Broker-Dealer Failure To Supervise: Determining Who is a "Supervisor"

REMARKS OF
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*The views expressed herein are those of Commissioner Schapiro and do not necessarily represent those of the Commission, other Commissioners or the staff.

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Good morning. I'd like to start my remarks by thanking George Schieren, in particular, and other officers of the SIA, for inviting me to speak at this conference. This seminar is one of the most important -- if not the most important -- gatherings of industry leaders to take place this year, and so I am honored by the opportunity to address you.

When I look back at the industry's accomplishments in 1992, and the numerous regulatory initiatives of the SEC, I come out concluding that 1992 was a year of rather profound change. On the regulatory front, the SEC joined the fight of many shareholders to open the doors to the boardrooms of corporate America, and let the owners of our corporations participate more fully in the proxy process. We also rewrote the rules governing capital raising by small businesses, in an effort to alleviate the effects of the credit crunch. We published a detailed study of the rules governing the investment adviser and mutual fund industries, and have adopted a number of the most important changes proposed in that study. And we finalized and implemented rules to assess the financial risks of broker-dealer subsidiaries and affiliates.

1992 was also a very impressive year for most U.S. securities firms. Collectively, U.S. firms hit a new record with a pretax profit of more than $6 billion, and one firm had the highest net income ever recorded for a publicly traded U.S. securities firm. These numbers reflect significant market participation by small investors, and a surge in new stock and bond offerings. If interest rates remain low, as many predict they will, then 1993 may produce similar results.

Against this backdrop of success and growth for the industry, I want to speak about something that makes a lot of the profit possible: that is, the relationship between individual investors and their registered reps, and the role firms must assume in overseeing these relationships.

When everything goes as it should, the relationship between an investor and his or her account executive is mutually beneficial: the investor relies on the account executive, and the firm for whom the account executive works, to give investment advice that is tailored to the particular needs of the investor. In turn, the account executive profits from this relationship in the form of commissions and client referrals. There is no overreaching on the part of the rep, no churning, no unauthorized trading, no misappropriation. When problems with a particular rep do develop, the firm's internal surveillance and compliance departments are quick to identify the problem, and take the necessary corrective action.

Unfortunately -- and more often than I would like -- things don't always go as they should, and my colleagues and I are presented with cases where the profit motive, or a reluctance to tarnish a firm's reputation, get in the way of adherence to the securities laws. And so the Commission's enforcement authority comes into play, and we walk through what seems like a minefield, trying to determine whether supervisory failures contributed to, or made possible, the underlying fraud.

I was pleased to see that this seminar offered at least two workshops dealing with the supervision of account executives, and the responsibility of whistleblowers. In the past few years, the firms, the SROs and the Commission have made great strides in bringing the compliance function of broker dealer firms to the forefront of our collective consciousness. I know that many of you who are here today put a great deal of time and effort into developing pro-active compliance departments and procedures for your firms. Many of these procedures are effective in weeding the bad apples out from the industry, but we are not at the point yet where we can all feel satisfied that we are doing our best to maintain and enhance the relationship of trust and confidence that lies at the heart of this business.

Failure to supervise cases are without question among the toughest cases with which the Commission must deal. Our statutory authority, found in sections 15(b)(4)(E) and 15(b)(6) of the Exchange Act, was no doubt intended to limit the persons whom the Commission could prosecute. In order to sanction a firm or an individual, we must find that the entity or individual "failed reasonably to supervise, with a view to preventing [securities] violations ... another person who commits such a violation, <u>if such other person is subject to his supervision</u>" (emphasis added). The statute includes an affirmative defense, providing that no person shall be held to have failed to reasonably supervise another person, so long as he "reasonably discharged the duties and obligations incumbent upon him by reason of his firm's procedures," and had no reasonable basis for believing that those procedures were not being followed.

An impartial observer -- or maybe just a non-lawyer -- might be tempted to think that any statute which has so many references to "reasonableness", would not be hard to administer, or generate much controversy. But, as you know, the manner in which the Commission has applied these provisions, particularly against persons who work in the compliance or legal departments of a broker-dealer, has been the subject of continuing controversy. I want to tell you why I think these criticisms are largely unfounded, but first I'd like to review exactly what I think the Commission has been saying to the industry, through the vehicle of the cases in which we have dealt directly with a failure to supervise.

Historically, the Commission's failure to supervise cases can be distinguished on the basis of whether the Commission was proceeding against persons who were in a direct supervisory chain of command above the principal wrongdoer, or were instead, in positions of some responsibility within a firm's legal or compliance department. When you are in the direct supervisory line, you are presumptively assumed to be a person who is a "supervisor" of the wrongdoer.[1] The presumption arises from the very nature of your responsibilities and authority; from the fact that in most organizations persons in the direct chain of command are given both the authority

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[1]Concurring opinion of Commissioners Schapiro and Lochner in Arthur James Huff, Securities Exchange Act Release No. 29017 (March 28, 1991), 48 SEC Doc. 0878, at 0888.

and the ability to influence the conduct of lower level employees. Accordingly, the liability of a line supervisor under the federal securities laws depends almost solely on the reasonableness of his or her conduct. Did he or she act in an appropriate manner, at an appropriate time?

If, on the other hand, you are not a line supervisor within the firm, the analysis of your liability breaks down into two components: first, were you in fact a supervisor of the wrongdoer, and second, did you act reasonably? The Commission has addressed the liability of non-line officials only a handful of times since enactment of the failure to supervise statute.

In Michael E. Tennenbaum,[2] a case decided in 1982, the Commission sanctioned a general partner of Bear Stearns for failing to adequately supervise a registered rep who had engaged in excessive options trading in numerous customer accounts. The Commission did not expressly address whether Tennenbaum was a supervisor of the rep, but such a finding is implicit in the opinion, and appears to be based on the fact that Tennenbaum had sole

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[2]Securities Exchange Act Release No. 18429 (Jan. 19, 1982).

authority within the firm to permit salesmen to engage in the type of trading at issue. The Commission found that once Tennenbaum authorized the trading, he assumed a continuing responsibility to ensure that the authority was not being abused. It is interesting to note that the Commission expressly rejected as a defense in this case the argument that only line employees can be "supervisors" within the meaning of the statute.

In 1989, the Commission reversed an administrative law judge who found that an assistant to a branch manager had failed to reasonably supervise a salesperson.[3] The assistant performed administrative and compliance functions, including having a responsibility to identify sales practice problems, but he had only a very limited authority to take corrective action.[4] In an interesting footnote to the case, the Commission stated that it found no need to decide whether the assistant was a "supervisor"; it simply assumed that a supervisory relationship existed. The finding of no liability in

[3]See Louis J. Trujillo, Securities Exchange Act Release No. 26635 (March 16, 1989). This case is noteworthy because it is one of the few times when the Commission, having authorized the initial action, came to a different conclusion when faced with a more developed factual record. See also Huff, discussed herein at pages 9-12.

[4]The power to discharge, suspend, fine or restrict a salesperson's activities resided exclusively in the branch manager.

this case rests on what the Commission found to be the "reasonableness" of the assistant's conduct. When the gravity of the underlying fraud increased, and the branch manager failed to respond in an effective manner, the assistant reported the matter to the firm's director of surveillance. The Commission stated that "... a supervisory employee with even limited authority must ... go beyond his limited authority to contact the firm's national headquarters concerning a rogue broker's activities."[5]

Approximately one year later, in the Gary W. Chambers case[6], the Commission found that a senior vice president of compliance and operations failed reasonably to supervise two salespersons engaged in a massive fraud. As in the Trujillo case, there is no discussion of whether Chambers was a supervisor within the meaning of the statute. Such a discussion probably seemed unnecessary, because the Commission found that the firm lacked any supervisory or compliance policies or procedures, sufficient to detect the trading abuses at issue. Chambers had been vested with responsibility to develop the necessary compliance procedures, and did in fact compile the firm's compliance manual. Citing his position and

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[5]Trujillo, at 43 SEC Doc. 694, n. 8.

[6]Securities Exchange Act Release No. 27963 (April 30, 1990).

responsibility within the firm, the Commission concluded that Chambers was liable because he either knew or should have known that unless he or other compliance personnel took action, there would be no supervision of broker trading.

These cases are followed by a decision that has received quite a bit of attention from industry observers, no doubt at least in part due to the fact that two opinions were issued in the case, by an evenly divided Commission. The case concerns Arthur James Huff, a vice president and senior registered options principal working in the New York headquarters of a large retail firm.[7] When Huff was hired, he was given the compliance file on a particular salesman, and was instructed to keep abreast of the salesman's activities. He was also put on notice that his own supervisor had recently conducted a review of the salesman and given his conduct a clean bill of health. Huff nonetheless engaged in his own investigation, identified substantial customer losses, and recommended to his supervisor that the salesman be terminated.

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[7] Cited <u>supra</u> at n. 1.

The Commission unanimously voted to dismiss the case against Huff. Two commissioners, Breeden and Roberts, assumed that some kind of supervisory relationship existed between Huff and the salesman, but did not answer the question whether this relationship brought Huff within the ambit of the failure to supervise statute. Instead, they focused their opinion on whether Huff had acted reasonably, with a view to preventing the salesman's fraudulent activities.

In a separate concurring opinion, former Commissioner Lochner and I took issue with our colleagues' disposition of the case, questioning whether it was necessary to address the reasonableness of an employee's actions without determining first whether that employee was in fact a "supervisor" within the meaning of the statute. We concurred in the decision to dismiss the case against Huff, but we did so on the basis of finding that Huff was not the salesman's supervisor.

The opinion articulates our view that a supervisory relationship:

> "... can only be found in those circumstances when, among other things, it should have been clear to the individual in question that he was responsible for the actions of another and that he could take effective action to fulfill that responsibility.... In our view the most probative factor that would indicate whether a person is

responsible for the actions of another is whether that person has the power to control the other's conduct.... Control... is the essence of supervision...."[8]

Our opinion about what must be the essence of a supervisory relationship was grounded on an analysis of the supervisory relationship that exists between line employees, because clearly, there must be a symmetry between the application of the statute to line employees and the application of the law to non-line employees. In words that have come back to haunt me, Commissioner Lochner and I cited as an example of control, a line employee's power to hire or fire, to reward or punish. I must tell you that my reference to these particular powers was never intended to indicate a de facto limiting principle, whereby an individual who did not possess the power to hire, fire, reward or punish, could insulate himself from the reach of the statute. Rather, the message of Huff's concurring opinion is that a non-line employee may be a "supervisor" of a particular employee when he or she has the authority and responsibility to exercise some degree of control over the salesperson's conduct, knows or should know that she is vested with

[8] Huff opinion at 48 SEC Doc. 0887.

this authority, and in fact could have influenced the violative behavior if she had exercised her control.

Last, but by no means least, is the Commission's recently issued administrative order arising from the Salomon case,[9] wherein we found that three executives who occupied positions at the highest level of firm management failed to reasonably supervise the activities of the firm's lead government securities trader.[10] The Commission's opinion concerning the conduct of these individuals lays out in chapter and verse what it means to "reasonably" supervise another employee. The opinion is very clearly drafted in this regard, so I won't attempt to replicate it here. What I will comment on, however, is the Commissions's decision to issue a "21(a) Report" concerning the supervisory responsibilities of in-house lawyers and compliance personnel in broker dealer firms.

As you know, this report addresses the role and activities of Donald Feuerstein, who formerly held the positions of chief legal

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[9]Gutfreund, et al., Securities Exchange Act Release No. 31554 (Dec. 3, 1992).

[10]The Commission had previously instituted and settled an administrative proceeding against the firm, for failing reasonably to supervise a person subject to its supervision with a view to preventing violations of the federal securities laws.

officer and head of the Legal Department at Salomon. The head of Salomon's Compliance Department reported directly to him. As stated in the Report, Feuerstein became aware, along with Messrs. Gutfreund, Strauss, and Meriwether, of two false bids submitted by Paul Mozer in auctions for U.S. treasury securities. Thereafter, he was included in a small group of top management people who debated among themselves what course of action to take. Although Feuerstein advised others in management that the matter should be reported to the government, that was, in essence, all he did.

Unlike Messrs. Gutfreund, Strauss and Meriwether, Feuerstein was not a direct, or line, supervisor of Mozer at the time he first learned of the allegedly violative conduct. Thus, the Commission elected to issue a report, rather than a sanction, amplifying its views on the supervisory responsibilities of legal and compliance officers.

This is the Commission's most recent pronouncement on who is a "supervisor" within the meaning of the statute, and it should be read, in my opinion, as the last, best notice to the industry of the Commission's views on this subject. There are three critical messages in this report concerning who may be deemed to be a "supervisor." First, employees who have legal or compliance responsibilities do not become "supervisors" solely because of their positions. In other words, the Commission will analyze each case on the basis of its unique facts and circumstances, taking into account the managerial structure of the particular firm and the devolution of responsibility within the firm. Second, the determination of whether 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."[11] A person's status as a line or non-line employee is not dispositive of the issue. Again, the facts and circumstances are crucial, as is an analysis of responsibility and control, to making the determination. And third, it is possible to become a supervisor under a particular set of facts and circumstances, even if formerly you did not have "direct supervisory responsibility for any of the activities of the employee (emphasis added)."[12]

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[11]Gutfreund et al. at 52 SEC Doc. 4392. If the concurring opinion in Huff has been interpreted by some as being inconsistent with this principle, footnote 24 of the Gutfreund order should clear matters up.

[12]Id. at 4394.

In my view, the facts and circumstances which may make you "become" a supervisor vis-a-vis a particular employee, when formerly you were not, are (1) your knowledge and awareness of allegedly improper conduct, and (2), being so situated within a firm that you have some ability to affect the conduct at issue. These are the starting points for liability, but they do not define the totality of the Commission's analysis. It is not our intention -- or at least my intention -- to prosecute legal or compliance officers for every mistake they may make in the course of their professional lives. Moreover, not all mistakes are of the same magnitude, and not every legal or compliance officer is engaged by his or her firm to be part of the firm's collective response to a problem. It is important to bear in mind that the Commission's 21(a) Report repeatedly notes the fact that Feuerstein was informed of Mozer's misconduct "by other members of senior management in order to obtain his advice and guidance, and to involve him as part of management's collective response to the problem."[13] Feuerstein had, on other occasions, been responsible for the resolution of disciplinary problems within the firm, and "management had relied on him to perform those tasks."[14]

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[13] Id. at 4393.

[14] Id.

I've gone through a discussion of these cases because I am concerned that they are being misinterpreted, at least in some respects. I have heard it said that the Commission has made it difficult for broker dealers to understand how it interprets the law on the issue of who is a supervisor. We have been accused of inconsistency; of overreaching; and of attempting to deputize in-house lawyers to do our work for us. Criticisms make for good commentary, and they undoubtedly make us, as regulators, think even more carefully about the consequences of our actions. But I must tell you in all candor that, if you work in this business, you should read the Commission's opinions for what they do say, not for what they do not say, or what some observers would like them to say.

In my opinion, the cases that I've discussed today, and others as well,[15] display a consistent emphasis on authority, responsibility, and control, as the hallmarks of a "supervisor." These attributes are present in the direct supervisory chain of command, and they must also be the defining characteristics of a non-line supervisor. The Huff opinion should not be read as giving legal and compliance officers an

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[15] See, e.g., Robert J. Check, Securities Exchange Act Release No. 26367 (Dec. 16, 1988), and First Albany Corporation, Securities Exchange Act Release No. 30515 (March 25, 1992).

automatic "out" from liability, because they do not, in many instances, possess the ability to hire, fire, reward, or punish. If those powers were all that mattered, the Commission would find itself in the position of allowing persons who are on notice of the occurrence of violative behavior, and are in a position to influence the outcome, to merely stand by and let it happen. Whether you are the chairman or president of the firm, an in-house lawyer or someone with lesser authority, the Commission should not in my opinion absolve you of the responsibility to act when you see that the house is on fire, and you are in possession of some part of the hose.

I am convinced that this approach to supervisory responsibility is in the best interests of the industry. It goes without saying that the SEC benefits greatly from the impact that individual prosecutions have on the industry as a whole, but that does not mean that the principles we have developed reflect an uninformed or misguided, prosecutorial bias. When we drop a single stone into the water, I am more than respectful of its ripple effect. But I am also cognizant of the very real benefits that accrue to this industry when its compliance and managerial functions, function in tandem. These benefits can be measured in hard dollars every time a firm avoids a costly mistake, or a hit to its reputation.

A former colleague of mine, Edward Fleischman, has stated that professionals working in a firm's compliance or legal departments should not be sanctioned by the Commission for a failure to supervise, because such a sanction will impair, or encroach upon, the independence of these professionals.[16] Maybe I don't fully understand the finer points of this remark, but in my opinion the independence of these professionals is not compromised by holding them accountable for their own conduct, if the circumstances so warrant. Moreover, independence, while certainly a virtuous quality, should not become a roadblock to enforcement of our laws.

I know that everyone in the industry is looking for limiting principles, so that liability can be avoided. I hope that my remarks today have cleared the air a little on the issue of who is a supervisor. If you are in the legal or compliance department of a firm, and you are concerned about whether you will at some future point in time be adjudged to be a "supervisor," then by all means act responsibly, i.e., reasonably, when you become aware of potentially violative behavior and are in a position to affect it or prevent its recurrence. Remember

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[16] Fleischman, Inside the SEC, N.Y.L.J., August 6, 1992, at pp. 5-6.

that being determined to be a supervisor is just one half of the liability equation; the other half being a determination regarding the reasonableness of your response.

Thank you.