Compliance and Legal Officer Guidelines To Prevent Non-Line Supervisory Liability

By James G. Lundy and Carrie DeLange

Introduction

The primary objective of this article is to provide guidance for compliance officers and in-house attorneys with investment management and broker-dealer firms to avoid supervisory liability related to the violative conduct of business personnel. As discussed below, important principles for firms such as – culture, (appropriate) collaboration, escalation, and documentation – are critically important. Although other publications have addressed this controversial topic, historically the majority of the discussions have appropriately focused on frustration that the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") even engage in these investigations. This frustration, while completely understandable, is not particularly beneficial because the SEC has been conducting investigations into the conduct of compliance and legal officers in limited and appropriate circumstances for about a quarter of a century. While the anticipated changes at the SEC may impact the Division of Enforcement's investigative techniques, the staff will continue to follow evidence where it leads them, including to the "doors" of compliance and legal departments. The goal of this piece is to provide guidance to compliance and legal personnel to be able to "slam those doors" as quickly as possible – or even better – avoid a "knock on the door" in the first place.

A Review of the Statutes and Rules for Supervisory Law

We begin with a summary of applicable supervisory laws and guidance. Many of you will be familiar with the laws and guidance described below, but a full analysis of these requirements as they apply to both investment management and brokerage firms is necessary to build towards the recommended takeaways. As we know, in addition to the SEC enforcing its supervisory regulations, for broker-dealers, FINRA also investigates and enforces its supervisory rules.[1] Further, with the increase of dual registrants and the growing complexity of the multiple business lines of larger financial services firms, it is important to understand and cross-reference the regulatory framework and guidance that has developed in this area over time.

Section 203(e)(6) of the Investment Advisers Act of 1940

The regulatory regime for the investment advisory industry is covered in the Investment Advisers Act of 1940 ("Advisers Act").

Amongst its various regulations is Section 203(e)(6), which requires that investment advisers, both entities and affiliated persons, reasonably supervise or face sanctions by the SEC. This regulation states:

> (e) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associate —
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> (6) . . . has failed reasonably to supervise, with a view to preventing violations of the provisions of statutes, rules and regulations [federal securities laws, the Commodity Exchange Act, or the rules of the Municipal Securities Rulemaking Board], another person who commits such a violation, if such other person is subject

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1. For futures, the Commodity Exchange Act and futures self-regulatory organization rulebooks also provide a supervisory legal framework for the futures industry. This article, however, focuses on the securities industry.

to his supervision. For the purposes of this paragraph no person shall be deemed to have failed reasonably to supervise any person, if:

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[2]

Notably absent from Section 203(e)(6) is a scienter requirement. This means that an individual can be held liable under Section 203(e)(6) even if she or he lacked knowledge.[3] Also of note, subparagraphs (A) and (B) provide for affirmative defenses, as discussed in more detail below.

Section 15(b)(4)(E) of the Securities and Exchange Act of 1934

The registration and regulation of broker-dealers is covered by Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act"). Among the various provisions of Section 15 of the Exchange Act is Section 15(b)(4)(E), which requires that broker-dealers, the entities and affiliated persons, reasonably supervise or face sanctions by the SEC. This regulation states:

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(E) . . . has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations [federal securities laws, the Commodity Exchange Act, or the rules of the Municipal Securities Rulemaking Board], another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[4]

The language of Section 15(b)(4)(e) of the Exchange Act mirrors Section 203(e)(6) of the Advisers Act. And like Section 203(e) (6), Section 15(b)(4)(e) does not require scienter.[5] Further, subparagraphs (i) and (ii) provide for affirmative defenses.

The failure to supervise case law for broker-dealers is more developed than the case law for investment advisors. To establish a failure to supervise charge, the SEC must demonstrate: 1) an underlying violation of the federal securities laws; 2) that the supervisor was associated with the person who committed the violation; 3) that the supervisor had supervisory responsibility over that person; and 4) that the supervisor failed to reasonably supervise the person committing the violation.[6] It is the third factor – supervisory responsibility – that the SEC needs to investigate and establish to charge compliance and legal officers for supervisory violations related to the conduct of non-linear business personnel. We explain this factor in more detail in the below discussion of the "Gutfreund Standard."

2. Advisers Act § 203(e)(6).
3. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. 2000).
4. Exchange Act §15(b)(4)(E).
5. *See In the Matter of Gary M. Kornman, Release No. 2840 (Feb. 13, 2009) (noting that there is "no scienter requirement" for Section 15(b) violations because the sanction is remedial and designed to protect the public.)*
6. *Id.*; see also *Collins v. S.E.C.*, 736 F.3d 521, 524 (D.C. Cir. 2013) (explaining that Section 15(b)(4) (e) "create[s] liability for a supervisor when his inadequate supervision is coupled with a violation by his supervisee."); *Branigan v. Alex. Brown & Sons, Inc.*, 978 F. Supp. 547, 549 (S.D.N.Y. 1997) (same).

Supervisory Systems Requirements

Rule 206(4)-7 of the Investment Advisers Act of 1940

Advisers Act Rule 206(4)-7 was adopted in 2003. It requires certain compliance procedures and practices, which have been described as a supervisory system for investment advisers.[7] Specifically, Rule 206(4)-7 states:

> If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3), it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you:
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> (a) Policies and Procedures. Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;
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> (b) Annual Review. Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and
>
> (c) Chief Compliance Officer. Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section.[8]
>
> The SEC initially charged investment advisory firms with violations of Rule 206(4)-7. Soon thereafter, however, the SEC also started charging the firm's chief compliance officer ("CCO") with Rule 206(4)-7 violations.[9]

FINRA Rule 3110

Neither Section 15 of the Exchange Act nor any other provisions of the federal securities laws require that a broker-dealer have a supervisory "system." Instead, FINRA, as the primary selfregulatory organization for broker-dealers, establishes this legal requirement with FINRA Rule 3110 "Supervision." FINRA Rule 3110 requires that FINRA member firms have: 1) a supervisory system; 2) written supervisory procedures; 3) conduct annual internal inspections of its businesses; 4) conduct a reasonable transaction review and investigation when necessary; and 5) investigate the member's applicants for registration.[10] FINRA routinely examines its broker-dealer member firms for compliance with this supervisory rule and enforces any violations. While FINRA's actions against CCOs for violations of this rule are less frequent than SEC Rule 206(4)-7 CCO cases, FINRA pursues these cases as well.[11]

The Gutfreund Standard

The standard that the SEC applies to the issue of whether a compliance or legal officer can be liable for failing to supervise business personnel outside their reporting lines was first described twenty-five years ago in the SEC's case and accompanying report from In the Matter of John H. Gutfreund, et al . This action included a "Report of Investigation Pursuant to Section 21(a)" of the Exchange Act (the "21(a) Report") regarding the conduct of Donald M. Feuerstein, the chief legal officer and head of the legal department at Salomon Brothers, Inc.[12] The SEC guidance in the 21(a) Report established the "Gutfreund Standard" cited by the SEC in subsequent enforcement actions.

However, approximately one year earlier, two Commissioners in a concurring opinion had espoused a "control" standard akin to the capability to hire or fire the employee.[13] While advocating for a more narrow "control" standard remains a valid legal defense strategy, the SEC has historically applied the Gutfreund Standard as described below. Further, when given the opportunity, the Commission has pointed to the Gutfreund Standard over the "control" / "hire or fire" standard as the legal precedent in this area.[14]

In *Gutfreund*, the underlying conduct involved a false bid in excess of $3 billion in an auction for U.S. Treasury securities. Feuerstein was informed of the bid at the same time as other senior executives of Salomon. Feuerstein was present at the meetings where the supervisors named as respondents in the proceeding discussed the matter. In his capacity as a legal adviser, Feuerstein advised the respondents that the submission of the bid was a criminal act and should be reported to the government. Feuerstein urged Salomon executives on several occasions to proceed

7. Regarding Investment Companies, Rule 38a-1 under the Investment Company Act of 1940 applies. Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 22044, Investment Company Act Release No. 26299, 68 Fed. Reg. 74714 (Dec. 24, 2003).
8. Advisers Act Rule 206(4)-7.
9. *See e.g., In the Matter of Omni Inv. Advisors Inc. & Gary R. Beynon*, Release No. 3323 (Nov. 28, 2011) (charging an investment advisor firm's Chief Compliance Officer with violations of Rule 206(4)-7.
10. FINRA Manual Rule 3110.
11. *See e.g., In the Matter of Jeffrey Stinnett, Respondent* (AWC 2014039194102, February 23, 2016); *see also* DISCIPLINARY AND OTHER FINRA ACTIONS, 2010 WL 652064, at *5.
12. *In the Matter of John H. Gutfreund, et al.* 51 S.E.C. 93 (1992).
13. *In the Matter of Arthur James Huff,* 50 S.E.C. 524 (1991).
14. *In the Matter of Arthur James Huff,* 55 S.E.C. 1009 (2002).

with disclosure when he learned that the report had not been made. However, Feuerstein did not direct that an inquiry be undertaken, and he did not recommend that appropriate procedures reasonably designed to prevent and detect future misconduct be instituted, or that other limitations be placed on the trader's activities. Feuerstein also did not inform the compliance department, for which he was responsible as Salomon's chief legal officer, of the false bid.[15]

In the 21(a) Report, the SEC advised that employees of brokerage firms who have compliance or legal responsibilities do not become "supervisors" solely because they occupy those positions.[16] Instead, determining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue. This is referred to as the Gutfreund Standard.[17]

While the Gutfreund Standard remains controversial, the 21(a) Report actually provided guidance for compliance and legal officers as well. Specifically, the 21(a) Report advises compliance and legal officers to reasonably respond to potential violative conduct by:

- directing or monitoring an inquiry or investigation of the conduct at issue;
- making appropriate recommendations for limiting the activities of the employee or for the institution of appropriate procedures, reasonably designed to prevent and detect future misconduct; and
- verifying that his or her recommendations, or acceptable alternatives, are implemented.[18]

None of these steps are remotely controversial in 2017. Indeed, these are now accepted compliance and legal department practices to address potential violative conduct that comes to their attention.

The 21(a) Report went further, however, with guidance that remains controversial, starting with: "If such a person [compliance or legal officer] takes appropriate steps but management fails to act and that person knows or has reason to know of that failure, he or she should consider what additional steps are appropriate to address the matter."[19] In this very uncommon and extremely unfortunate circumstance, the SEC advised that the additional steps to consider may include:

- escalation to appropriate members of senior management;
- escalation to the entity's board of directors;
- disclosure to regulatory authorities; or
- resignation from the firm.[20]

The first of these steps – escalation to senior management – may come up periodically, but hopefully not regularly, as part of a firm's escalation process. Thereafter, the following three steps quickly become significantly more sensitive and controversial. If a compliance or legal officer finds that escalation to senior management does not address the issues, then he or she needs to consider consulting with outside counsel. The last two of these steps should only be considered in dire circumstances as a last resort because they are extremely controversial and involve highly sensitive and complex legal and regulatory issues. That said, for the vast majority of firms that strive for a strong culture of compliance and where management appropriately fosters an appropriate collaborative relationship with the compliance and legal departments, any issues should be resolved as early in the process as possible.

SEC Guidance

On September 30, 2013, the SEC Division of Trading and Markets issued a Frequently Asked Questions ("FAQ") release to serve as guidance regarding this controversial topic.[21] Although focused on the brokerage industry, due

to the similar language and case law interpretations of Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(6) of the Advisers Act, the guidance in this FAQ can be extended to the investment management industry.

15. *Id*.
16. *Id*.
17. *Id*.
18. Id.
19. *Id*.
20. *Id*.
21. *Frequently asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act,* available at: http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

In the FAQ, the SEC emphasized that they have brought these types of failure to supervise actions against compliance or legal personnel "only in limited circumstances in which these individuals have been delegated, or have assumed, supervisory responsibility for particular activities or situations, and therefore have 'the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.'"[22] In terms of determining whether an individual has the requisite degree of – "responsibility, [or] ability or authority to affect the conduct of the employee whose behavior is at issue" – the SEC's FAQ posits these considerations:

- Has the person [compliance or legal officer] clearly been given, or otherwise assumed, supervisory authority or responsibility for particular business activities or situations?
- Do the firm's policies and procedures, or other documents, identify the person as responsible for supervising, or for overseeing, one or more business persons or activities?
- Did the person have the power to affect another's conduct? Did the person, for example, have the ability to hire, reward or punish that person?
- Did the person otherwise have authority and responsibility such that he or she could have prevented the violation from continuing, even if he or she did not have the power to fire, demote or reduce the pay of the person in question?
- Did the person know that he or she was responsible for the actions of another, and that he or she could have taken effective action to fulfill that responsibility?
- Should the person nonetheless reasonably have known in light of all the facts and circumstances that he or she had the authority or responsibility within the administrative structure to exercise control to prevent the underlying violation?[23]

The FAQ further recommends processes to escalate identified instances of noncompliance to business line personnel for remediation and procedures that clearly designate responsibility to business line personnel for supervision of functions and persons. In fact, escalation and appropriate collaboration with management are themes throughout the FAQ. Regarding collaborative counseling and advice, the FAQ states:

> Compliance and legal personnel play a critical role in efforts by broker-dealers to develop and implement an effective compliance system throughout their organizations,including by providing advice and counsel to senior management. Compliance and legal personnel do not become "supervisors" solely because they provide advice to, or consult with, senior management. In fact, compliance and legal personnel play a key role in providing advice and counsel to senior management, including keeping management informed about the state of compliance at the broker-dealer, major regulatory developments, and external events that may have an impact on the broker-dealer. In this regard, compliance and legal personnel should inform direct supervisors of business line employees about conduct that raises red flags and continue to follow up in situations where misconduct may have occurred to help ensure that a proper response to an issue is implemented by business line supervisors. Compliance and legal personnel may need to escalate situations to persons of higher authority if they determine that concerns have not been addressed.[24]

By way of more recent guidance from the SEC, in a June 29, 2015 speech, former Commissioner Luis Aguilar gave his perspective on this topic:

> The vast majority of these cases involved CCOs who "wore more than one hat," and many of their activities went outside the traditional work of CCOs, such as CCOs who were also founders, sole owners, chief executive officers, chief financial officers, general counsels, chief investment officers, company presidents, partners, directors, majority owners, minority owners, and portfolio managers. Many of these cases also involved compliance personnel who affirmatively participated in the misconduct, misled regulators, or failed entirely to carry out their compliance responsibilities.[25]

Providing guidance from an enforcement perspective and following the 2015 In the Matter of SFX Financial Advisory Management Enterprises, Inc., et al. and In the Matter of Blackrock Advisors, LLC cases, at that year's

22. Id.
23. Id.
24. Id.
25. SEC Commissioner Luis A. Aguilar, *The Role of Chief Compliance Officers Must be Supported* (Jun. 29, 2015), available at https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html.

National Society of Compliance Professionals National Conference Keynote Address, then Enforcement Director Andrew Ceresney stated that in the limited situations when the SEC brings actions against compliance officers they generally fall into three categories.[26] He specified these categories as: 1) compliance officers who are affirmatively involved in misconduct; 2) compliance officers who engage in efforts to obstruct or mislead the staff; and 3) compliance officers who exhibit a wholesale failure to carry out his or her responsibilities.[27] To put all of this in the proper perspective though, throughout both of their speeches and in their concluding remarks both Commissioner Aguilar and Director Ceresney expressed the SEC's full support for the compliance community.

Takeaways / Strategic Recommendations

In considering the above statutes, rules, and guidance – several strategic lessons and recommendations serve as takeaways.

First, investment management and broker-dealer firms should continue to be vigilant regarding their compliance with Rule 206(4)-7 of the Advisers Act and FINRA Rule 3110 with respect to their supervisory systems. Among the many important benefits, strong supervisory systems provide firms and individuals with affirmative defenses to SEC investigations into violations of Sections 203(e)(6) and 15(b)(4)(E) via subparagraphs 203(e)(6)(A) and 15(b)(4)(E)(i). Specifically, these supervisory systems allow firms to establish that "there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person."[28] Thus, by the plain language and interplay of these regulations, strong supervisory systems will thwart efforts by regulators to bring these types of charges.

Perhaps most importantly, firms need to foster a strong compliance culture and a culture of appropriate collaboration between managment and compliance and legal personnnel. This is hardly a novel concept in the 21st century.

Second, but perhaps most importantly, firms need to foster a strong compliance culture and a culture of appropriate collaboration between management and compliance and legal personnel. This is hardly a novel concept in the 21st century. Indeed, one of the primary themes of FINRA's 2016 Regulatory and Examination Priorities Letter was the culture of compliance.[29] A strong compliance culture and appropriate collaborative relationships allow for issues to be addressed as early as possible in the escalation process.

Third, firms should clearly delineate supervisory responsibility for business functions to business line management and the supervisory responsibilities of compliance and legal should be delineated and limited specifically to the employees in those departments. This should be documented clearly in a firm's written supervisory procedures – leaving no ambiguity – and should be included in the reviews of the written supervisory procedures and updated as needed.

Fourth, in addition to the written supervisory procedures, firms should have written firm-wide escalation policies and procedures or have them in place on a department-by-department basis across the firm, including the compliance and legal departments. These escalation policies should address when escalation will be triggered and provide the steps to be followed, including when to escalate issues to senior management. These policies and procedures should address the documentation required at the various stages of the escalation process. Escalation policies and procedures serve several purposes, including providing notice across the firm on how "red flags" of possible violative conduct will be addressed. A firm's periodic trainings should include a review of these escalation policies and procedures at least annually.

Lastly – if the circumstances arise that a compliance or legal officer is delegated or assumes supervisory responsibility and therefore ends up with "the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue" – the compliance or legal officer needs to appropriately document his or her efforts. This cannot be recommended strongly enough. Creating contemporaneous written records of the efforts to respond reasonably to "red flags" of possible violative conduct by engaging management

26. Andrew J. Ceresney, Director, Div. of Enforcement, Secs. & Exch. Comm'n, *Keynote Address at National Society of Compliance Professionals*, National Conference (Nov. 4, 2015), available at https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance- prof-cereseney.html. (*Citing, In the Matter of SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason, Advisers Act Release No. 4116 (June 15, 2015); In the Matter of Blackrock Advisors, LLC and Bartholomew A. Battista*, Advisers Act Release No. 4065
(Apr. 20, 2015)).
27. Andrew J. Ceresney, Director, Div. of Enforcement, Secs. & Exch. Comm'n, *Keynote Address at National Society of Compliance Professionals, National Conference* (Nov. 4, 2015).
28. Advisers Act § 203(e)(6)(A) and Exchange Act §15(b)(4)(e).
29. *FINRA 2016 Regulatory and Examination Priorities Letter*, available at: http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter.

or escalating to senior management pursuant to the firm's escalation policies and procedures is critical. Regarding this documentation, if a compliance officer ends up in this situation they should closely coordinate with the legal department. This will allow the documentation that is generated to be covered by the firm's attorney-client and attorney work product privileges. For compliance officers who are also attorneys, but work in the compliance department, be advised that the SEC and FINRA view compliance as an operational function to which these privileges do not apply. Therefore, in an abundance of caution to preserve these privileges, compliance officers should consult with the legal department. For those firms that do not have legal departments, depending on the seriousness of the issues and where they are at in the escalation process, they should consider consulting with outside counsel.

Conclusion

This topic has historically caused both frustration and fear with compliance and legal officers. Rightfully so. However, armed with a thorough understanding of the legal standards, the guidance, and these takeaways and strategic recommendations, compliance and legal officers can use appropriate planning to extricate themselves from a supervisory investigation as quickly as possible – or even better – avoid being subjected to any exposure in the first place.