pdf.

[9] Stacey English, Susannah Hammond, *Cost of Compliance 2016*, Thomson Reuters, *available at* https://legal.thomsonreuters.com/content/dam/ewp-m/documents/legal/en/pdf/reports/cost-compliance-2016.pdf.

functionality.[10] So why are financial services firms increasingly outsourcing compliance functionality?

While the needs of and benefits for small financial services firms versus large financial services firms will vary, certain reasons to engage outsourced compliance firms may include the following (which may often overlap):

Resources. An outsourced compliance firm can assist a small financial services firm that lacks sufficient experienced personnel and/or resources, and even a larger financial services firm that may undergo periods where it may not have as much regulatory knowledge in a particular area as it would prefer or may need assistance in a new, non-U.S. location.

Additional Assurances on Compliance Processes. Outsourced compliance firms can also act as an independent third-party for select tasks, such as mock audits and targeted reviews for which a financial services firm may want a new perspective about the firm's compliance program (or certain aspects of it) or a second viewpoint about planned or proposed enhancements.

Additional Compliance Monitoring. Some financial services firms, rather than employing compliance monitoring professionals directly, may outsource certain monitoring to provide an additional layer of oversight, as well as increase the independence of the compliance monitoring function.

Potential Reduced Costs and/or Increased Efficiency. Some financial services firms, based on size, limited scope of business, or other reasons, may not have the financial resources, desire, or need to hire a full-time compliance professional. Examples are a small financial services firm with limited business or a financial services firm establishing a satellite office where a full-time, onsite compliance presence may not be necessary. Certain financial services firms also may believe that their compliance professionals' time is more efficiently spent on certain tasks and delegate other tasks to an outsourced compliance firm. For example, an outsourced compliance firm may conduct the initial reviews of financial services firm e-mails and report the results back to an internal compliance professional.

[10] Susannah Hammond, Mike Cowan, *Cost of Compliance 2020: New decade, new challenges*, Thomson Reuters, *available at* https://images.marketing.refinitiv.com/Web/ThomsonReutersFinancialRisk/%7Bf798765e-1a9b-4975-98c9-a133945d21e8%7D_Cost_of_compliance_2020_FINAL230620.pdf.

No Need for a Full-Time CCO. Overlapping other potential drivers, a financial services firm may believe that there is simply no need for a full-time CCO given the firm's limited personnel and business, and perceived time needed to be devoted to compliance. In such case, the outsourced compliance firm can designate one of its employees or partners to be the firm's CCO.

Lack of In-House Compliance Skills. A financial services firm may need additional help to supplement its compliance program in certain areas. Outsourced compliance firms generally have broad industry experience and can apply experiences working with many different financial services firms.

Training. All financial services firms have some form of mandatory training program that takes staff through various relevant legal and regulatory subjects. Historically, financial services firms may have had internal training personnel to develop these programs. In recent years, certain outsourced compliance firms have developed training modules, presentations, or materials which can cover the main points in a range of subjects.

AML Monitoring, KYC Processes, and Client On-Boarding. Outsourced compliance firms can provide targeted assistance to improve anti-money laundering ("AML"), know-your-customer ("KYC"), and client on-boarding operations, as well as undertake enhanced due diligence and investigations of customers.

Regulatory Updates. The often large quantity of regulatory material produced in the last few years and the costly exercise of keeping up to date with proposed and enacted regulatory changes has prompted some financial services firms to engage outsourced compliance firms to identify upcoming regulatory changes, and provide succinct updates and timelines on such changes and their effect on a financial services firm's businesses.

The above list is not exhaustive and there may be myriad reasons why an outsourced compliance firm may be used. Importantly, financial services firms need to be aware of the challenges and risks that accompany outsourcing any compliance functions.

EXAMINING CERTAIN RISKS OF OUTSOURCING INVESTMENT ADVISER COMPLIANCE

Since its release in 2015, the OCIE CCO Risk Alert continues to remain an important resource for an investment adviser to understand the SEC staff's perspective and to examine risks associated with

outsourcing compliance functions. While the OCIE CCO Risk Alert is predominantly focused on the risks of outsourcing the CCO function, its practical guidance can be applied to other outsourced functions.

The OCIE CCO Risk Alert highlighted the most prevalent issues found by the staff when they examined various investment advisers that had outsourced its COO compliance functionality. Some of these are discussed below.

Prioritizing and Allocating Sufficient Resources to Compliance. Compliance should be a priority at investment advisers, including dedicating sufficient resources to compliance. The SEC staff found significant compliance-related issues more frequently at investment advisers that did not appear to provide their outsourced compliance firms with sufficient resources. Adequate resources can mean not only having sufficient personnel to conduct the compliance activities but also having such personnel devote sufficient time for such tasks, in addition to being given the proper electronic and non-electronic tools.

Compliance Independence and Empowerment. Outsourced compliance firms need to be provided with independence and empowerment within investment advisers. Outsourced compliance firms need to be able to independently obtain the records and access to individuals that they deem necessary for performing their services. The SEC staff found outsourced compliance firms that visit their investment advisers' offices infrequently, have limited contact with personnel, and conduct only limited reviews of documents or training on compliance matters while onsite, appear to have limited authority within organizations.

Critical Policies and Procedures Not Adopted. The SEC adopting release for Rule 206(4)-7[11] states that an investment adviser's policies and procedures should, at a minimum, address the following 10 areas, to the extent they are relevant to that firm:

1. portfolio management processes, including allocation of investment opportunities among clients and other issues;

2. trading practices, including best execution and soft dollar arrangements;

3. proprietary trading and personal trading by supervised persons;

4. accuracy of disclosures, account statements, and advertisements;

5. safeguarding of client assets from conversion or inappropriate use by advisory personnel;

6. accurate creation and retention of required records;

7. marketing of advisory services;

8. processes to value client holdings and assess fees based on those valuations;

9. privacy protection of client records and information; and

10. business continuity plans.

The SEC staff found that certain investment advisers with outsourced compliance lacked policies and procedures in critical areas, including: (1) conflicts of interest, and in particular in areas such as compensation practices; (2) portfolio valuation; (3) brokerage and execution; and (4) personal securities transactions by access persons.

Policies and Procedures Not Tailored to the Investment Adviser's Business. The SEC staff found that several investment advisers had compliance manuals that were created using outsourced compliance firms-provided templates, which were not tailored to the investment adviser's businesses and practices. Examples of adopted policies inapplicable to or inconsistent with the investment adviser's practices include: (1) advertising procedures that did not match the investment adviser's marketing materials; (2) the practice of collecting management fees quarterly in advance when, in practice, clients were billed monthly in arrears; and (3) policies that continued to identify departed employees as responsible for designated compliance task.

Policies and Procedures Not Implemented. The SEC staff found some investment advisers that utilized outsourced compliance firms failed to ensure implementation of the written policies and procedures that the investment adviser had adopted. These investment advisers failed to perform certain critical control procedures, or did not perform them as described, in such areas as: (1) fee and expense allocations; (2) review of solicitation activities; (3) trade allocation; (4) performance advertising; and (5) personal trading and trade reconciliation.

[11] Rel. No. IA-2204 (2003).

EXAMINING CERTAIN RISKS OF OUTSOURCING BROKER-DEALER COMPLIANCE

In July 2005, NASD issued Notice to Members 05-48[12] detailing members' responsibilities when outsourcing certain activities, such as compliance functions. NtM 05-48 highlights that outsourced compliance personnel conducting activities or functions that require registration under FINRA rules will be considered associated persons of the member, and the outsourcing of an activity or function to an outsourced compliance firm does not relieve member firms of their ultimate responsibility for compliance with all applicable federal securities laws and regulations, and FINRA rules, regarding the outsourced activity or function.

NtM 05-48 also noted common issues with broker-dealers who outsource certain compliance functions, including: (1) a lack of written procedures to monitor the outsourcing of compliance functions; (2) a lack of awareness of the business continuity plan and the role of the outsourced compliance firm, particularly with respect to continuing critical services, if applicable; and (3) a lack of formalized due diligence processes to screen outsourced compliance firms for proficiency.

As mentioned above, since at least 2009, given its potential relationship to a critical function such as compliance, outsourcing has been an area of review during many FINRA examinations, even if it has not been a highlighted topic in each year's examination priorities letter. FINRA examinations have typically reviewed the due diligence and risk assessment member firms conducted regarding outsourcing and focused on how the outsourced activities were conducted and the extent of the member firm's supervision over the activities. FINRA did re-emphasize the issues when in his 2015 as well as his 2016 Regulatory and Examination Priorities Letters,[13] then-FINRA Chairman and CEO, Rick Ketchum, acknowledged that broker-dealers continue to outsource key operational functions to reduce expenses and focus on core business activities, and again reiterated that outsourcing covered activities in no way diminishes a member firm's responsibility for (1) full compliance with all applicable federal securities laws and regulations, and FINRA rules and (2) supervising an outsourced compliance firm's performance of covered functions.

THEORIES REGARDING CCO LIABILITY

The chief compliance officer performs a vital role in a financial services firm's compliance program. Outsourcing such vital functions can potentially increase the risks of a possible regulatory problem. Moreover, in recent years, agencies and self-regulatory organizations, including the SEC, FINRA, the Department of Justice, and the Financial Crimes Enforcement Network have all sought to hold CCOs liable for organizational misconduct.

In a keynote speech at the National Conference of the 2015 National Society of Compliance Professionals, then-SEC Director Andrew Ceresney stated that the SEC's actions against CCOs (without distinguishing outsourced versus internal CCOs) generally fall into three categories: (1) CCOs who are affirmatively involved in misconduct; (2) CCOs who engage in efforts to obstruct or mislead the SEC staff; and (3) CCOs who have exhibited a wholesale failure to carry out their responsibilities.[14]

Ceresney's categorization of SEC enforcement actions also generally reflects the major theories under which other agencies have held CCOs personably liable, which generally include: (1) primary liability for directly participating in misconduct; (2) liability for secondary violations; and (3) liability for failing to supervise appropriately.

Primary Liability. In primary liability enforcement actions, the focus is not on the violator's role and function as the CCO, but on the CCO's actual conduct. Enforcement cases have found compliance professionals primarily liable for, including but not limited to, misstatements in Form ADV,[15] fraudulent expense

[12] NASD *Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers*, *supra* note 6.

[13] Richard G. Ketchum, Chairman and Chief Executive Officer of the Financial Industry Regulatory Authority, Inc., *Cover Letter from FINRA Chairman and CEO, Rick Ketchum re: 2015 Regulatory and Examination Priorities Letter* (January 6, 2015), *available at* https://www.finra.org/rules-guidance/communications-firms/2015-exam-priorities; *id.*, *2016 Regulatory and Examination Priorities Letter* (January 6, 2016), *available at* https://www.finra.org/rules-guidance/communications-firms/2016-exam-priorities.

[14] Andrew Ceresney, Director of the Division of Enforcement of the SEC, *Keynote Address at the National Conference of the 2015 National Society of Compliance Professionals* (November 4, 2015), *available at* https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-prof-cereseney.html.

[15] Rel. No. 34-81405 (2017).

reports[16] and personal use of financial services firm assets.[17]

Secondary Liability. Secondary liability enforcement actions are focused on the violator's role and duties as the CCO and may arise when a CCO has knowledge or should have knowledge of violations, but nevertheless aids in the activity or violation, fails to prevent the violation, or otherwise disregards the warnings of possible violations. Enforcement cases have found compliance professionals secondarily liable for, including but not limited to, aiding and abetting violations of the Securities Exchange Act and the Advisers Act based on the alteration of compliance documents, [18] failure to establish, maintain, and enforce policies and procedures to prevent the misuse of material, nonpublic information,[19] and failure to file Suspicious Activity Reports.[20]

Liability for Failing to Supervise. Even when not directly involved in misconduct (i.e. primary liability) or actively assisting in violations, known or unknown (i.e. secondary liability), CCOs may still experience enforcement consequences for failing to adequately perform their duties to supervise the financial services firm's businesses. In such actions, enforcement cases have examined the actual role and authority of the CCO, the specific compliance requirements and duties imposed on the CCO by the applicable regulatory framework, and the financial service firm's policies and whether and how such duties have actually been carried out.[21]

ENFORCEMENT AGAINST OUTSOURCED COMPLIANCE FIRM CCO

A recent enforcement action, *In the Matter of David I. Osunkwo*,[22] highlights many of the shortcomings the SEC identified in the OCIE Risk Alert, as well as exemplifies the current climate for personal liability of outsourced compliance professionals.

In brief: an SEC-registered investment adviser retained an outsourced compliance firm to provide certain compliance functions, as well as a to provide an outsourced CCO. A principal at the outsourced compliance firm, David Osunkwo, was designated as the financial services firm's CCO, and in this role Osunkwo assisted the adviser and its management with, among other things, preparing and filing their Forms ADV.

According to the SEC, Osunkwo's actions and inactions with respect to several Form ADVs led to the investment adviser's failure to file accurate reports with the SEC. So, what exactly did the outsourced CCO do and/or fail to do? The Form ADV prepared by Osunkwo and filed by the adviser overstated the investment adviser's assets under management by over $119 million and the total number of client accounts by at least 1,000 accounts.

In preparing the filing of that Form ADV, Osunkwo relied solely on a single piece of information — an e-mail from the investment adviser's chief investment officer. Neither Osunkwo nor his outsourced compliance firm reviewed any custodial or account records or took any affirmative steps to ascertain the accuracy of those numbers. The underlying implication here also appears to be that had Osunkwo been more integrated into the business of the financial services firm and more diligent in his responsibilities, he would have realized that the information given to him was incorrect, or at least questioned or double checked its accuracy by talking to someone else within the organization.

The *Osunkwo* case exemplifies that outsourced compliance firms and personnel need to be able to independently obtain the records and access to individuals that they deem necessary for performing their services, as well as illustrating various theories of liability. The SEC's posture in the enforcement action was to hold Osunkwo primarily liable for his direct actions of willfully making untrue statements of material fact in a report filed with the SEC in violation of Section 207 of the Advisers Act. Notably, Osunkwo could also have been seen as secondarily liable for failing to take sufficient steps to ascertain the accuracy of the information provided for the filing of Form ADV in his role as CCO. As a result of such violations, Osunkwo was suspended from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization for a period of 12 months; suspended from serving or acting as an

[16] Rel. No. IA-5490 (2020).

[17] Rel. No. LR-24736 (2020).

[18] Rel. No. 34-75969 (2015).

[19] *Id*.

[20] Rel. No. 34-83604 (2018).

[21] Rel. No. LR-23551 (2016); Rel. No. IA-4065 (2015); U.S. Dep't of Treasury v. Haider, No. 15-CV-01518 (D. Minn. Dec. 18, 2014), ECF No. 1; The Non-Prosecution Agreement re: Banamex USA Criminal Investigation, U.S. Department of Justice Criminal Division (May 18, 2017), *available at* https://www.justice.gov/opa/press-release/file/967871/download.

[22] Rel. No. 34-81405 (2017).

employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such entities for a period of 12 months; and ordered to pay a civil money penalty in the amount of $30,000.

ENFORCEMENT AGAINST FINANCIAL SERVICES FIRMS UTILIZING OUTSOURCED COMPLIANCE FIRM SERVICES

There are also a number of cases against financial services firms that outsourced compliance functions. These include circumstances where the financial services firm either failed to supervise the outsourced compliance firm's or their personnel's activities, or failed to establish and maintain adequate written policies and procedures designed to prevent violations of the Advisers Act and its rules through the use of an outsourced compliance firm. In such cases, the SEC found financial services firms liable for, including but not limited to, failing to supervise an outside compliance firm's personnel with respect to their access to material non-public information,[23] failing to establish policies and procedures to prevent making any untrue statement of a material fact in any registration application or report filed with the SEC,[24] and failing to establish policies and procedures reasonably designed to safeguard customer records and information.[25]

A case in the United States District Court for the District of Massachusetts highlights another important issue when using an outsourced compliance firm — how should the outsourced firm be engaged? In *SEC v. Navellier & Associates,*[26] the district court ruled that, under the following circumstances, a financial services firm's engagement of, and interactions with, an outsourced compliance firm fell outside the scope of attorney-client privilege in an enforcement action against the financial services firm.

In the Navellier & Associates, Inc. ("NAI") case, an SEC-registered investment adviser, having recently learned about a FINRA enforcement action against a brokerage firm for marketing exchange traded funds, retained an outsourced compliance firm to conduct a compliance review of NAI's marketing materials regarding its exchange traded fund strategies. At the time NAI engaged the services of the outsourced compliance firm, NAI did not anticipate any enforcement action being brought.

Near the outset of the engagement, NAI's president forwarded various marketing materials directly to a partner of the outsourced compliance firm for review. In his reply e-mail, the partner invited NAI's president to follow up with him or his associate to gain clarity on the issues without any mention of counsel. Thereafter, the outsourced compliance firm performed a mock audit of NAI's marketing materials to give guidance to NAI's principals.

Subsequently, the SEC's enforcement division opened an investigation into NAI's marketing materials for its exchange traded fund strategies and subpoenaed NAI for documents relating to the investigation, including the mock-audit results and correspondence with the outsourced compliance firm.

Ultimately, the court held that the subpoenaed materials did not constitute attorney-client privileged materials or protected materials under the work-product doctrine and compelled NAI to turn over such subpoenaed materials to the SEC. The court found that the outsourced compliance firm was not "necessary, or at least highly useful" to NAI's counsel in providing legal advice to NAI, thereby failing to establish attorney-client privilege, and such materials were not prepared in anticipation of litigation, meaning the withheld materials were not protected by the work-product doctrine. Presumably, had NAI's outside law firm or potentially even in-house counsel engaged the outsourced compliance firm and managed the process, including sending information to the compliance firm and receiving information about its findings, and then sharing those findings along with its/their own legal analysis with NAI's principals, the records may likely have been protected by attorney-client privilege.

MANAGING OUTSOURCED COMPLIANCE RISKS

Anticipating the trend of increasing utilization of outsourced compliance firms to continue, financial services firms, whether they currently utilize or in the future may utilize outsourced compliance firms, should be cognizant that to effectively leverage the benefits of an outsourced compliance firm or personnel they must also recognize the potential challenges and risks accompanying such an approach and take appropriate steps to mitigate the risks in light of the current regulatory environment. Financial services firms need to recognize that outsourcing compliance functions has been and will likely continue to be subject to regulatory

[23] Rel. No. IA-4401 (2016).

[24] Rel. No. 33-10581 (2018).

[25] Rel. No. 34-84288 (2018).

[26] 2020 U.S. Dist. LEXIS 25154 (D. Mass., Feb. 13, 2020).

scrutiny. In addition, given the similarities of regulatory frameworks and uses of outsourced compliance firms, both investment advisers and broker-dealers should take note of the relevant interpretations, guidance, and cases illustrating the challenges and risks of outsourcing for both types of regulated entities.

In addition to being mindful of the challenges and risks, financial services firms and outsourced compliance professionals that perform critical compliance functions should consider: (1) that outsourced personnel have a strong and comprehensive understanding of the financial services firm's business, organizational and supervisory structure, key employees, corporate systems and governance, and the risks faced by the firm; (2) that outsourced personnel familiarize themselves with all regulatory schemes and compliance requirements applicable to the financial services firm; (3) that both the financial services firm and the outsourced personnel review the financial services firm's compliance and supervisory procedures for the specific functions of compliance, including the supervision of delegated functions, and appropriate tailoring to the financial services firm's actual business and compliance practices, taking into account the outsourced activities; (4) setting up a system to monitor and evaluate all outsourced functions, including as appropriate direct reporting and supervision, and potential redundant sampling; and (5) keeping track of the regulatory and enforcement climate, and regularly examine the guidelines, programs, comments, and major decisions issued by relevant regulatory authorities.

When evaluating outsourced compliance firms, financial service firms should perform due diligence reviews and carefully analyze: (1) the experience, expertise, and ability of the outsourced compliance firm; (2) the outsourced compliance firm's reputation and financial status, including obtaining referrals; (3) the effectiveness of the outsourced compliance firm's privacy and confidentiality controls and compliance tools; and (4) the risk of concentration of compliance functions with any single outsourced compliance firm. Candidates for outsourcing should be interviewed by different people at the financial services firm, including in-house counsel, or if there is no in-house counsel, by the financial services firm's outside regulatory law firm.

Lastly, financial services firms should consider acting through their regulatory counsel when engaging outsourced compliance firms for non-CCO functions. Having legal counsel engage, manage the process, and interact with the outsourced compliance firm, and act as a go-between the financial services firm and the outsourced compliance firm should strengthen the financial services firm's ability to preserve attorney-client privilege in the event any enforcement proceedings are commenced after having engaged the outsourced firm.

ARE CHANGES ON THE HORIZON?

On October 19, 2020, in an address before the National Society of Compliance Professionals, SEC Commissioner Hester M. Peirce advocated for a review of the Compliance Rules, including CCO personal liability.[27] In her address, Commissioner Peirce criticized the uncertainty surrounding the Compliance Rules, and the facts and circumstances underlying the SEC's enforcement decisions to charge and to not charge CCOs. Commissioner Peirce also argued that, under current SEC guidance and enforcement precedent, pursuing CCO's under the theory of "Liability for Failing to Supervise" has created a system of strict liability that is driving professionals away from practicing compliance. Commissioner Peirce called for the creation of a "framework detailing which circumstances will cause the SEC to seek personal liability and which circumstances will militate against seeking personal liability" to eliminate uncertainty and inspire good compliance practices. Commissioner Peirce is considering developing a draft framework to be submitted to the SEC and industry participants. Any such changes, if adopted, also could affect how the SEC views and brings enforcement actions against outsourced compliance, and in particular, outsourced CCOs. ■

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[27] Hester M. Peirce, Commissioner of the Securities and Exchange Commission, Speech *When the Nail Fails – Remarks before the National Society of Compliance Professionals* (October 19, 2020) *available at* https://www.sec.gov/news/speech/peirce-nscp-2020-10-19.