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SEC's Friendly Fire Against CCOs — And How To Avoid It

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The U.S. Securities and Exchange Commission has long recognized that chief compliance officers and other legal and compliance personnel serve the public interest as the first line of defense against misconduct. Recently, the agency brought two separate settled enforcement actions against CCOs of investment advisory firms for allegedly being "a cause" of their respective firm's compliance failure. In doing so, the SEC charged these CCOs for what it viewed to be mere negligence on the part of the CCOs in performing their purely compliance functions.

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This "hair-trigger" approach against CCOs is inconsistent with the agency's historical policy to tread carefully in charging legal and compliance personnel. In the past, the SEC tended not to charge such personnel unless they acted beyond their consulting and monitoring role to become a "supervisor" under the federal securities laws. Overzealous enforcement actions that deviate from this policy could create a "chilling effect" that would discourage the best talents from taking on compliance roles in the financial industry. In addition, if legal and compliance personnel make decisions based primarily on the fear of personal liability, their advice and guidance would not be trusted.

Unless the SEC issues a concrete and specific policy pronouncement to clear up prevailing uncertainties, legal and compliance professionals will continue to be haunted by the disconcerting possibility that the agency is focusing its firepower on its most important allies in its mission to protect the investing public.

Recent SEC Actions Against CCOs

In June 2015, the SEC instituted a settled enforcement action against SFX Financial Advisory Management Enterprises Inc. and SFX's CCO in connection with an SFX employee's misappropriation of client assets. SFX was charged, among other things, with violation of Rule 206(4)-7 under the Investment Advisers Act of 1940 for failure to adopt and implement written policies and procedures reasonably designed to prevent various violations. The CCO was alleged to have negligently "caused" SFX's violation of this policy and procedures rule and was required to pay a civil penalty of $25,000. The CCO was not alleged to be the employee's supervisor or to have failed to supervise the employee. In fact, the SEC did not identify any individual as the supervisor of the alleged wrongdoer.

Two months earlier, the SEC instituted settled administrative enforcement action against Blackrock Advisors and its CCO. The primary misconduct involved alleged failure to disclose a Blackrock portfolio manager's outside investment activities and related potential conflicts of interest. Similar to SFX, the Blackrock CCO was alleged to have caused the company's violation of Rule 206(4)-7 based on his allegedly negligent failure to adopt and implement written procedures reasonably designed to prevent the alleged misconduct. He was also required to pay a civil penalty of $60,000. Again, the CCO was not alleged to be the portfolio manager's supervisor.

Gallagher's Dissent, Followed by Aguilar's and White's Assurances

SEC Commissioner Daniel Gallagher voted against the two settled enforcement actions. In a strongly worded June 18, 2015, public statement explaining his dissent, the commissioner stated that both settlements reflect a commission trend toward strict liability for CCOs under Rule 206(4)-7 and would send a "troubling message" that CCOs should not take ownership of their firm's compliance policies and procedures in order to avoid personal liability.

In response, Commissioner Luis Aguilar, who voted in favor of SFX and Blackrock, issued a statement on June 29, 2015, stating that the "Commission does not bring enforcement actions against CCOs who take their jobs seriously and do their jobs competently, diligently, and in good faith to protect investors." Aguilar also stated that actions against CCOs are statistically rare.

In a speech on July 15, 2015, Chairwoman Mary Jo White stated that the SEC does not target compliance professionals and that the agency would bring enforcement actions against compliance professionals only when their actions or inactions "cross a clear line."

The SEC's Use of an Aggressive Legal Theory Against CCOs

Despite the assurances by White and Aguilar, the SEC had employed an aggressive legal theory against the CCOs in SFX and Blackrock. Both CCOs were charged with having "caused" their firm's compliance failures. The SEC can bring administrative "cease-and-desist" enforcement proceedings and seek civil penalties by alleging that a respondent was a cause of another person's or entity's violation of the federal securities laws. Negligence is sufficient to establish "causing" liability unless the person is alleged to "cause" a primary violation that requires intent. Since a CCO is typically responsible for firm compliance policies and implementation, it would be relatively easy for the SEC enforcement staff to allege that the CCO was, as a result of negligence, a "cause" of any nonfraud violations related to the firm's alleged compliance deficiencies.

Deviation from the SEC's Historical Enforcement Approach Regarding Legal and Compliance Personnel

The recent CCO actions deviate greatly from the SEC's historical restraint in bringing enforcement actions against legal and compliance personnel. This policy was first established by the agency's seminal opinion of Carter & Johnson in 1981.[1] The commission in Carter & Johnson, on appeal, reversed an administrative law judge's finding of liability against two securities lawyers for their negligent legal advice that allegedly contributed to a company's materially inaccurate disclosure. The commission recognized the critical role of securities lawyers in promoting compliance through often difficult judgment of complex securities law issues and even stated that:

If a securities lawyer is to bring his best independent judgment to bear on a disclosure problem, *he must have the freedom to make innocent — or even, in certain cases, careless — mistakes* without fear of

legal liability ...

(emphasis added).

The commission further stated in Carter & Johnson that if a securities lawyer is motivated by fear of personal liability when advising a client, he or she will not be trusted by the client, thus defeating the lawyer's ability to guide the client toward compliance. As later explained in a speech by the SEC's general counsel in 2005, the agency under this policy would not charge attorneys for making a mistake in advising clients, unless the attorneys acted beyond their role such that their violations were not related to legal advice or the incorrect advice is a gross departure from legal standards.

Consistent with Carter & Johnson, the SEC historically charged CCOs and other legal and compliance personnel in the securities industry based on a failure to supervise theory in which the threshold question is whether the CCO was acting as a supervisor under the federal securities laws. In other words, was the CCO acting beyond his or her legal and compliance consulting role such that he or she was acting as the employee's supervisor?

In the Matter of Arthur James Huff, the commission in 1991 reversed an ALJ finding that a broker-dealer compliance officer failed reasonably to supervise a registered representative who committed fraud.[2] Two of the commissioners issued a concurring opinion finding that the compliance officer was not a supervisor because he lacked the ability to "control" the registered representative.

In 1992, in the Matter of John H. Gutfreund et al., the SEC brought a failure to supervise action against senior executives of Solomon Brothers Inc. for failure to supervise an employee in connection with the employee's misconduct.[3] The commission at the same time issued a special report of investigation under Section 21(a) of the Exchange Act. It issued the report to "amplify [the SEC's] views on the supervisory responsibilities of legal and compliance officers" but decided not to charge Solomon Brother's chief legal officer. The commission explained that employees of brokerage firms who have legal or compliance responsibilities do not become supervisors solely because they occupy those positions. Instead the focus is on whether the legal and compliance officer had the requisite degree of responsibility, ability or authority to affect the conduct of the employee to be considered the employee's supervisor. The SEC warned that given the role and influence of the Solomon Brothers' CLO, such a person could be considered a supervisor and thus shared in the responsibility to take appropriate action to respond to the misconduct.

Despite Gutfreund's apparent expansion of potential legal and compliance personnel liability beyond the Huff decision, Gutfreund's theory of legal and compliance personnel liability was still within the four corners of the analysis of whether the legal and compliance person is a "supervisor."

There were few, if any, significant SEC enforcement actions against legal and compliance personnel until 2010, when after an evidentiary hearing, an ALJ in the Matter of Theodore W. Urban issued an initial decision finding that a broker-dealer and investment advisory firm's general counsel was a supervisor of an employee who allegedly committed misconduct.[4] The ALJ nevertheless dismissed the proceedings against the GC because she found that the GC did not fail to exercise that supervision reasonably. On appeal, the commission was unable to arrive at a decision because three of the commissioners were unable to participate in the decision and the two remaining commissioners could not agree on a decision, resulting in a 1-1 tie.

With the matter unresolved, there were widespread concerns in the financial industry as to whether the enforcement staff would take aggressive actions against legal and compliance personnel by labeling them as supervisors under Urban. In apparent response to this anxiety in the industry, in September 2013, the SEC's Division of Trading and Markets issued an FAQ, which provided the assurance that "the staff does not single out compliance or legal personnel" in bringing failure to supervise actions, and such personnel do not become supervisors solely because they provide advice to, or consult with, senior management.

Inexplicably, in pursuing the SFX and Blackrock actions against CCOs, the SEC did a complete "about-face" in apparent disregard of the earlier special effort by the SEC staff to provide assurance to legal and compliance professionals in the aftermath of Urban. The enforcement actions entirely bypassed the traditional "failure to supervise" analysis and employed the more aggressive "causing" theory against legal and compliance personnel. These actions contradict the SEC's policy of restraint of the past decades and may ultimately "chill" the good work of legal and compliance personnel. Below are recommendations to address this troubling development.

Recommendations

To the SEC: It is in the interest of the commission that legal and compliance personnel do their job in good faith without the unnecessary fear of hindsight enforcement action. The commission should reaffirm the policy of restraint first set out under Carter & Johnson. As such, the commission should make a policy pronouncement with precedential effect, such as a 21(a) report of investigation, that it will not bring an enforcement action against a legal and compliance personnel in connection with his or her exercise of compliance responsibilities unless he or she:

was acting as a "supervisor" and failed reasonably to supervise; or
was at least reckless or intentional, as opposed to negligent, in failing to fulfill his or her compliance responsibilities.

To CCOs: Despite assurances from the SEC, these are dangerous times for legal and compliance personnel. When confronted with high-risk compliance issues, consultation with outside counsel may be prudent.
To Counsel Representing CCOs in SEC Enforcement Actions: Counsel representing CCOs subject to an SEC enforcement action should consider, among other things, a defense that such action is not "in the public interest," a legal prerequisite for the SEC in seeking sanctions. For instance, one can cite the Carter & Johnson decision, which is still good law, for the proposition that it is not in the public interest to target the SEC's best allies in the agency's mission to protect the investing public.

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[1] *In the Matter of William R. Carter, Charles Johnson, JR.,* 47 S.E.C. 471 (1981).

[2] *In the Matter of Arthur James Huff*, 50 S.E.C. 524 (1991)

[3] *In the Matter of John H. Gutfreund*, Exchange Act Rel. No. 31544 (Dec. 3, 1992)

[4] *In the Matter of Theodore W. Urban*, SEC AP File No. 3-13655, Initial Decision Rel. No. 402 (Sept. 8 2010), *dismissed* by Exchange Act Rel. No. 66359 (Jan. 26, 2012).
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