REMARKS OF COMMISSIONER MARY L. SCHAPIRO* UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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Good Afternoon. I'd like to thank Rick Ketchum, Doug Henderson and the other organizers of this conference for inviting me to speak to you today. The annual education seminar is just one of the many ways the NASD promotes the continuing education of its members on topics of critical importance. Forums such as this help to ensure that NASD members can do their jobs effectively and responsibly, within the confines of legal and regulatory requirements, and I am glad to be a part of the effort.

I would like to focus today on recent developments involving the supervisory responsibilities of securities firm managers -- a topic that I'm sure is near, if not especially dear, to the hearts of those of you involved in day-to-day legal and compliance responsibilities for member firms. It is a topic that also is important to all of us who are concerned with preserving the integrity and vitality of U.S. securities markets. Overall, I believe that legal and compliance personnel do their jobs well in the face of complex and changing conditions -- and that I should add, gratefully, makes <u>my</u> job easier.

Nonetheless, we all know that, no matter how much attention is devoted to devising good compliance procedures, there often is a

strong temptation, whether because of profit motive, or a reluctance to tarnish a firm's reputation, to look the other way when there is evidence of wrongdoing. This can occur because of a reluctance to reduce the income provided by a "big producer," or it may be accentuated by the firm's compensation structure. For example, when firms compensate branch managers largely on the basis of the volume of business conducted by salespersons within the branch, there is an apparent conflict of interest with the manager's responsibility to supervise the same salespersons. In the worst scenario, these factors may lead to a systemic breakdown in supervision that permits or encourages widespread fraud at multiple branch offices, with results that are devastating to the firm and harmful to investor confidence.

When fraud by securities firm employees is uncovered, the Commission is charged with the obligation to determine whether supervisory failures contributed to, or made possible, the misconduct. This task is particularly difficult when supervisory responsibilities within a firm do not follow the line hierarchies of the firm's organizational chart, as is often the case. This issue was highlighted by the Commission's administrative order and public report involving the government securities trading activities of Salomon Brothers

during the first half of 1991.[1] The Commission's report on the responsibilities of non-line supervisors caused some to question whether the Commission was seeking to enlarge the universe of persons who may be deemed to have supervisory responsibilities, and whether this could adversely affect the functioning of legal and compliance departments.

A central message of the failure to supervise proceedings in Salomon as I see it, is that the legal obligation to supervise must be based on actual ability to affect behavior and respond to misconduct, and not solely on formal distinctions relating to line responsibility. This message is entirely consistent with past Commission decisions in this area, although the Commission had not before been so explicit in its analysis.

Although I understand that the absence of a bright line test may cause some uncertainty, which in human terms often translates to anxiety, I believe that the Commission's approach should not cause panic or alarm for compliance and legal officers, or unduly complicate their lives. It does, instead, give appropriate recognition to the

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

significant role that compliance officers and others without specific line supervisory authority often play in modern securities firms. The compliment may seem a little backhanded, but let me assure you in any event that the Commission is not on a crusade against legal and compliance professionals.

Failure to supervise cases are without question among the toughest cases with which the Commission must deal, not only in terms of technical legal principles, but also from the standpoint of simply trying to "do the right thing." Our statutory authority, found in sections 15(b)(4)(E) and 15(b)(6) of the Exchange Act, requires us to find that a firm 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 or she "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.

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 an officer is in the direct supervisory line, he or she is presumptively assumed to be a person who is a "supervisor" of the wrongdoer.[2] The presumption arises from the very nature of the line officer's responsibilities and authority -- from the fact that in most organizations persons in the direct chain of command are given both the authority 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 as a "statutory supervisor" breaks down into two components: first, were you in fact a supervisor of the wrongdoer, and second, did you act reasonably in discharging that

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[2] 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.

duty? The Commission has addressed the liability of non-line officers in relatively few cases since enactment of the failure to supervise provisions.

In Michael E. Tennenbaum,[3] a case decided in 1982, the Commission sanctioned a general partner of Bear Stearns for failing to adequately supervise a salesman who had engaged in excessive options trading in numerous customer accounts. The Commission did not expressly address whether Tennenbaum was a supervisor of the representative, but such a finding is implicit in the opinion, and appears to be based on the fact that Tennenbaum had sole authority within the firm to permit salespersons 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 important to note that the Commission expressly rejected as a defense in the case the argument that only line employees can be "supervisors" within the meaning of the statute.

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[3] Securities Exchange Act Release No. 18429 (January 19, 1982).

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.[4] 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.[5] 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 this case rested 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 in its order 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."[6]

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4 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 that the Commission, having authorized the initial action, came to a different conclusion when faced with a more developed factual record. See also Huff, discussed infra.

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

6 Trujillo, at 43 SEC Doc. 694, n. 8.

Approximately one year later, in the Gary W. Chambers case,[7] 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 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 the Commission's Huff decision. Huff was a vice president and senior registered options principal working in the New York headquarters of a large retail firm. When

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

Huff was hired, he was given the compliance file on a particular salesperson, and was instructed to keep abreast of the salesperson's activities. He also was put on notice that his own supervisor had recently conducted a review of the salesperson 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 salesperson be terminated.

The Commission unanimously voted to dismiss the case against Huff. Two commissioners assumed that some kind of supervisory relationship existed between Huff and the salesperson, 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 salesperson'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 salesperson's supervisor.

We said in the opinion 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 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. 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 these powers could insulate herself 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

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8 Huff opinion at 48 SEC Doc. 0887.

when 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 this authority, and fails to discharge that responsibility.

The Commission's next decision involving non-line supervisors was First Albany Corporation,[9] a case in which the power to directly punish violations did in fact exist. First Albany involved undetected manipulative trading activities, including "wash sales," by a single registered representative. The Commission found that the firm lacked adequate supervisory and compliance procedures, as well as an adequate system for applying the procedures that did exist. The Commission also found that not only the rep's branch manager, but also Lindburg, the firm's General Counsel and Chief Compliance Officer, failed reasonably to supervise the salesman.

In finding Lindburg liable for failure to supervise, the Commission noted that he had the power to sanction salespersons for violations of firm policy, including the authority to impose fines or remove commissions. Although he was aware that the firm had

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[9] Securities Exchange Act Release No. 30515 , 51 SEC Doc. 106 (March 25, 1992).

placed certain trading restrictions on the rep and various red flags should have alerted him that those restrictions were not being followed, Lindburg failed to take any action to confirm whether ongoing violations were in fact occurring or to prevent recurring violations.

The Commission's determination in First Albany clearly was not premised on Lindburg's title as General Counsel or as Chief Compliance Officer. At the same time, it is not clear that Lindburg's power unilaterally to impose monetary penalties was necessary to the decision, in light of his other responsibilities for insuring compliance and the existence of various red flags. It should be noted that the facts give rise to an inference that the representative may have been treated differently from others because he was the most successful "producer" in the office. This is a contributing factor that the Commission sees all too often in failure to supervise cases (including, one could argue, in Salomon), and it reinforces the need for flexible and realistic legal standards to promote adequate supervision.

The Commission's most recent pronouncement involving "non-line" failure to supervise cases grew out of the Salomon investigation, which revealed that three executives who occupied positions at the

highest level of firm management failed to reasonably supervise the activities of the firm's government securities trader.[10] The Commission issued an administrative order sanctioning those three individuals, but for purposes of my remarks I would like to focus on the Commission's public report concerning the supervisory responsibilities of in-house lawyers and compliance personnel in broker-dealer firms.

The Commission's report, issued under Section 21(a) of the Exchange Act, related to the roles and activities of Donald Feuerstein, who formerly held the positions of Chief Legal Officer and head of the Legal Department at Salomon, and who had authority over the firm's Compliance Department. 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. The Commission did not name Feuerstein as a respondent, but instead took the opportunity to amplify its views on the supervisory duty of persons in similar situations.

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[10] The Commission previously had 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.

Unlike Gutfreund, Strauss, and Meriwether, Feuerstein did not have direct line supervision over Mozer. The Commission found that Feuerstein was informed of the misconduct by these other officers in order to obtain his advice and guidance and involve him in formulating a response and that, in other instances of misconduct, he had directed the firm's response. In this particular instance, the legal officer advised management that the bid was a criminal act and should be reported to the government and he urged that disclosure be made. However, he did not direct an inquiry to determine the scope of the false bidding activity, recommend additional procedures be instituted or limitations be placed on Mozer's conduct, or inform the firm's Compliance Department of the false bids. In fact, as we know now, disclosure was not made for several months, while violations continued to occur. The Commission said that in its view a person in Feuerstein's position under these circumstances becomes a statutory supervisor and must share responsibility for taking appropriate action.

It should be clear from the report and from earlier Commission decisions in this area that the Commission does not believe that legal or compliance employees become statutory supervisors solely because of their titles or positions, nor are these employees

automatically excluded from that definition because the firm's organization chart does not give them line authority over salespersons. Instead, the Commission said that, in the context of a particular case, the question is whether the individual has the "requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." Further, the Commission stated that under this standard, an employee may become a supervisor under a particular set of facts and circumstances, even if he or she formerly did not have "direct supervisory responsibility for any of the activities of the employee."[11]

These principles may still beg the question: How do I as a legal or compliance officer know whether I will be deemed to be a statutory supervisor in any particular context? If you have actual power to "hire or fire, reward or punish" wrongdoers, the answer should be clear. With respect to facts such as those in Salomon, as I see it the question you should ask yourself is: Once on notice of actual or possible wrongdoing by a particular individual, have I been asked to do something -- investigate the conduct in question, recommend sanctions, review trade tickets, direct the firm's response, or take any

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[11] Gutfreund, et al., at 43 SEC Doc. 4394.

other actions designed to affect the conduct of the individual in question and limit the potential for violations by that individual? If the answer is yes, you should make reasonable efforts to carry out that responsibility, and if you do so, you should not be liable for a failure to supervise. The statute does not require a guarantee against violations, merely reasonable efforts to discharge the obligations that have been imposed.

As should be clear from Salomon, once an employee has been charged with responding to, rather than merely identifying, wrongdoing, it generally will not be sufficient to recommend a course of action without taking additional measures reasonably designed to see that the violation is not recurring. Another important message is that, when a group of officers are acting jointly to respond to red flags or violations, those individuals must clearly define among themselves their individual responsibilities. Group finger pointing can not serve as an effective excuse for the failure of supervisors, individually or collectively, to act.

I do not think the Commission intends or desires to micromanage the compliance process through the failure to supervise doctrine. Accordingly, the test for whether a supervisor has

discharged his or her responsibility is not whether, in hindsight, violations could have been better prevented by any other course of conduct. Instead, the appropriate inquiry should be whether the actions taken represent a reasonable response based on the information available at the time. Using Salomon again as an example, in the face of such serious violations, notifying senior management of the need for disclosure could not by itself reasonably have been expected to prevent ongoing violations where the admitted wrongdoer continued to submit Treasury bids on behalf of the firm and customers, no limitations were placed on his activities, and nothing was done for several months to ensure that disclosure was in fact made.

It is important to keep in mind some important limitations on the exposure of non-line supervisors that emerge from the Huff and Salomon orders. First, there must be some actual, rather than theoretical, power to respond to wrongdoing. I don't think the Commission intends to allow legal or compliance officers to be designated as "sacrificial lambs" who are made to bear the responsibility for supervision where it is in fact reposed in other managers.

A related limitation is that the individual must know or have reason to know that he or she has been charged with the duty to supervise. This knowledge may arise from the express authority to "hire or fire, reward or punish," but it also may exist in more subtle ways. For example, if a compliance officer knows that senior management is looking to him or her to recommend and devise a course of action that will respond to misconduct and prevent violations by a particular individual, that responsibility is no less substantial than if it were spelled out in an employment agreement. This principle is simply a reflection of what we all know from work experience: that rarely are all of an employee's actual responsibilities set in concrete or set out in writing, and that those responsibilities may change over time and vary with circumstance.

Perhaps the most controversial aspect of the Salomon report is its suggestion that, in some circumstances, where management has been apprised of a wrongdoing but has failed to act, a supervisor knowing of the wrongdoing and the failure to act may need to consider further action, including disclosure to the Board or regulatory authorities, or even resignation. I should say that I think the circumstances requiring such drastic action are rather extraordinary. Even in extreme and egregious situations, it may seem

to be asking a lot of compliance or legal officers to go over the heads of their immediate supervisors. But it must be remembered that once an individual has been charged with supervisory responsibility, the discharge of that responsibility is required by law, and not only by virtue of the management-employee relationship.

I acknowledge that the standard for adequate supervision may not always be distinct, but I also think that is unavoidable if we are to be committed to an approach that reflects the realities of control and responsibility in modern securities firms. A simpler approach could either permit some supervisors to avoid responsibility by hiding behind the shield of a title, or else subject persons to liability only because of their titles. Either result would be unfair.

Some have voiced concern that the absence of a bright line test will cause legal and compliance officers either to avoid assuming any responsibility not clearly imposed, or else be too quick to point blame or impose sanctions. This concern seems to me unfounded and in any event derives less from uncertainty over legal principles than uncertainty over how actual responsibility will or should be allocated. It may be that legal and compliance officers will want to have a clearer understanding of what they are being asked to do in a

particular case, but that does not strike me as a bad consequence. It also seems to me that the legal standard for discharge of supervisory responsibility is not so strict, or the potential for liability so great, that compliance officers will be discouraged from becoming involved in supervision, or will overreact to signs of misconduct.

In sum, I believe that the Commission's administrative proceedings in failure to supervise cases over the years, and particularly in the Salomon case, reflect a willingness to reach beyond form and organizational structure to impose liability when necessary to reflect the true functions performed by employees of every type. In recent years, many firms have justifiably placed an increased emphasis on legal and compliance functions. In the 1990s, compliance and legal personnel are part of the life blood of securities firms and have had to adjust to that reality. They are involved in daily decision making, and they allow firms to avoid mistakes that cost money and, more important, reputations.

As the world changes, the Commission, too, strives to keep up. Increased actual responsibility in some cases may mean greater legal responsibility, but this does not strike me as causing significant changes in the internal dynamics of securities firms. I expect that

legal and compliance personnel will continue to be actively involved in every aspect of the business, and I see that as a good development, not only for the firms themselves, but also for our markets and investors.