

Client Alert

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When Legal or Compliance Personnel May Be Subject to Failure to Supervise Liability Under the Securities Laws

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The SEC has provided some much-needed clarity on the issue of when broker-dealer compliance or legal personnel may be considered to be supervisors. On September 30, 2013, the Division of Trading and Markets (the "Division") issued a set of eight [FAQs](#) providing guidance relating to potential liability of Chief Compliance Officers, and other compliance and legal personnel at broker-dealers under Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934. Broker-dealers should carefully review these FAQs to understand when their compliance or legal personnel function as "supervisors," and thereby become potentially subject to liability for failure to supervise. Even though they do not specifically say so, the FAQs strongly suggest that they are articulating a test for finding supervisory authority to replace the test set out in the Initial Decision in the *Theodore Urban* administrative proceeding.

By way of background, Section 15(b)(6) authorizes the Commission to institute proceedings against a natural person associated with a broker-dealer for failure to supervise if someone under that person's supervision violates the provisions of the federal securities laws, the Commodity Exchange Act, the rules or regulations under those statutes, or the rules of the Municipal Securities Rulemaking Board, and the supervisor fails reasonably to supervise that person with a view to preventing the particular violation.

The Exchange Act does not presume that broker-dealer compliance or legal personnel are supervisors solely by virtue of their compliance or legal functions; rather, the inquiry turns on whether compliance or legal personnel have supervisory authority over business units or other personnel outside the compliance and legal departments. While the Commission has brought many actions alleging failure to supervise against individuals with supervisory authority, it has infrequently brought actions against broker-dealer legal or compliance personnel, and typically only in the limited circumstances in which compliance and legal personnel 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." In *Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995), the Commission stated that ultimately the responsibility for a broker-dealer's compliance resides with its chief executive officer and senior management, and the FAQs clarify that "[a]s a general matter, the staff does not single out compliance or legal personnel," but the staff does encourage "compliance officers and other compliance and legal personnel to take strong and vigorous action regarding indications of misconduct."

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THE STATUS OF THE *THEODORE W. URBAN* INITIAL DECISION

In the midst of the FAQs, the Division reminds readers that the hearing decision in *Theodore Urban* is “of no effect” because on appeal the Commission was evenly divided as to whether the allegations in the Order Instituting Proceedings were established. In the September 8, 2010 [initial decision](#), the Administrative Law Judge determined that, while Urban, a broker-dealer’s general counsel, executive vice president, and a voting member of the Board of Directors, was a supervisor, the SEC had failed to prove that he had failed to supervise a broker. On appeal, the Commission decided on January 26, 2012, to dismiss the proceeding. The Division’s reminder that the ALJ’s findings about Urban’s supervisory status are no longer effective suggests that the SEC is expecting the industry to look to the FAQs rather than any precedent for the appropriate standards in this area.

THE DUTIES OF LEGAL OR COMPLIANCE PERSONNEL WHO ARE “SUPERVISORS”

According to the FAQs, if a person working in a legal or compliance capacity becomes a supervisor for purposes of the Exchange Act, he must reasonably supervise with a view to preventing violations of the federal securities laws, the Commodity Exchange Act, the rules or regulations under those statutes, or the rules of the Municipal Securities Rulemaking Board. That person must reasonably discharge those obligations or know that others are taking appropriate action, and it is not reasonable for such a person to be a “mere bystander” to events that occurred, or to ignore wrongdoing, “red flags” or other suggestions of irregularity.

Section 15(b)(4)(E) provides an affirmative defense to potential liability for failure to supervise if a firm has procedures and a system for applying those procedures reasonably expected to prevent and detect a violation, and the supervisor has reasonably discharged his duties pursuant to such procedures and system, without reasonable cause to believe that the procedures and system were not being complied with.

WHEN COMPLIANCE AND LEGAL PERSONNEL ARE “SUPERVISORS”

The FAQs make clear that compliance and legal personnel are not “supervisors” of business line personnel for purposes of Sections 15(b)(4) and 15(b)(6) solely because they occupy compliance or legal positions. Rather, determining if a particular person is a supervisor comes down to whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

A person’s actual responsibilities and authority, rather than his “line” or “non-line” status, determine whether he is a “supervisor” for purposes of Sections 15(b)(4) and 15(b)(6), and some of the relevant factors include whether:

- the person was clearly entrusted with, or assumed supervisory authority or responsibility for, particular business activities;
- the firm’s policies and procedures or other documentation identify the person as responsible for supervising, or for overseeing, business persons or activities;
- the person has the power to affect another’s conduct by hiring, rewarding or punishing that person;
- the person had such authority and responsibility that he could have prevented the violation from continuing, even if he did not have the authority to fire, demote or reduce the pay of the person in question;

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- the person knew that he was responsible for the actions of another, and could have taken effective action to fulfill that responsibility;
- the person should have known in light of all the facts and circumstances that he had the authority or responsibility within the administrative structure to exercise control to prevent the underlying violation.

WHEN COMPLIANCE AND LEGAL PERSONNEL ARE NOT “SUPERVISORS”

Compliance and legal personnel do not become “supervisors” of business line personnel solely because:

- they provide advice regarding compliance or legal issues to business line personnel, or assist in the remediation of an issue. If the responsibility or authority of legal and compliance personnel extends beyond compliance and legal functions, giving personnel the requisite degree of responsibility, ability or authority to affect the conduct of business line personnel, then the firm needs to conduct additional inquiries to determine whether they could be considered supervisors of the business line personnel;
- they participate in, provide advice to, or consult with a management or other committee. Firms should evaluate what role legal or compliance personnel perform on management or other committees, and should consider, in order to avoid having legal or compliance personnel be considered supervisors, that they serve *ex officio*, as nonvoting members, in an active but advisory role to the committee;
- they provide advice to, or consult with, senior management, since they routinely 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. Compliance and legal personnel should inform direct supervisors of business line employees about conduct that raises red flags, continue to follow up to ensure that a proper response is implemented by business line supervisors, and potentially escalate situations to persons of higher authority if they determine that concerns have not been addressed.

A broker-dealer may establish and implement a robust compliance program without its compliance and legal personnel being considered to be supervisors. To fulfill their duty to build effective compliance programs reasonably designed to ensure compliance with applicable laws and regulations, broker-dealers should consider robust compliance monitoring systems, processes to escalate identified instances of noncompliance to business line personnel for remediation, and procedures clearly designating responsibility to business line personnel for supervision of functions and persons. To avoid considering compliance and legal personnel who exclusively fulfill legal and compliance functions to be supervisors of business line employees, broker-dealers should consider clearly defining compliance and advisory duties, and distinguishing those duties from business line duties.

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