While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers (Again)[1]

By Brian L. Rubin and Katherine L. Kelly

Brian L. Rubin is a partner in the Washington, D.C. office of Sutherland Asbill and Brennan, LLP, where he represents companies and individuals being examined, investigated and prosecuted by the Securities and Exchange Commission, the Financial Industry Regulatory Authority (FINRA) and the states. He also advises broker-dealers and investment advisers on federal and state regulatory and compliance matters.

Katherine L. Kelly is a member of Sutherland Asbill & Brennan's Litigation Practice Group where she focuses on securities litigation.

Introduction

*"I would **never** act that way."*

*"Such conduct couldn't happen at **my** firm."*

*"I certainly am not a supervisor. I'm in **compliance**."*

Time and again, we have heard these comments when discussing disciplinary actions taken against chief compliance officers (CCOs). Everyone's sure that he or she could *never* be disciplined. Yet, the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) regularly bring disciplinary actions against compliance officers and other non-business line supervisors (such as attorneys). Therefore, we are writing this column on disciplinary actions as a regular feature in this journal, with the hope that compliance officers (and management) may be able to learn from the "mistakes" of others.

From August through mid-November 2010, the SEC and FINRA brought disciplinary actions against CCOs and, in one attention-getting case, a general counsel for alleged misconduct that included failing to supervise, aiding and abetting their firms' underlying violations (deficient recordkeeping and inadequate written policies and procedures), permitting an unregistered individual to act as a principal, and failing to report customer complaints.

Failing to Supervise

This section analyzes cases where CCOs (and in one case, a general counsel) were deemed to be acting as supervisors, were charged with inadequate supervision, and, apart from the general counsel, were found liable. In general, CCOs don't – and shouldn't – supervise.

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Therefore, they are usually not subject to supervisory liability. However, compliance officers on occasion take on certain supervisory obligations, sometimes all at once and sometimes slowly over time (what we call "supervisory creep"). When this occurs, and, more specifically, when compliance officers have sufficient "responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue," they may become subject to liability for supervisory failures.[2] The meaning of "responsibility, ability, or authority to affect" an employee's conduct was recently analyzed in great detail by an SEC administrative law judge (ALJ) in a case brought against a firm's general counsel.[3] The ALJ's decision represents an extremely broad understanding of what it means for a compliance or legal officer to "affect" the conduct of an employee. If the ALJ's analysis is affirmed on appeal to the full Commission, it could potentially expand the scope of conduct that may brand a compliance officer with a supervisory label.

"A supervisor by any other name…"

In one recent litigated SEC administrative proceeding, the ALJ found that the general counsel of a broker-dealer was a supervisor, much to the surprise of many in the industry.[4] (To the relief of many, including presumably the general counsel, the ALJ also found that he had been acting reasonably in exercising that supervisory responsibility.) While this case does not involve a CCO, it does illustrate circumstances in which CCOs may be considered supervisors. It further provides examples of how a non-business line supervisor reasonably discharged supervisory duties.

The genesis of the case was a broker who was involved with a well-publicized $50 million Ponzi scheme.[5] The SEC, naturally, investigated what the firm knew or should have known about his conduct. That led them to the general counsel who also headed the Compliance, Human Resources, and Internal Audit departments of his firm. The ALJ noted that the Legal and Compliance departments were essentially viewed in the firm as one entity. In assessing whether the general counsel was the broker's supervisor, the ALJ acknowledged that the general counsel "did not have any of the traditional powers associated with a person supervising brokers," such as hiring or firing the broker. Instead, the general counsel fulfilled the typical legal and compliance function of providing advice and recommendations. Nonetheless, the ALJ determined that the general counsel was the broker's supervisor based largely on the following facts:

- His legal and compliance opinions were viewed as "authoritative" and his "recommendations were generally followed by people in [the firm's] business units."
- Though he did not direct the firm's response to concerns about the broker, he was a member of the firm's Credit and Risk Committee which reviewed compliance employees' concerns about the broker, and the general counsel dealt directly with the broker on behalf of the Committee.

In determining that the general counsel exercised his supervisory responsibility reasonably, the ALJ emphasized the following:

- The general counsel did not know of the broker's criminal conduct.
- After receiving a Compliance Department memorandum outlining concerns about the broker, the general counsel visited the broker's branch office and consulted numerous supervisory personnel who assured him the broker was adequately supervised.
- After learning that the broker was not informing his clients of trades within their accounts, the general counsel recommended the broker's termination (although the recommendation was not followed) and had the Compliance Department file a Form RE-3 with the New York Stock Exchange, citing the broker for unauthorized trading.
- The general counsel had a reasonable basis for relying on a senior executive's representation that he would exercise special supervision over the broker.
- The general counsel shared with the Compliance Department all information he had regarding the broker.

In finding that the general counsel acted reasonably, the ALJ rejected the Enforcement Division's arguments that the general counsel was required to go to his Chief Executive Officer or Executive

Committee, stating that it was reasonable for the general counsel to believe these actions would have been futile. The ALJ did not, however, directly address the Enforcement Division's argument that the general counsel ought to have resigned and reported his concerns to regulatory authorities.

The SEC's Enforcement Division has filed a petition to the full Commission for a review of the dismissal, while the general counsel has filed a cross-petition requesting a review of the finding that he was the broker's supervisor. The general counsel argues that the ALJ employed an overly broad standard for determining who is a supervisor and that the decision could subject any legal officer to supervisory liability.[6] Other interested parties, who agree that the ALJ's supervision standard is overly broad, argue that the decision places compliance officers at a similar risk for supervisory liability merely for performing day-to-day compliance functions.[7]

The general counsel appears to have performed traditional legal and compliance functions for his firm. Indeed, the very conduct that formed the basis of the ALJ's determination that the general counsel exercised supervision (making recommendations and serving on committees) seems like behavior one would expect (and want) from legal and compliance officers. In performing their advisory roles, legal and compliance officers often make inquiries and conduct investigations into potential compliance issues. However, ultimate responsibility for acting on the advice of legal and compliance personnel rests with business line supervisors. This separation from business line supervisors and the firm's revenue-generating units could help compliance and legal officers maintain their objectivity and their independence. In contrast, by subjecting the general counsel to supervisory liability, without any finding that he could, for example, terminate, suspend, fine, or reduce the compensation of the broker, the decision may deter legal and compliance officers from involving themselves too significantly in situations where their advice is most needed.

To minimize exposure to similar findings of supervisory responsibility in the future, firms, counsel and compliance officers may want to consider implementing the following steps:

- Written supervisory policies and procedures could:
  - Identify the direct supervisors of all employees; and
  - Specifically state that legal and compliance personnel are limited to offering advice and recommendations and do not have the responsibility, ability or authority to affect the conduct of employees outside of their departments.
- Where misconduct of employees or representatives is addressed, the firm could document which business line supervisor is handling the issue and how.
- When attorneys or compliance officers serve on firm committees, the firm could document that their role is only advisory in nature.
- Where a legal or compliance officer does have serious concerns about potential violations of the law, she may want to consider escalating the matter to senior management.

"Keep your friends close . . . and your staff closer."

At times, CCOs supervise their compliance officers or staff. Such direct supervision can lead to liability. In November 2010, FINRA announced it had fined a CCO $50,000 and suspended her in a principal capacity for one year based, in part, on her failure to supervise two such employees.[8] The firm's written supervisory procedures identified the CCO as a supervisor and both employees reported directly to her. The first employee, a compliance officer, had

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been delegated the duty of ensuring that order tickets were properly prepared and maintained. According to the Letter of Acceptance, Waiver and Consent (AWC), the CCO failed to supervise because she took no steps to ensure that the compliance officer fulfilled his responsibilities. The second employee, an administrative assistant, had been delegated the responsibility of reviewing electronic communications. The AWC states that the delegation was not made in writing and that the CCO failed to provide the assistant sufficient guidance regarding how she should review electronic communications.

The sanctions were also based on the CCO's role in the firm's failure to establish, maintain, and enforce an adequate supervisory system. That failure arose because a firm committee, on which the CCO served, failed to establish interim procedures to monitor the firm's order activity, while the committee was reviewing and approving changes to the firm's written supervisory procedure and developing the firm's monitoring procedures. The AWC found that the CCO and another executive were responsible for this failure.

Two other cases also concern a failure to supervise individuals who reported directly to the CCO. In one, a CCO submitted an AWC fining her $10,000 and suspending her in any principal capacity for one year for, among other violations, failing adequately to supervise the firm's designated securities compliance officer (DSCO).[9] More specifically, the CCO failed to ensure that the DSCO was taking adequate steps to uncover fraudulent or manipulative schemes.

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In the other case, FINRA fined a CCO $5,000 and suspended him in any principal capacity for one year for a number of violations, including failing to supervise personnel who had been delegated the task of reporting customer complaints and filing Forms U4 and U5 with FINRA.[10] In addition, pursuant to the AWC, the CCO was liable for failures connected with his role as his firm's Anti-Money Laundering Compliance Officer.

Aiding and Abetting

CCOs are sometimes found liable for aiding and abetting the conduct of others. Under the relevant case law, liability for aiding and abetting requires an underlying violation, substantial assistance in connection with the primary violation, and scienter. Previously there was a split among Circuits as to whether recklessness satisfied this scienter requirement. This issue was clarified by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Sections 929M, 929N, and 929O of that Act amended Section 15 of the Securities Act of 1933 (Securities Act), Section 20(e) of the Securities and Exchange Act of 1934 (Exchange Act), and Section 209(f) of the Investment Advisers Act of 1940 (Advisers Act) to provide explicitly for aiding and abetting liability for reckless, as well as knowing, conduct.[11] In addition, CCOs are sometimes found secondarily liable for "causing" violations. Causing liability similarly requires a primary violation and an act or omission by the respondent that causes the violation, but causing liability, at least in some cases, requires only a negligent state of mind.[12]

"I said I would do what?"

CCOs sometimes respond substantively to regulatory requests, such as concerns expressed by a regulator in a deficiency letter or cautionary action letter. The firm, through the CCO, may respond by explaining what the firm intends to do to address those concerns. If the firm fails to follow through, the CCO might be left holding the bag (and paying the penalty). This situation arose in a November 2010 SEC administrative settlement.[13] In that case, the SEC censured the CCO of a registered broker-dealer and its subsidiary registered investment adviser, entered a cease and desist order, and assessed a $35,000 civil penalty against the CCO for aiding and abetting his firms' violations. In response to a deficiency letter regarding the investment adviser's monitoring of employees' personal trading, the CCO authored a response in which he represented that the deficiencies would be remedied through new written policies that were going to be drafted and implemented. According to the SEC's later findings, the new written policies and procedures that were implemented after the deficiency letter did not adequately reflect the promised more stringent procedures, and the CCO failed to conduct quarterly reviews of employee trading, which he had indicated he would do.

The CCO was liable because he was responsible for establishing and administering the policies at issue, and he "was aware of the compliance weaknesses and failures and either failed to act or failed to correct them." The SEC found that both the broker-dealer and the investment adviser failed to establish, maintain, and enforce policies designed to prevent the misuse of material, non-public information. According to the SEC, the CCO willfully aided and abetted and caused the firms' violations under both the Exchange Act and the Advisers Act. Pursuant to the terms of the settlement, both firms were censured, the broker-dealer agreed to pay a penalty of $50,000, and the investment adviser agreed to pay $75,000.

"Policies? Yeah, I guess that does ring a bell."

Many CCOs are directly responsible for ensuring that their firm's policies and procedures are adequate. When those policies are inadequate, the SEC and FINRA sometimes blame the CCOs for that failure. For example, in a September 2010 settlement order, the SEC barred a registered investment adviser's CCO from association with any investment adviser for, among other violations, willfully aiding and abetting and causing his firm's failure to adopt and implement written policies and procedures designed to prevent violations of the Advisers Act.[14] With respect to the written policy failures, the SEC found in connection with a settlement the following:

- The firm's policies and procedures recited general legal requirements, but did not contain procedures tailored to the firm's business operations and practices.
- The CCO failed to implement effectively the policies the firm did have in place.
- The CCO failed to conduct annual reviews of the firm's policies and procedures to assess their adequacy.

Based on that conduct, the SEC concluded that the CCO willfully aided and abetted and caused the firm's violation of the Advisers Act policies and procedures provision.

The SEC settlement further found that the firm violated the recordkeeping provision of the Advisers Act by failing to keep adequate records of the transactions. Because the CCO and the firm's other principal were responsible for maintaining records for the investments they had directed, the SEC determined they had willfully aided and abetted and caused the firm's recordkeeping violation.

The CCO was also found to have directly violated certain provisions of the Advisers Act (and those violations likely weighed heavily in his getting barred). The SEC held that the CCO and the firm violated Section 207 of the Advisers Act by repeatedly misrepresenting on the firm's Form ADV that it did not recommend securities to clients in which the firm or its principals had an interest. The SEC Order highlighted the fact that the CCO's "primary activity as [the firm's] chief compliance officer was to prepare, sign, and file [the firm's] Form ADV filings." In addition, the firm and its two principals, one of whom was the CCO, were found liable by the SEC for violating the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act in connection with their investment of client funds into entities that the firm's principals owned without disclosing the conflict of interest.

Permitting an Unregistered Individual to Act as Principal

"But I checked to make sure he had a driver's license."

CCOs play a variety of roles. On occasion, one of those is to ensure that people are properly licensed. When it turns out that someone does not have the proper registration, the CCO may be disciplined for that failure. For example, in August 2010, FINRA sanctioned a CCO for, among other things, allowing an individual to act as a firm principal without proper registration.[15] In addition, FINRA found that the CCO failed to ensure the sufficiency of the firm's written supervisory procedures and did not enforce the firm's documentation requirements relating to outside business activities. FINRA fined the CCO $5,000, suspended him for two months, and required him to requalify in all principal capacities.

Failing to Report Customer Complaints to FINRA

"Complaints are so . . . negative."

CCOs often play a role with regard to making filings to regulators. When firms fail to make required filings, they may get sanctioned. On occasion, individuals who are responsible for that failure may also face disciplinary actions. In October 2010, FINRA fined and censured both a firm and its CCO for failing to report customer complaints to FINRA pursuant to NASD Rule 3070(c).[16] Through a settled action, the parties were fined $10,000, jointly and severally. Similarly, in one of the settlements cited above, a CCO was fined $10,000 and suspended as a principal for one year for, among other violations, failing to ensure that her firm reported customer complaints to FINRA and timely filed Forms U4 and U5 with FINRA.[17]

Conclusion

The handful of cases outlined here does not provide a comprehensive guide to CCOs seeking to comply, nor does it set forth hard and fast rules. Instead, these cases provide examples of behavior that has caught the eye of regulators and that the wary CCO may want to keep in mind if faced with similar factual circumstances. In addition, this review of recent disciplinary actions highlights a regulatory gray area that firms and CCOs may want to approach with special caution. Specifically, the SEC's ALJ decision has highlighted the nebulous nature of what it means to "supervise." If that decision survives the appeal, CCOs and general counsel (or "general counsels" or "generals counsel," if you prefer) should consider documenting as clearly as possible who supervises whom and the specific roles being played (and not being played) by compliance and legal staff. Moreover, given the heightened risk of potential supervisory liability, they should consider thoroughly documenting their response to compliance concerns and reporting serious concerns up the chain to their own supervisors.

ENDNOTES

1. The first article in this series was published in the September-October 2010 issue of this journal. *See* Brian L. Rubin & Katherine L. Kelly, *While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers*, Practical Compliance & Risk Management, Sept-Oct 2010 at 39.
2. *George J. Kolar*, Exchange Act Rel. No. 46127, 55 S.E.C. 1009, 2002 SEC LEXIS 1647, *13 (June 26, 2002) (quoting *John H. Gutfreund*, Exchange Act Rel. No. 31554, 51 S.E.C. 93, 113, 1992 SEC LEXIS 2939, *47 (Dec. 3, 1992)).
3. *Theodore W. Urban*, Initial Decisions Rel. No. 402, 2010 SEC LEXIS 2941 (Sept. 8, 2010).
4. *Id.*
5. Paul Adams, *Ex-Ferris broker given 33 month prison term*, Baltimore Sun, Dec. 14, 2007, *available at* http://articles.baltimoresun.com/2007-12-14/business/0712140018_1_glantz-broker-securities-fraud.
6. Respondent Theodore W. Urban's Brief in Support of His Conditional Cross-Petition for Review at 23-24, *In the Matter of Theodore W. Urban*, Admin. Proc. File No. 3-12655 (Nov. 22, 2010).
7. *See* Brief of *Amici Curiae* the Securities Industry and Financial Markets Association, *et al.* at 4, *In the Matter of Theodore W. Urban*, Admin. Proc. File No. 3-12655 (Nov. 22, 2010).
8. *FINRA Sanctions Trillium Brokerage Services, LLC, Director of Trading, Chief Compliance Officer, and Nine Traders $2.26 Million for Illicit Equities Trading Strategy*, Disciplinary and Other FINRA Actions (Nov. 2010); *see also* Trillium Brokerage Services, LLC, Letter of Acceptance, Waiver, and Consent, No. 20070076782-01 (July 7, 2010).
9. FINRA Case No. 2007007151701, Disciplinary and Other FINRA Actions (Oct. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p122274.pdf.
10. FINRA Case No. 2007007151703, Disciplinary and Other FINRA Actions (Oct. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p122274.pdf.
11. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. H.R. 4173, 111th Cong. (2009-2010).
12. *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1175 (2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002) ("[N]egligence is sufficient to establish 'causing' liability under Exchange Act Section 21C(a), at least in cases in which a person is alleged to 'cause' a primary violation that does not require scienter").

[13] *Buckingham Research Group, Inc.*, Exchange Act Rel. No. 63323, 2010 SEC LEXIS 3830 (Nov. 17, 2010).

[14] *Sierra Financial Advisers, LLC*, Securities Act Rel. No. 9145, 2010 SEC LEXIS 3130 (Sept. 23, 2010). The SEC did not impose a monetary penalty against the CCO, based on his sworn representation in his Statement of Financial Condition.

[15] FINRA Case No. 2006003916901, Disciplinary and Other FINRA Actions (Aug. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p121915.pdf.

[16] FINRA Case No. 2008011806301, Disciplinary and Other FINRA Actions (Oct. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p122274.pdf.

[17] FINRA Case No. 2007007151701, Disciplinary and Other FINRA Actions (Oct. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p122274.pdf.

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