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COMMENTARY: How compliance officers and firms can help limit CCO personal liability

Feb 22 2017 Janaya Moscony and Steve Troche

Many fear the President Donald Trump's deregulation drive could undo much of the hard work and progress that has been made over the past several years in reforming Wall Street's culture. In particular, Mary Jo White, former Commissioner of the Securities and Exchange Commission (SEC), made significant headway in promoting ethics through her "broken-window" approach to enforcing SEC rules.

Before 2008, we witnessed an industry that dismissed compliance much more readily than today. The recent critical eye on compliance has resulted in tightened controls and operations at firms which in turn has resulted in additional protections for investors.

The discussion regarding the affects the new administration will have on the compliance and the industry reverberates throughout the financial services industry. It appears the SEC does not plan on reversing course anytime soon despite assumptions being made about Trump's administration.

In fact, the SEC's more recent trend toward holding individuals personally liable for their conduct will continue to hold steady as well.

Speaking last November at ACI's 33rd International Conference on the Foreign Corrupt Practices Act (FCPA), the SEC's then-Enforcement Director, Andrew Ceresney, described how the SEC has prioritized FCPA enforcement with a focus on individual liability. Ceresney explained that "pursuing individual accountability is a critical part of deterrence" and holding officers accountable for negligence.

Ceresney's statements are the kind that keep financial professionals wondering when the other shoe will drop. This guidance -- and the varying fact patterns inherent in the cases involving recent instances of CCOs being held personally liable -- reinforce the necessity that companies and officers (like CCOs) evaluate what they can do to shield themselves from professional and personal liability.

Indemnities -- the first line of defense

Directors and officers are generally provided with indemnification with respect to the entity that they serve. Subject to limitations, indemnification generally allows for directors and officers to be financially covered by the firm for legal expenses and other liabilities incurred by them as defendants or witnesses in related actions.

Indemnification protections are generally delineated in contracts, but can occasionally be found in an insured entity's organizational documents. They typically provide directors and officers with the maximum indemnification permitted under state and federal law.

Whether a CCO is required to be indemnified by a company depends on the state of incorporation, so it is important to make sure that the CCO is properly recognized as a corporate officer of the insured entity. Some states require that the CCOs are need only be appointed in the bylaws of the insured entity as a corporate officer, while other states might additionally require that the CCO also be appointed as a corporate officer in state filings.

Some circumstances could cause the entity providing the indemnity to withhold it. The entity may not have the funds or it may just choose to withhold it because of a conflict with the director or officer. This is why the indemnity is only the first line of defense.

Insurance -- Do not cut corners

When considering insurance, CCOs initially must understand exactly what risks can be transferred or mitigated.

Careful attention must be given to matching the exact insurance products and riders to the risk sought to be transferred, and knowing where the pitfalls exist which could result in a claim being denied. Both errors-and-omissions and directors and officer liability coverage have been in the marketplace for decades, and as such, have well-established standards and terms.

Other types of coverage, such as cyber security insurance, which are infants in the marketplace, do not have the same conventions as other policies.

Errors & omissions (E&O) policies are widely used throughout the industry to help protect against claims by clients arising out of professional services provided by the insured.

Directors & Officer Liability (D&O) coverage can be added to an E&O policy or purchased separately, to protect the firm as well as the directors, officers, partners and employees of the insured entity for claims arising out of business decisions, not investment decisions.

D&O is where one would find coverage for "claims" (including formal regulatory investigations costs) by non-clients such as the SEC and U.S. Department of Labor that are not triggered by a client complaint.

Side A, Independent Directors Liability (IDL) Insurance typically serves as a supplemental policy to D&O coverage, and would come into play in circumstances where indemnification is not available or is refused. Side A IDL insurance helps fund independent directors mitigate liability and exposure to various risks associated with indemnification (when a fund is legally prohibited from paying for a director/officer's defense); erosion risk (when a D&O policy has exhausted its limits of liability); and coverage risk (when a D&O policy does not provide coverage for the situation).

Cyber Insurance is designed to cover consumers of technology services or products. More specifically, the policies are intended to cover a variety of both liability and property losses that may result when a business engages in various electronic

activities.

Most notably, but not exclusively, cyber policies cover liability for a data breach in which client information is exposed or stolen by an individual who has gained access to the firm's electronic network.

Additional riders

Many insurance riders can accompany the policies outlined above. An insurance rider is an available enhancement option that a broker can negotiate to be included in a policy.

Riders can help supplement your existing coverage and provide additional benefits usually at little additional cost. Financial professionals need to understand policy definitions and exclusions, and discuss the various options available with their broker.

When reviewing these policies, directors and CCOs should gauge their total risk profile (including total amount of assets) and review against existing protections, such as indemnification. Then, while consulting with an insurance professional, you should work towards understanding what risks are covered, and which risks are not.

Chief Compliance Officers must ensure they are diligent when reviewing or purchasing insurance products. Quite often, when it is time to file a claim the fine print is what matters.

What to look for in a CCO

Given the SEC's recent cases and speeches, advisers should ensure that the CCO has the right experience and background -- specifically a background that shows he or she understands all relevant SEC regulations. Advisers should also ask questions and understand the niche experience that is needed to be an effective CCO.

Several factors distinguish a well-suited CCO from an inexperienced, lower-cost alternative. Such examples include:

- extensive experience;
- the ability to customize a compliance program to the fund's business, interact with service providers and test the compliance program to appropriately identify potential failures;
- accountability and time-management skills; and
- dependability and reliability.

These skills are not exclusive to CCOs however, as fund directors must possess many of the aforementioned skills in order to perform their oversight tasks in an ever-evolving regulatory environment.

Additionally, while fund directors do not need to customize and test a compliance program, they must have a certain level of familiarity in order to properly identify potential failures.

These traits and issues for both board members and officers are long standing and well-established in the industry, and will remain paramount for the foreseeable future. Whether under one administration or the next, certain issues remain enduring.

New regime

Even if SEC enforcement under Trump's nominee for SEC chair, Jay Clayton, proves to be less prone to bringing cases than White, there are more reasons to take compliance seriously than just to avoid SEC enforcement.

Even under the new regime, insurance claims are expected to continue to rise.

In ICI Mutual's 2015 Annual Claims Trends, the company noted that 2015 saw an increase in the overall number of claims submitted to them by fund groups under their D&O/E&O policies. Further, ICI Mutual stated that nearly 25 percent of their insured fund groups submitted at least one claim notice during 2015.

Over the five-year period from 2011 to 2015, approximately 50 percent of their insured fund group submitted at least one claim notice. The continuing trend of claims increasing year over year will remain largely unaffected by a new administration, and any possible effect down the road would likely be marginal at best.

Another trend that unlikely to lose steam is increasing institutional investor demand for compliance. Institutional investors are not unlikely to turn back the clock with their due diligence procedures nor are they likely to reduce demands.

Heightened demand for due diligence on cyber security is rampant throughout the industry.

Also, even if the new administration shows a lighter touch on enforcement, deficiency letters are likely to remain unchanged. Institutional investors and boards will still need to know about compliance issues and they will still present liability concerns and hence, require mitigation.

Some expect the Trump administration to promote a deregulatory regime similar to the Reagan Administration, which would reduce SEC oversight, and subsequently, reduce oversight by financial industry participants.

Even if some areas of financial and securities regulations are rolled back, the SEC will likely continue to name individuals in future enforcement cases. Recent history has shown that CCOs and boards of directors need to know more than compliance.They need to understand how to protect their reputation and livelihood. Even under a deregulatory administration this will be critical.

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