

# CLIENT UPDATE

## GUIDANCE (AND A TOUCH OF SOLACE) FOR COMPLIANCE AND LEGAL PERSONNEL ON POTENTIAL SUPERVISORY LIABILITY

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On September 30, the staff of the Securities and Exchange Commission's (the "SEC") Division of Trading and Markets addressed an issue of great interest to the compliance and legal community concerning the circumstances under which the compliance and legal staffs of broker-dealers may be viewed as "supervisors" and thus face liability under the securities laws for failing to supervise firm employees.<sup>1</sup> The guidance, which appears in the form of responses to frequently asked questions (the "FAQs"), seems to confirm the industry's long-held view that supervisory liability does not attach unless a compliance or legal employee truly functions in a supervisory capacity. However, given that any such determination turns on all of the facts and circumstances, the FAQs underscore that senior management of broker-dealers would do well to engage in an assessment of the roles and responsibilities of their compliance and legal teams. In order for compliance and legal staff of a broker-dealer to avoid potential supervisory liability, their roles should be limited to serving as advisers to, and a resource for, the chief executive officer and other senior management who, the FAQs confirm, bear ultimate supervisory responsibility. While the FAQs focus on broker-dealers, they are also relevant to assessing the potential supervisory liability of compliance and legal personnel of registered investment advisers.

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<sup>1</sup> 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, SEC (Sept. 30, 2013), available at <http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm>

Although the FAQs provide welcome guidance, the SEC enforcement program is broad in scope, and is increasingly emphasizing the potential liability of so-called “gatekeepers.” Under this separate rubric, compliance and legal personnel may be viewed as “gatekeepers” and, as such, their activities will likely continue to be subject to increasing SEC scrutiny.

## DISCUSSION

The requirements of supervision at a broker-dealer are long-established and fairly simple: Management personnel must oversee (“supervise”) the employees and activities of the broker-dealer in a manner reasonably designed to ensure compliance with applicable laws and rules. The failure to adequately supervise personnel and/or activities may result in liability.<sup>2</sup>

The possibility that compliance and/or legal personnel might be supervisors received its most comprehensive early articulation in 1992 in an action by the SEC against the general counsel of Salomon Brothers, who was found to have supervisory liability for failing to halt the bid rigging activities of certain Salomon Brothers personnel in connection with its role as a primary dealer in U.S. government securities.<sup>3</sup> The SEC concluded that Mr. Feuerstein was a supervisor because he had “the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior [was] at issue.” In contrast, more recently the SEC dismissed an enforcement action against another broker-dealer general counsel, Theodore Urban, because the participating Commissioners were evenly divided over the issue of whether Mr. Urban had the requisite authority to be a supervisor.<sup>4</sup>

In 2005, the Compliance and Legal Division of the predecessor to SIFMA issued its “White Paper on the Role of Compliance.”<sup>5</sup> This white paper discussed at some length the role and structure of the compliance function and advocated for the treatment of broker-dealer compliance personnel as a resource for senior management and supervisors—namely, assisting management in their role as the keepers of the compliance flame. The paper also

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<sup>2</sup> Exchange Act §15(b)(4)(E) (supervisory liability for broker-dealers); *see also* Investment Advisers Act §203(e)(6) (similar for investment advisers); NASD Rules 3010 & 3012 (requiring supervisory system and discussing requirements thereof); FINRA Rule 3130 (requiring annual certification by chief executive officer concerning compliance and supervisory procedures).

<sup>3</sup> *John H. Gutfreund*, Exchange Act Release No. 31554 (Dec. 3, 1992).

<sup>4</sup> *Theodore W. Urban*, SEC Administrative Proceeding File No. 3-13655, Initial Decision Release No. 402 (Sept. 8, 2010), *dismissed by* Exchange Act Release No. 66359, Investment Advisers Act Release No. 3366 (Jan. 26, 2012).

<sup>5</sup> Sec. Indus. Ass’n, Compliance & Legal Div., *White Paper on the Role of Compliance*, (Oct. 2005), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100>.

stressed that “the distinctions between the responsibilities of the compliance department and those of supervisors and senior management must be maintained.”<sup>6</sup> These concepts are equally applicable to legal personnel.

Earlier this year, SIFMA issued a new white paper entitled “The Evolving Role of Compliance.”<sup>7</sup> SIFMA reiterated various points from the earlier white paper but also discussed the many new challenges facing compliance officers stemming from a combination of more complex businesses, demands from management, and greater regulation, including regulatory scrutiny of their roles. SIFMA once again strongly opposed placing supervisory responsibilities on compliance personnel:

Although close, cooperative relationships with Compliance are beneficial, senior management must be mindful that they should not assign supervisory or managerial responsibilities to Compliance. Supervisory powers should rest with senior management and line supervisors and should not be delegated, even in limited ways or on a temporary basis, to Compliance.<sup>8</sup>

In April 2013, SEC Commissioner Daniel Gallagher offered some thoughts on the role of compliance personnel.<sup>9</sup> He recognized the challenges facing compliance teams and then addressed his views about supervisory (and perhaps other) liability for compliance personnel: “Regulators should be focusing on the business-line supervisors, not the compliance official who steps in and takes action in good faith, even if the results of his or her actions are less than ideal.”<sup>10</sup>

It is against this backdrop that the FAQs arrive. They offer some important positive guidance for compliance staff, including:

- A chief compliance or legal officer and other staff are not supervisors by the nature of their positions or because they provide advice to business personnel (FAQs 1, 3).
- The ultimate responsibility for compliance resides with the chief executive officer and senior management. Moreover, participation in the management of a broker-dealer,

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<sup>6</sup> *Id.* at 10-13.

<sup>7</sup> SIFMA, *White Paper: The Evolving Role of Compliance* (Mar. 2013), available at <http://www.sifma.org/issues/item.aspx?id=8589942363>.

<sup>8</sup> *Id.* at 29.

<sup>9</sup> Remarks at the 2013 National Compliance Outreach Program for Broker-Dealers (Apr. 9, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1365171515226>.

<sup>10</sup> *Id.*

even at the most senior levels, does not cause a lawyer or compliance person to become a supervisor (FAQs 5-6).

- A broker-dealer can establish and implement a robust compliance program without its compliance staff being viewed as supervisors. “Among the things that firms should consider including in their programs are robust compliance monitoring systems, 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.” (FAQ 4.)

The FAQs also make clear, however, that the SEC staff will take into account a variety of factors when considering whether a particular compliance and legal employee plays a supervisory role, because, in its view, such a role can arise not only by express delegation, but also can be assumed by the person through their actions (FAQs 2, 6 & 8). FAQ 2 sets forth six considerations for evaluating whether a supervisory role exists. The factors look at, among other things, whether the person has (a) supervisory authority or responsibility for business activities and (b) the authority and responsibility to prevent a violation from occurring or continuing (FAQ 2).

An obvious situation where a compliance or legal person would have supervisory responsibility is when he/she plays a dual role, such as a chief compliance officer who is also the president or chief executive officer.<sup>11</sup> Other situations will be less obvious, so broker-dealers will want to closely read the six factors against their compliance and legal staff’s job functions and give a realistic assessment of potential exposure in light of the answers.<sup>12</sup> Perhaps the toughest situations will be determining whether such personnel

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<sup>11</sup> See e.g., *Hector Gallardo*, Exchange Act Release No. 65658 (Oct. 31 2011); *Prichard Capital Partners, LLC*, Exchange Act Release No. 57704, Investment Company Act Release No. 28251 (Apr. 23, 2008); *John A. Carley*, Securities Act Release No. 8888, Exchange Act Release No. 57246 (Jan. 31, 2008).

<sup>12</sup> The full text of the factors appears below:

Has the person 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?

has “otherwise assumed supervisory authority or responsibility” for a business or for certain situations; whether compliance staff has “the power to affect another’s conduct”; and whether compliance staff “could have prevented the violation from continuing” by “escalat[ing] situations to persons of higher authority if they determine that concerns have not been addressed” (FAQ 2, 6). For these reasons, broker-dealers should distinguish compliance and advisory duties from business line duties in order for persons who perform only compliance and legal functions to avoid becoming (or being deemed) supervisors.

## CONCLUSION

Broker-dealers and investment advisers should consider the important guidance contained in the FAQs in assessing the roles and responsibilities of their compliance and legal personnel. As SEC Chair Mary Jo White made clear in a speech on October 9, SEC enforcement efforts will extend to “every issue you face in the SEC’s space.”<sup>13</sup> Supervisory liability clearly is part of that “space.” Another area she mentioned in the speech was an increased focus “on deficient gatekeepers – pursuing those who should be serving as the neighborhood watch, but who fail to do their jobs.” While not specifically referred to in her remarks, compliance and legal personnel potentially could be viewed as having a gate keeping role that will place them under separate SEC scrutiny. The FAQs note that “[r]egardless of their status as supervisors, compliance and legal personnel who otherwise violate the federal securities laws or aid and abet or cause a violation may independently be held liable for the violation.” Conducting a careful and continuing evaluation of all potential sources of liability should be high on the agenda of broker-dealers and investment advisers.

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Please do not hesitate to contact us with any questions.

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<sup>13</sup> Remarks at the Securities Enforcement Forum ( Oct. 9, 2013), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.UoEzSH92m1g>.