While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers*

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Introduction

This column on disciplinary actions will be a regular feature in this journal. The articles will analyze Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) actions so that compliance officers (and others) may be able to learn from the "mistakes" of others.

From April through July 2010, the SEC and FINRA brought disciplinary actions against Chief Compliance Officers (CCOs) for conduct including failing to supervise, aiding and abetting recordkeeping violations, and acting as a CCO without proper qualifications.

Failing to Supervise

Compliance officers are generally not subject to supervisory liability. Where, however, they are deemed to have sufficient "responsibility, ability, or authority" to affect an employee's conduct, they may be considered supervisors.[1] For those compliance officers who are acting in supervisory roles, recent cases caution against taking half-measures in the exercise of their supervisory responsibilities.

Heightened supervision, but . . . not heightened enough

In June 2010, an SEC administrative law judge (ALJ) ordered a CCO to pay a civil penalty of $65,000 and barred her from association in a supervisory capacity with any broker, dealer, or investment advisor for one year, with the right to reapply, for failure to supervise in connection with the sale of variable annuities.[2] The ALJ had found that registered representatives at the CCO's firm had committed fraud by making material misrepresentations to elderly customers while selling unsuitable securities. While CCOs, in general, do not supervise registered representatives, in this case, the ALJ concluded that the CCO had the authority to affect the conduct of the registered representatives at issue and that she (along with the firm's president) failed reasonably to supervise those registered representatives.

The CCO was responsible for supervising compliance department employees at the home office and supervising supervisors and registered representatives in branch offices. As CCO, she could require training, issue training letters, and assess small fines. After conferring with the firm's president, she could assess larger fines, withhold commissions or terminate the employment of registered representatives.

The CCO's supervisory liability arose from the actions she took (or didn't take) in the following areas:

- Inadequate heightened supervision:
- When a registered representative on heightened supervision repeatedly refused to cooperate with his supervisor, the CCO treated the conflict as a human resources issue, rather than disciplining the registered representative.
- Inadequate investigation of customer complaints:
- Where investors complained in writing to the firm about sales practices, the CCO's investigation did not include contacting the investors.
- Inadequate response to license revocation:
- When the CCO learned that the state of Florida was revoking a representative's license, she allowed him to continue to sell securities until she received written confirmation of the revocation. The ALJ suggested that halting sales until the firm had received definitive notice that his license was in good standing would have been a better course of action.

In imposing a temporary, rather than a permanent bar, the ALJ took into account the efforts of the CCO and the president to improve compliance at the firm, although the ALJ found the efforts to be "insufficient." For example, the ALJ acknowledged that the CCO had strengthened compliance procedures during her tenure, including increasing the number of files reviewed during branch examinations and hiring additional personnel in the compliance department. In addition, the CCO had placed some "problem" registered representatives on heightened supervision, ordered weekly compliance visits for one representative, issued a training letter, and recommended additional follow-up after a branch examination report indicated deficiencies in sales practices. These steps, however, were considered "too little" and/or "too late," and the ALJ found the CCO to be liable.

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So many red flags . . . so little action

Also in its June 2010 Regulatory Notice, FINRA announced that, through a settlement, it had fined and suspended a former CCO for failing to supervise registered representatives who engaged in churning and made unauthorized and unsuitable trades in customer accounts.[3] The CCO was responsible for supervising branch managers, performing background investigations in connection with hiring decisions, implementing and monitoring heightened supervision, and reviewing transactions to ensure that representatives' recommendations were suitable. FINRA found that the firm's overall supervisory system was deficient and that the CCO had failed to supervise the representatives at issue by failing adequately to scrutinize their conduct and failing to follow up on red flags.

FINRA noted several red flags that it said ought to have prompted additional scrutiny of the representatives including the following:

- The representatives at issue had been associated with firms that were expelled for sales practice violations.
- The representatives had been fired or forced to resign from previous firms.
- The representatives had a history of customer complaints.
- The turnover rates and cost-to-equity ratios in customer accounts suggested excessive trading.
- Customer accounts were highly margined and frequently concentrated in one security.

In addition, FINRA noted that the CCO's review of customer transactions was limited to ensuring that individual transactions did not involve excessive markups or commissions, which FINRA characterized as not reasonably designed to detect misconduct. For failing to supervise the representatives, FINRA fined the CCO $5,000 and suspended him in any principal capacity for four months.

Aiding and Abetting Recordkeeping Violations

Liability for aiding and abetting requires an underlying violation, substantial assistance in connection with the primary violation, and scienter (either knowing or reckless conduct).[4] Even inaction, where there is duty to act, may give rise to aiding and abetting liability.[5]

Once bitten, twice . . . bitten

In July 2010, the SEC upheld an ALJ's decision that a CCO willfully aided and abetted the firm's violations of Section 17(a) of the Securities Exchange Act of 1934 in connection with his firm's underlying recordkeeping and document production violations.[6] The CCO had appealed an ALJ's decision that found him liable for aiding and abetting the firm's failure to preserve and produce the emails and instant messages of a registered representative who was also a branch manager. The SEC affirmed the ALJ's decision that the CCO should pay a $30,000 penalty, but added to his sanction by imposing a two-year bar, with the right to reapply. Finally, the SEC also upheld a $100,000 penalty against the firm.

The CCO was responsible for preservation of records at the firm, including preservation of email and instant messages. In July 2003, the CCO approved a revised written policy requiring registered representatives either to disable their computers' instant messaging programs or to preserve paper copies of their instant messages. Contrary to this policy, at the end of 2003, the CCO approved a registered representative's practice of storing instant messages electronically. At this time, the CCO also became aware that the same registered representative was using a personal email address for business purposes, contrary to the registered representative's written affirmation to the contrary during a branch audit. In connection with branch audits during the following two years, the CCO failed to alert the firm's auditors about the personal email account, and the CCO continued to approve electronic storage of instant messages. While the CCO repeatedly threatened to take disciplinary action against the representative for using a personal email account, he never took any action.

The SEC Enforcement staff contacted the CCO in July 2005 requesting firm documents, including electronic materials, relating to the representative's trading of a particular stock. In response to this request, the CCO assigned to the representative the responsibility for producing records of correspondence and then relayed to the SEC the representative's false assertion that he had no responsive correspondence to produce. During the next several months, the SEC sent at least five request letters to the CCO, spoke with him by telephone, and contacted the registered representative through his counsel. Although the firm produced limited emails, without attachments, and the representative's phone records, the CCO never visited the representative's office to search for responsive documents. The representative made multiple incomplete email productions and declined to produce his computer's hard drive.

In January 2006, the CCO threatened to terminate the representative if he did not comply with the SEC request. Weeks later, the representative did provide his hard drive, but by that time he had "electronically shredded" approximately 1,000 messages. Finally, in response to a July 2006 SEC subpoena directed at the firm, the firm produced emails from the registered representative's firm email account. Not until March 2007 did the CCO visit the representative's branch office to collect additional responsive documents. At that time, he found two boxes of responsive documents.

Based on the firm's underlying failure to produce business records in a timely fashion and failure to preserve records, and based on the CCO's substantial assistance with respect to those actions, which the SEC characterized as "variously knowing and extremely reckless," the Commission concluded that the CCO had willfully aided and abetted the firm's violations.

The SEC's decision highlighted the following facts regarding the CCO's conduct and the firm's failure to produce documents:

- The CCO delegated responsibility for production to the registered representative;
- The CCO failed to follow up on threats to discipline the representative for his failure to produce; and
- The firm delayed physically searching the relevant branch office.

Similarly, regarding the firm's failure to preserve records, the SEC noted the following conduct by the CCO:

- The CCO failed to inform firm auditors of the use of the personal email account;

- The CCO failed to follow up on threats to discipline the representative for using a personal email account; and
- The CCO allowed electronic storage of instant messages, contrary to the written policy.

One notable lesson from this case is that appeals of ALJ decisions are not without peril because, as in this case, the Commission can increase the sanction if it deems the ALJ's action to be insufficient.

Acting as CCO Without Proper Qualifications

Some people just don't like to take tests

In its June 2010 Regulatory Notice, FINRA announced that, through a settlement, it had censured, fined $10,000, and suspended for ten business days an individual for acting as a CCO even though he had not qualified by examination as a general securities representative, limited representative-corporate securities or general securities principal.[7]

Conclusion

One way to determine how regulators are looking at issues is to review disciplinary actions, both settled and litigated. The conduct in the cases discussed above led the SEC or FINRA to seek and obtain formal disciplinary actions and sanctions. As a result, the CCOs may have left the industry to seek other pursuits. While the readers of this journal are likely in compliance with applicable rules and regulations, they may want to review these cases with colleagues to remind them of the importance of maintaining such compliance.

ENDNOTES

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1 *George J. Kolar*, Admin. Proc. File No. 3-9570, 2002 SEC LEXIS 1647 (June 26, 2002) (quoting *John H. Gutfreund*, Admin Proc. File No. 3-7930, 1992 LEXIS 2939, (Dec. 3, 1992)).

2 *Prime Capital Services, Inc.,* Admin. Proc. File No. 3-13532, 2010 SEC Lexis 2086 (June 25, 2010).

3 *FINRA Orders Westpark Capital to Pay $400,000 for Failing to Supervise Brokers with Histories of Disciplinary Actions, Customer Complaints Who Churned Accounts, Engaged in Unauthorized and Unsuitable Trading,* Disciplinary and Other FINRA Actions (June 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p121625.pdf; *see also* Westpark Capital, Inc., Letter of Acceptance, Waiver, and Consent, No. 2007007400504 (March 31, 2010).

4 There was previously a split among Circuits as to whether recklessness satisfies the scienter requirement of the Securities Exchange Act of 1934 for aiding and abetting violations. *Compare Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000) (explaining that knowing or reckless conduct satisfies the scienter element) *with SEC v. Fehn*, 97 F.3d 1276, 1295 (9th Cir. 1996) (holding that "the requisite scienter for aiding and abetting liability is 'knowingly'"). The Dodd-Frank Wall Street Reform and Consumer Protection Act clarifies that the SEC can establish aiding and abetting violations for reckless or knowing conduct under Section 15 of the Securities Act of 1933, Section 20(e) of the Exchange Act, and Section 209(f) of the Investment Advisors Act of 1940. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

5 *Marc N. Geman*, Admin. Proc. File. No. 3-9032, 2001 SEC LEXIS 282, *67 (holding that an individual respondent's inaction "amply supports a finding that he willfully aided and abetted the Firm's recordkeeping violation").

6 *vFinance Investments, Inc., et al.*, Admin. Proc. File No. 3-12918, 2010 SEC LEXIS 2216 (July 2, 2010).

7 FINRA Case No. 2006004466102, Disciplinary and Other FINRA Actions (June 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p121625.pdf.