The Chief Compliance Officer Who Wasn't Framed: Applying the NSCP's Firm and CCO Liability Framework to an SEC CCO Enforcement Action

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"If a problem can't be solved within the frame it was conceived, the solution lies in reframing the problem."[1]

On June 30, 2022, the Securities and Exchange Commission (SEC) brought a settled enforcement case[2] against a Chief Compliance Officer (CCO) and a Registered Investment Adviser (RIA). At first glance, the case appears straightforward. As the layers of the onion are peeled off, the case is far more confusing, and it screams for a framework to see whether the SEC alleged sufficient facts to charge and sanction the CCO and to provide guidance to other CCOs going forward. Luckily for us, on January 10, 2022, the National Society of Compliance Professionals (NSCP) issued its "Firm and CCO Liability Framework" to "provide guidance to regulators, CCOs, and firms regarding perceived or actual CCO liability."[3]

An analysis of this enforcement case under the NSCP Framework shows that, given the dearth of facts set forth in the Order, it raises more questions than answers—and will, unfortunately, lead to more uncertainty about the role of CCOs and the standards the SEC uses when it sanctions them.

The Basic Facts

The SEC found that the RIA failed to adopt and implement reasonable written policies and procedures and that the CCO aided and abetted and caused those violations. The CCO was a firm "principal" and a registered representative with a Broker-Dealer (BD) used by the RIA in its advisory business. The "bad" conduct that is the genesis of this case is an Investment Adviser Representative (IAR) who allegedly failed to disclose his Outside Business Activities (OBAs) to the RIA and failed to comply with the policies of the unaffiliated BD. (Although the SEC's Order does not state who the IAR was or whether the SEC brought an action against him, as discussed below, it appears that the SEC did file a Complaint against him, however, not for OBA violations, but for committing fraud.)[4] With regard to the CCO, the Order alleged that he failed to make sufficient changes to the design and implementation of the RIA's compliance program, and he failed to take sufficient steps when he became aware of the IAR's OBAs.

Underlying (Missing) Facts

The Order, unfortunately, fails to include many facts that appear to be relevant for determining both liability and sanctions. Such facts also would have assisted other CCOs in knowing what the charged CCO did incorrectly and what he should have done differently to avoid liability. As shown below, the missing facts also make it difficult to apply a framework for liability, such as the NSCP Framework. If the SEC had focused more on the questions presented in the NSCP Framework, answers to those questions would have provided the industry with much-needed guidance.

1. Missing facts about the IAR

As noted above, on June 30, 2022, the same date as the settled Order, the SEC filed a Complaint in federal court apparently against the unnamed IAR. According to the Complaint, he was co-owner, principal, managing member, and an IAR of the RIA, as well as a registered representative of the BD. While he was not charged with OBA violations, he was charged with defrauding two advisory clients and one brokerage customer by misappropriating their funds for his personal use. The Complaint alleged that the IAR solicited, advised, or helped advisory clients invest in an entity he controlled or had account authority over, and then used those funds for his personal use.

1. https://www.goodreads.com/quotes/tag/frame#:~:text=%E2%80%9CIf%20a%20problem%20can't,lies%20in%20reframing%20the%20problem.%E2%80%9D&text=%E2%80%9CIt's%20funny%20how%20the%20beauty,frame%20than%20the%20artwork%20itself.%E2%80%9D&text=%E2%80%9CMy%20power%20grew%20angry%20that,pulled%20against%20my%20taut%20skin.
2. A copy of the settled Order can be found at https://www.sec.gov/litigation/admin/2022/34-95189.pdf?utm_medium=email&utm_source=govdelivery.
3. A copy of NSCP's "Firm and CCO Liability Framework" can be found at https://static1.squarespace.com/static/61a9074028e505179c284c97/t/61e19a0f1d3d656f1cfbbf3c/1642174991168/NSCP+Firm+and+CCO+Liability+Framework+Jan+2022.pdf.
4. A copy of the SEC's complaint can be found at https://www.sec.gov/litigation/complaints/2022/comp25435.pdf.

Notably, the Order, which sanctions the CCO, fails to set forth any of these facts, including identifying the IAR or his supervisor, and whether that supervisor had the ability to control his conduct. Further, the Order does not explain how the IAR's OBAs relate to the allegations in the Complaint that the IAR misappropriated customer funds. The Order also is confusing because, at one point, it refers to "another OBA" that should have been reported, without detailing the difference between that OBA and the previously referenced OBA. Later in the Order, it refers to "the OBA" five times, without explaining which OBA it was referring to.

2. Missing facts about the RIA's compliance program

The SEC summarily asserts that "[f]rom at least December 2019, [the CCO] knew or should have known that [the RIA's] compliance program was inadequately implemented. Despite this, he did not make sufficient changes to the design and implementation of [the RIA's] compliance program."

The Order does not explain the basis for finding the compliance program was "inadequately implemented." The only facts presented in the Order address the CCO's knowledge about the IAR's conduct and the "insufficient" steps taken by the CCO—without a detailed recitation of what the CCO actually did or failed to do, or what the CCO could have done differently. Further, the Order does not address what changes to the design and implementation of the compliance program the CCO could have made or whether the CCO had requested or received sufficient support from the RIA's management, which included the IAR.

3. Missing facts about the adequacy of disclosures

The SEC found that "[the CCO] did not take sufficient steps to verify that [the RIA] or the IAR had adequately disclosed to clients the IAR's relationship to the OBA or any associated conflicts of interest."

The Order does not explain why the CCO was faulted for not taking sufficient steps regarding the adequacy of disclosure to clients about the OBA and any associated conflicts. In fact, the Order does not even allege that this was the responsibility of the CCO. Along these same lines, the Order does not spell out who at the RIA had the actual responsibility, ability, or authority to verify the adequacy of the disclosures.

4. Missing facts about communications received by the CCO

The SEC found that "[i]n June 2020, [the CCO] received further communications related to the OBA that indicated the IAR had failed to meet the requirements of [the IAR's] compliance program. Despite this notice, [the CCO] did not sufficiently ensure the OBA was being adequately and accurately reported pursuant to [the RIA's] compliance program."

The Order does not provide details regarding the nature, content, or source of these communications. The Order also does not specify what "requirements" the IAR failed to meet, including whether that failure was related to the IAR's failure to submit a reporting form or something else. Finally, the Order does not explain how the CCO could have sufficiently ensured that the OBA was adequately and accurately reported.

5. Missing facts about flagged transactions

The SEC found that "[i]n August 2020, [the CCO] received notice that certain transactions conducted by the IAR involving transfers of [the RIA's] client assets to the IAR's OBA had been flagged by the Broker-Dealer for review, but [the CCO] did not conduct sufficient review to determine the legitimacy of the transactions."

The Order does not explain: (i) why the transactions were flagged; (ii) why the BD reported the issue to the RIA; (iii) the meaning of the term "legitimacy" in this context; (iv) whether a supervisor, the CCO, or someone else was tasked with reviewing the legitimacy of transactions or whether the firm's policies were unclear as to who was responsible; (v) what the CCO could have done if he had conducted a review; and (vi) whether the CCO was required to report anything to the BD about this issue given that it flagged the transactions.

Basis for Liability and Sanctions

Unfortunately, with this record, it isn't exactly clear why the SEC sanctioned the CCO (or the firm for that matter) and imposed the sanctions that it did. For example, it's not clear:

- Why one individual's failure to take certain unspecified steps means that the firm failed to adequately implement its compliance program;
- Why the RIA and the CCO were charged in connection with the unaffiliated BD's policies;
- What authority the CCO had as a "principal," and whether the CCO had the actual responsibility, ability, or authority to:
    - affect the IAR's conduct by requiring him to complete and submit the OBA form;
    - change disclosures or conduct conflict review; or
    - affect transaction review to determine the legitimacy of the transactions;
- What steps the CCO took that were insufficient, why didn't he take sufficient steps (due to, for example, resource or other constraints), what sufficient steps would have been, and whether he could have taken them; and
- How the Order took into account that the CCO eventually reported the OBA.

Without answers to these questions, we don't know why exactly the CCO was charged or what he could have done differently. Enforcement actions should provide guidance to market participants so that others will "do the right thing" in the future (at least, according to Enforcement Staff) and protect clients and the marketplace. Instead, the Order suggests that CCOs have targets on their backs and that the SEC will continue to second-guess CCOs' conduct.

Applying the NSCP Framework

Because of the importance of CCO liability to the financial services industry, various organizations, including the New York City Bar Association (NYCBA)[5] and the NSCP, have proposed frameworks to assist regulators in the difficult task of assessing the conduct of CCOs. Indeed, in a separate statement supporting the settlement, Commissioner Peirce attempted to apply the NYCBA's framework.[6] Unfortunately, applying that framework was difficult because of the dearth of alleged facts included in the final Order, raising questions about what liability standards the SEC applied. For example, one question the NYCBA's framework asks is whether the CCO made a good faith effort to fulfill his or her responsibilities. Commissioner Peirce responded to this question by concluding that, "As a principal of the firm, he had adequate authority to address the compliance inadequacies." While the Order found that the CCO was a principal, the Order did not explain what that term meant in this context. (It is of course possible that Commissioners and Enforcement Staff knew additional facts not set forth in the Order or in the Complaint.) However, based on the SEC's Complaint filed against the apparent "bad guy," it was the IAR, and not the CCO, who was the firm's "managing member," presumably meaning that he was the head of the RIA and possibly meaning that the CCO reported to him. In addition, although Commissioner Peirce used the word "authority," the Order *never* used that word.

5. The NYCBA "Framework for Chief Compliance Officer Liability in the Financial Sector" can be found at: https://s3.amazonaws.com/documents.nycbar.org/files/NYC_Bar_CCO_Framework.pdf.
6. Commissioner Peirce's July 1, 2022 statement titled: "Chief Compliance Officer Liability: Statement on In the Matter of Hamilton Investment Counsel LLC and Jeffrey Kirkpatrick" can be found at: https://www.sec.gov/news/statement/peirce-statement-hamilton-investment-counsel-070122?utm_medium=email&utm_source=govdelivery#_ftn2.

Instead, the Order stated that the CCO was "responsible" for "administering" the compliance program and "implementing" the firm's compliance policies and procedures. But the Order did not state that he had the authority (or responsibility or ability) to affect the conduct of the IAR.

In determining whether to charge the CCO here, the Commissioners could have applied the NSCP Framework, which focuses on "the larger context of the compliance function within firms," evaluating real-world issues such as whether the compliance officer had actual ability to affect conduct and the resources to do the job. As such, the NSCP Framework presented nine questions to be "considered by regulators where a compliance failure may have occurred." According to the Framework, a "yes" answer to any of the questions "mitigates against CCO liability." The nine questions are as follows:

- *Did the CCO have nominal rather than actual responsibility, ability, or authority to affect the violative conduct?*
- *Was there insufficient support from firm leadership to compliance, including, for example, insufficient resources, for the CCO to affect the violative conduct?*
- *Did the CCO escalate the issue or violative conduct to firm management through a risk assessment, annual review, CEO certification meeting/report, or otherwise?*
- *Did firm management fail to respond appropriately after becoming aware of the issue (through the CCO or otherwise)?*
- *If the firm made misstatements or omitted material information, did the CCO have nominal rather than actual responsibility, ability, or authority for reviewing or verifying that information?*
- *Was firm leadership provided the opportunity to review and accept the policies and procedures?*
- *Did the CCO consult with legal counsel (in-house or external) and/or securities compliance consultants and adhere to the advice provided?*
- *Did the CCO otherwise act to prevent, mitigate, and/or address the issue?*
- *Did the CCO reasonably rely on information from others in the firm or firm systems?*

The nine questions do not apply to all fact patterns. In this case, it appears that the following questions could have been relevant to the SEC finding the CCO liable and assessing sanctions:

<table>
<tr><td rowspan="2">Did the CCO have nominal rather than actual responsibility, ability, or authority to affect the violative conduct?</td><td>"[The CCO] did not make sufficient changes to the design and implementation of [the RIA's] compliance program."

Maybe: It is unclear from the Order what "changes" the CCO made and what "changes" the SEC expected the CCO to make to the RIA's compliance program. While the CCO was "responsible for administering [the RIA's] compliance program" and "implementing the firm's compliance policies and procedures," the Order doesn't state whether the CCO could have made the changes. In addition, the fact that the violative conduct was conducted by the RIA's managing member may have made it difficult for the CCO to make sufficient changes.</td></tr>
<tr><td>"[The CCO] did not require the IAR to complete and submit the formal reporting form required for OBAs by [the RIA's] compliance manual."</td></tr>
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	Yes: It appears that the CCO had "nominal," rather than actual ability to address this issue. According to the Order, the CCO "instructed" the IAR to "complete and submit the formal reporting form required for OBAs," but did not "require" him to do so. The Order does not state that the CCO could have "required" this conduct. Indeed, given that the IAR was the RIA's managing member, it is questionable whether the CCO could have ordered this conduct.
	"[The CCO] did not take sufficient steps to verify that [the RIA] or the IAR had adequately disclosed to clients the IAR's relationship to the OBA or any associated conflicts of interest." *Yes: It appears that the CCO had "nominal" authority to address this issue. There is no basis in the Order to support that the CCO's actual authority included reviewing disclosure to clients of the RIA or of the IAR, or that the CCO's actual authority included reviewing conflicts of interest.*
	"[The CCO] did not conduct sufficient review to determine the legitimacy of the transactions." *Yes: It appears that the CCO had "nominal" authority to address this issue. There is no basis in the Order to support that the CCO's actual authority included transaction review.*
	"[The CCO] did not take sufficient steps to monitor the IAR's compliance with the [BD's] policies as required by [the RIA's] compliance manual." *No: It appears that the CCO had the requisite "responsibility, ability, or authority" to affect this conduct. The CCO was "responsible for administering [the RIA's] compliance program" and "implementing the firm's compliance policies and procedures," and it appears that monitoring the IAR's compliance fell within these duties.* *But it is questionable whether the failure to take sufficient steps with regard to one IAR (who the CCO likely had no control over) constitutes a failure to adopt and implement reasonable written policies and procedures by the RIA, which the CCO aided and abetted and caused.* *In addition, it is questionable whether "monitoring," without more authority, would have stopped the IAR's underlying conduct (committing fraud, as alleged in the Complaint). Thus, the ability to monitor by the CCO, without the ability to affect the IAR's conduct, may not have provided a sufficient basis to charge the CCO.*
Was there insufficient support from firm leadership to compliance, including, for example, insufficient resources, for the CCO to affect the violative conduct?	*Yes: The only evidence of support or lack of support is the CCO's "instruction" to the IAR (the RIA's managing member) that he "complete and submit the formal reporting form required for OBAs," which the IAR did not do. If firm leadership (the IAR) had supported the CCO and complied with the CCO's instruction, presumably, the SEC would not have charged the RIA or the CCO.*

Did the CCO escalate the issue or violative conduct to firm management through a risk assessment, annual review, CEO certification meeting/report, or otherwise?	*Yes: The CCO escalated the issue to firm management by instructing the IAR (the RIA's managing member) to "complete and submit the formal reporting form required for OBAs," which the IAR did not do.*
Did firm management fail to respond appropriately after becoming aware of the issue (through the CCO or otherwise)?	*Yes: Firm management (the IAR who was the RIA's managing member) was aware of his: (1) OBAs; (2) the instruction he received from the CCO; and (3) his alleged fraudulent conduct, which is the subject of the SEC's Complaint— defrauding two advisory clients and one brokerage customer by misappropriating their funds for his personal use.*
Was firm leadership provided the opportunity to review and accept the policies and procedures?	*Maybe: According to the Order, the RIA failed to "adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules promulgated thereunder." It is possible that the IAR, as the managing principal, had the opportunity to review those policies and procedures, but the Order does not address this issue.*
Did the CCO consult with legal counsel (in-house or external) and/ or securities compliance consultants and adhere to the advice provided?	*The Order does not contain any facts about whether the CCO consulted with legal counsel and/or securities compliance consultants to obtain advice as to the issues discussed in the Order.*
Did the CCO otherwise act to prevent, mitigate, and/or address the issue?	*The Order does not contain sufficient facts to address this issue. Eight times the Order stated that the CCO took steps or other action called not "sufficient." Unfortunately, the Order does not state what he specifically did, why those steps or actions were not sufficient, what he could have done, and what he should have done. It is possible that certain of those steps and actions prevented, mitigated, and/or partially addressed the issue.* *The Order does state that more than a year after first learning about one of the OBAs, the CCO received additional information about "the OBA" (we don't know which one), and he reported the OBA to the BD, which led to the BD terminating its relationship with the RIA. This action appears to provide some mitigation, particularly since the Order does not state that the CCO was required to report information to the BD, only that IARs were required to comply with the BD's compliance policies. But the Order does not state whether that conduct affected the CCO's liability or his sanctions.* *We do know that the SEC did not charge the CCO for aiding and abetting or causing the IAR's alleged fraud, so it is possible that certain of the steps or actions he took mitigated those charges.*
Did the CCO reasonably rely on information from others in the firm or firm systems?	*Maybe: After the CCO "instructed" the IAR to complete and submit the OBA reporting form, we don't know what the IAR (the RIA's managing member) told the CCO. Hypothetically, the IAR told the CCO that he was not required to complete and submit the OBA form.*

Conclusion

Many CCOs feel they have targets on their backs. In fact, according to a survey conducted by the NSCP, 72% of compliance professionals are concerned that regulators have expanded the role of compliance officers and the scope of their responsibilities in imposing personal liability.[7] In response to this industry-wide concern, various SEC Commissioners and Staff have given speeches over the years about the importance of charging CCOs in only limited circumstances. For example, former Commissioner Gallagher stated, the Commission should "tread carefully when bringing enforcement actions against compliance personnel."[8] Similarly, current Commissioner Peirce stated, "We should not bring enforcement actions simply because we disagree, in hindsight, with [CCOs'] judgment."[9]

While Commissioner Peirce's separate statement in this case may have been an attempt to provide some comfort to CCOs, that reassurance is limited because the Order leaves many questions unanswered. The Order stated that the CCO took steps or other action deemed to be not "sufficient" (a term used eight times), but the Order failed to state what steps or other action he did take, and it failed to allege that he had the actual responsibility, ability, or authority to take "sufficient" steps, and it failed to state what those "sufficient" steps should have been. Without further guidance, CCOs will continue to operate in a state of limbo—not knowing what conduct will cause the SEC to bring down the hammer and strike at CCOs. Had the SEC applied the NSCP Framework (or another similar framework) or at least provided more details in the Order, CCOs would know what the SEC's expectations were. Without more clear guidance from the SEC, CCOs may waste time and energy worrying about avoiding liability (with no clear regulatory direction), rather than addressing their firms' critical compliance issues.

> *"It's funny how the beauty of art has so much more to do with the frame than the artwork itself."*[10] ■

7. https://static1.squarespace.com/static/61a9074028e505179c284c97/t/61e19a0f1d3d656f1cfbbf3c/1642174991168/NSCP+Firm+and+CCO+Liability+Framework+Jan+2022.pdf.
8. https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.
9. https://www.sec.gov/news/speech/speech-peirce-103018.
10. https://www.goodreads.com/quotes/tag/frame#:~:text=%E2%80%9CIf%20a%20problem%20can't,lies%20in%20reframing%20the%20problem.%E2%80%9D&text=%E2%80%9CIt's%20funny%20how%20the%20beauty,frame%20than%20the%20artwork%20itself.%E2%80%9D&text=%E2%80%9CMy%20power%20grew%20angry%20that,pulled%20against%20my%20taut%20skin.