Remarks Of

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"Failure to Supervise Liability for Legal and Compliance Personnel"

Securities Law Committee
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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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"Failure to Supervise Liability for Legal and Compliance Personnel"

I. Introduction

I appreciate the opportunity to address the Securities Law Committee of the Federal Bar Association. The last time I was before this audience was shortly after I joined the Commission. As I recall, at that time, I indicated that it was important for the Commission to continue the strong tradition it had established in the area of enforcement. I believe that that tradition has been maintained during my first two years on the Commission and hopefully will continue to be maintained during the remainder of my term.

The most recent prominent examples of Commission enforcement activity were the announcements last week pertaining to the Salomon Brothers case. In my judgment, the Commission's Division of Enforcement thus far has handled the Salomon situation appropriately and responsibly through a reasoned, balanced, and thorough approach.

On December 2, 1992, the Commission filed a complaint (the "Complaint") against Paul Mozer and Thomas Murphy in the U.S. District Court for the Southern District of New York alleging violations, and aiding and abetting of violations, of the antifraud provisions and of the recordkeeping provisions of the Exchange Act in connection with the submission of false bids in auctions for U.S. Treasury securities. The next day, the Commission released an order instituting proceedings pursuant to the Exchange Act making findings and imposing remedial sanctions (the "Order") whereby John Gutfreund, Thomas Strauss and John Meriwether settled failure to supervise allegations arising from some of the same facts set forth in the aforementioned Complaint by agreeing to pay a civil penalty, among other things. As a part of this Order, the Commission also issued a report of investigation pursuant to Section 21(a) of the Exchange Act (the "Report") with respect to the supervisory responsibilities of brokerage firm employees in certain circumstances. Donald Feuerstein, the former chief legal officer of Salomon, consented to the issuance of this Report, without admitting or denying any of the statements contained therein.

It is my intention today to focus on the series of proceedings that have been instituted by the Commission against legal and compliance professionals under the "failure to supervise" provision of Section 15(b)(4)(E) of the Exchange Act and on the ramifications in this area presented by the recently issued 21(a) Report. If you have not already done so, I recommend that you read the Report carefully, and, in particular, pages 22 through 25.

II. Statute and Legislative History

In the early 1960s, concern over inadequate broker-dealer supervision grew. Abuses pointed out in the Special Study of the Securities Markets led industry leaders and Commission representatives to stress the importance of vigilant supervision over far flung branch offices and personnel.[1] This concern for the need to protect the public from the wrongful acts of employees of broker-dealers during times of expanding markets and new markets is obviously not outdated today.

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1 SEC, Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 237-230 (1963).

In 1963, the Commission asked Congress for authority to impose sanctions less severe than suspension or revocation in order to better address specific deficiencies, as well as the power to institute administrative proceedings against individuals employed by brokerage firms. In response to this request, in 1964, Congress enacted what are now Sections 15(b)(4) and (b)(6) of the Exchange Act. As you know, Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to impose sanctions against a broker-dealer if the firm has "failed reasonably to supervise, with a view to preventing violations [of federal securities laws], another person who commits such a violation, if such other person is subject to his supervision."

Section 15(b)(6) of the Exchange Act incorporates Section 15(b)(4)(E) by reference and authorizes the Commission to impose sanctions for deficient supervision on individuals associated with broker-dealers. Unfortunately, the legislative history behind these provisions provides little guidance as to what was intended by the phrase "subject to his supervision."[2] This has led to a great deal of confusion as to just who can be a "supervisor" within the meaning of the failure to supervise liability provisions of the Exchange Act.

The Commission has emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal securities regulatory scheme. As the Commission stated in Wedbush Securities, Inc., "[i]n large organizations it is especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention."[3]

III. Failure to Supervise by Compliance Officers and Non-Line Supervisors

Under Exchange Act Sections 15(b)(4)(E) and 15(b)(6), a finding of liability for failure to supervise requires that a person has failed reasonably to supervise another person who has committed violations of the federal securities laws while subject to that person's supervision; and insofar as any

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2 See H.R. Rep. No. 1418, 88th Cong. 2d Sess., reprinted in 1964 U.S. Code Cong. and Admin. News., at 3013.

3 48 S.E.C. 963, 967 (1988).

sanction is concerned, there also must be a finding that it is in the "public interest" to impose the sanction. Typically, this finding of liability involves two distinct considerations: one, whether the person was the supervisor of a person who violated the federal securities laws and, two, whether the person performed reasonably in discharging his supervisory responsibilities. Both of these questions ordinarily entail a fact specific inquiry, especially in the case of non-line personnel, such as most legal and compliance personnel, where the concept of supervisory responsibility is far less developed than in the case of "line supervisors." The fact specific nature of the past cases involving legal and compliance personnel have made it very difficult to achieve any analytical consistency in this area which, in turn, creates the need for clearer guidance. Hopefully, the Report provides such clearer guidance.

A. When has a Non-Line Person Performed Reasonably in Discharging His Supervisory Responsibilities?

Taking the second liability consideration first, as the case law demonstrates, it is easier to determine when a person has performed reasonably in discharging his supervisory responsibilities than it is to determine when a person is a supervisor. There do exist a few Commission proceedings involving compliance or non-line supervisory personnel which have found that a person acted reasonably in discharging his supervisory duties based on the limited scope of the duties delegated to that person.

For example, in Louis J. Trujillo, the Commission overturned an administrative law judge's determination that a person had failed reasonably to supervise a registered representative who defrauded his customer through, among other things, misrepresentations, churning and unauthorized transactions.[4] Trujillo served as the administrative manager in a branch office under the branch manager who retained final responsibility in all branch matters. The branch manager was the only person who exercised actual control, while Trujillo was delegated the responsibility of surveillance and certain compliance matters. Although expressly declining to

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4 Release No. 26635 (March 16, 1989).

address whether the registered representative was "subject to [Trujillo's] supervision," the Commission found that he had reasonably discharged his duties in view of the "limited scope of [his] duties." Moreover, as the Commission noted, although Trujillo's performance of his duties was not faultless, he had made "reasonable and diligent efforts to inform [the branch manager] of the need to discipline and control [the registered representative]."[5]

Another example is Arthur James Huff, in which the Commission divided over the issue of whether Huff, a compliance officer, was a supervisor under the facts of the case.[6] As you may recall, in Huff, Chairman Breeden and I joined in an opinion finding that Mr. Huff performed reasonably in discharging his supervisory responsibilities under the facts and circumstances presented without

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5 See also Alfred Bryant Tallman, Jr. and Peter J. Slater, Release No. 34-8830 (March 2, 1970) (holding that compliance director, specifically charged with a wide variety of duties, including supervision of salesmen to ensure observance of federal and state laws, training of salesmen, and cooperation with regulatory bodies, had failed in his duty to supervise, although no sanction imposed in view of his inexperience and lack of disciplinary power).

6 Release No. 34-29017 (March 28, 1991).

determining if Huff was a supervisor. In a concurring opinion, Commissioners Lochner and Schapiro found that Mr. Huff was not a supervisor under the facts of the case. Obviously, all four Commissioners agreed that under the facts and circumstances presented, Mr. Huff was not liable for failure to supervise.

Huff is a difficult case to make much sense out of with these two somewhat disparate opinions. Among other things, what may not be fully reflected in the Huff opinions is that the conduct in question was very old and that Huff was brought into a pre-existing compliance problem situation. The case underscores the difficulty in deriving any analytical consistency from the failure to supervise cases involving compliance or non-line personnel because the outcome appears to hinge on the particular facts involved. In my judgment, the interpretative confusion resulting from the Huff opinions substantially contributes to the need for clearer guidance in this area, guidance which I hope will be provided by pages 22 through 25 of the Report.

I believe that the limited scope of the duties delegated to Huff as a compliance officer led Chairman Breeden and myself in our opinion to conclude that Huff had not acted unreasonably in supervising the registered representative Greenman. The compliance officer, Huff, was instructed to monitor the activities of Greenman and to follow up if any questions arose. While Huff failed to investigate fully, following customer complaints regarding Greenman's misconduct, he nevertheless recommended that Greenman be fired based on an independent evaluation of the representative's customer records. Although Huff's "performance of his assignment was less than exemplary," the opinion of Chairman Breeden and myself concluded that Mr. Huff had nevertheless acted reasonably in discharging his responsibilities under the circumstances presented.

In their concurring opinion, Commissioners Lochner and Schapiro concluded that Huff was not a supervisor of Greenman, since "Huff was not in the line of authority at PaineWebber to hire, fire, reward or punish Greenman." This latter language has been seized upon by a segment of the securities industry and bar to support the proposition that non-line personnel, such as most legal and compliance personnel, which lack hire, fire, reward or punish authority, can never be a supervisor within the meaning of the failure to supervise liability provisions of the Exchange Act. It is interesting to mention that after a detailed survey of controlling Commission decisions, Commissioners Lochner and Schapiro in their opinion defined supervisor for purposes of Section 15(b)(4)(E) as

> a person at a broker-dealer who has been given . . . the authority and the responsibility for exercising such control over one or more specific activities of a supervised person which fall within the Commission's purview so that such person could take effective action to prevent a violation of the Commission's rules which involves such activity or activities by such supervised person.[7]

Arguably, under this view, it is a person's power to control (defined narrowly in terms of the ability to sanction) that is determinative of whether a supervisory relationship exists. I submit that this view is not the view advocated in

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[7] 48 SEC Dkt., at 891. <u>See</u> note 16 <u>infra</u>.

the Report. However, I should point out that the concurring opinion did note specifically that the mere fact that Huff was the firm's compliance officer did not mean automatically that Huff was not in a position to superivse Greenman.[8] Thus, there is some common ground between the Huff concurring opinion and the Report.

Predictably, I believe that the opinion of Chairman Breeden and myself in Huff is consistent with the language of the Report. It is more difficult, in my view, to square all of the language of the concurring opinion in Huff with the Report. Of course, the concurring opinion was concerned with the more difficult liability consideration of when a compliance officer or other non-line personnel is a supervisor, which is a question that Chairman Breeden and I avoided answering in our opinion.

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8 See 48 SEC Dkt., at 893 ("We do not find that Huff was not Greenman's supervisor merely because of Huff's position as a staff compliance officer, i.e., he was not one of Greenman's 'line' supervisors.")

B. When is a Compliance Officer a Supervisor?

In recent years, as I previously mentioned, a segment of the securities industry has questioned whether compliance officers should ever be deemed supervisors within the meaning of Section 15(b)(4) of the Exchange Act.[9] While some of these parties apparently are of the view that the concurring opinion in Huff supports that proposition, I am not so sure; and, in any event, I am not sure what the concurring opinion in Huff means any longer.[10] Even before the publication of the Report, I believe that the Commission had rejected the contention that the statutory language of Exchange Act Section 15(b)(4) precludes treating compliance officers as supervisors as a matter of law; and, in fact, the Commission has previously administratively sanctioned compliance officers for failure to supervise.[11] At a minimum,

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9 See Brief of the Securities Industry Association in Arthur James Huff, Release No. 34-29017 (March 28, 1991).

10 See Fleischman, Toward Neutral Principles: Compliance Professionals, N.Y.L.J. (August 6, 1992).

11 See Gary W. Chambers, Release No. 34-27963 (April 30, 1990); First Albany Corporation, Release No. 34-30515 (March 25, 1992).

the Report should put that proposition to rest. It may be helpful at this juncture to run through some of the case law.

The control over the supervised person as emphasized in the Huff concurring opinion has been an important factor in delineating the supervisory responsibilities of compliance officers in some Commission cases. For example, in Michael E. Tennenbaum, the Commission found that a senior registered options principal ("SROP") at Bear, Stearns failed reasonably to supervise a branch office salesman who engaged in churning and options transactions for unsuitable customers, even though the SROP was not the salesman's line supervisor.[12] The Commission's finding rested on the fact that the SROP had sole authority to permit salesmen to handle discretionary option accounts and, by virtue of the SROP's right to revoke his approval, assumed responsibility for ensuring that this grant of authority was not being abused.[13]

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12 Release No. 34-18429 (January 19, 1982).

13 See also Robert J. Check, Release No. 34-26367 (June 26, 1987) (finding supervisory relationship where non-line supervisor (continued...)

Although control has been an important factor in several cases involving non-line supervisory personnel, recent decisions have diminished the significance of the control factor and instead have focused to a greater extent on the nature of the responsibilities delegated to the person. In one recent important case, Gary W. Chambers, it is not even clear from the Commission's order of findings that Chambers, who was the firm's senior vice president of compliance and operations, had any power to sanction the particular individuals who committed the securities law violations.[14] Rather, the key element in Chambers in determining a duty to supervise was the authority delegated to the compliance officer. In that case, the Commission found that Chambers had failed reasonably to supervise in failing to discharge his responsibility to ensure that his firm "adopted and maintained adequate supervisory and compliance policies and procedures," a responsibility which the firm's compliance

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[13](...continued) exercised control by virtue of authority to break salespersons' mutual fund sales orders).

[14] Release No. 34-27963 (April 30, 1990).

manual "vested" in him. Chambers' failure to supervise stemmed from his failure to discharge his responsibilities relating to establishment of adequate firm supervisory and compliance procedures. The Commission's order accepted, without addressing, the conclusion that the responsibilities vested in Chambers were supervisory as to the persons committing the securities law violations.

Another even more recent case, First Albany Corporation, which was issued subsequent to Huff, echoes the Chambers type of analysis, although it also notes certain control factors as well.[15] In that case, a chief compliance officer (the firm's general counsel) had responsibility for ensuring that the firm had implemented procedures which "provided a sufficient system of review" for enforcing the firm's trading restrictions with respect to a specific security. The compliance officer "had the power to take disciplinary action against a registered representative who violated firm policy by removing commissions and imposing small fines."

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15 Release No. 34-30515 (March 25, 1992).

The Commission concluded that the compliance officer failed reasonably to supervise a registered representative in neglecting to initiate action or to perform reasonable inquiry after being put on notice of the registered representative's breach of the trading restriction. Specifically, the compliance officer, after notifying the branch office of possible deficiencies, failed to determine whether the branch office instituted corrective measures.

IV. Recently Issued Report

Now that brings us to the recently issued 21(a) Report. In an attempt to clarify the confusion that apparently continues to linger in the area of failure to supervise liability for non-line personnel, such as most legal and compliance personnel, which may have resulted from, among other things, the Huff decision, and to make it clear that there can be liability for such non-line personnel under certain facts and circumstances, not necessarily dependent upon control or even upon hire, fire, reward or punish authority, the Commission addressed this issue in the Report.

In my opinion, the key sentence in the Report appears on page 23. "Rather, 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 sentence is linked to footnote 24 which refers to the concurring opinion in Huff.

Footnote 24 attempts to interpret this particular sentence and the concurring opinion in Huff as being totally consistent with each other. I am uncertain that that objective was achieved or even could be achieved. Footnote 24 states that the concurring opinion in Huff "explains that in each situation a person's actual responsibilities and authority, rather than, for example, his or her 'line' or 'non-line' status, will determine whether he or she is a 'supervisor' for purposes of Section 15(b)(4)(E) and (6)." This language is consistent with the Report but only to the extent that "line" or "non-line" status is not necessarily determinative of when a person is deemed to be a supervisor.

For example, in spite of footnote 24, it is unclear to me how "the authority and the responsibility for exercising such control"[16] (emphasis added) language of the concurring *Huff* opinion, purporting to define supervisor, is consistent with the "a requisite degree of responsibility, ability, or authority to affect the conduct" (emphasis added) language which appears on page 23 of the Report. Among other things, "or" rather than "and" is used in the Report; and the word "control" is not used in the Report. I submit that the language appearing in the text of the Report overrides any ambiguity posed by footnote 24, and I believe that footnote 24 is to some extent inconsistent with the sentence footnoted. I would also argue that the guideline for determining a "supervisor" for purposes of Section 15(b)(4)(E), as expressed in the text of the Report on page 23, is considerably broader than the definition of "supervisor"

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[16] *See* 48 SEC Dkt., at 891. *See also* note 7 *supra*.

contained in the concurring Huff opinion and is somewhat broader than the definition of "supervisor" that appears in most of the case law in this area.

I believe it is important to make these points since failure to supervise enforcement cases will probably continue to be a high Commission priority in the near future.

There is one other portion of the Report which I wish to mention specifically and that is the last paragraph which appears on page 24. That paragraph delineates action legal or compliance supervisory personnel could take when made aware of misconduct. It closes with a description of steps that such a person could take if management fails to act. "These steps may include disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities."

Footnote 26 is connected with this sentence, and the text of footnote 26 states: "Of course, in the case of an attorney, the applicable Code of Professional Responsibility and the Canons of Ethics may bear upon what course of conduct that individual may properly pursue." I suspect that the portion of the sentence in the Report referring to "disclosure to regulatory authorities" and footnote 26 will be the subject of substantial future bar discussion. I will only add editorially that the sentence in the Report states that the "steps may include" those things, and the steps are set forth in "A, B, or C" fashion.

V. Conclusion

In conclusion, you should keep in mind that every individual probably considers himself or herself to be the perfect wordsmith. The Report was prepared and/or reviewed by the Divisions of Enforcement and Market Regulation, the Office of General Counsel, and the Commissioners and their staff. Obviously, too many cooks are involved for the product to be perfect. However, I hope that the Report does provide clearer guidance in the failure to supervise liability area, particularly with respect to non-line personnel. At a minimum, the proposition that a legal or compliance officer could never be deemed a supervisor should be laid to rest. Further, the proposition that failure to supervise liability is totally dependent upon hire, fire, reward, or punish authority should also be laid to rest.

I suppose that only the future will decide whether in fact the Commission has provided some clarity to this area or simply made the area murkier than it already was. For certain, the issue will surface again in the near future since I do anticipate that the Commission's Division of Enforcement will continue to be attentive to potential failure to supervise violations in general, including potential violations by legal and compliance personnel.