CLEAR AS MUD:
THE STATUS OF LEGAL AND COMPLIANCE OFFICERS AS SUPERVISORS AFTER THE URBAN CASE

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“The necessity for supervision is a fact of life in the securities industry.”


* * *

“The question of what makes a legal or compliance officer a supervisor, however, remains disturbingly murky.”

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I. INTRODUCTION

When are legal and compliance officers also “supervisors” of business line-level employees? Can carrying out their duties in the legal and/or compliance department make them liable for failure to supervise a rogue salesman or other line-level employee? The answers are far from clear, particularly after the Securities and Exchange Commission (“Commission” or “SEC”) earlier this year was unable to agree on whether Theodore W. Urban (“Urban”) was acting in a supervisory capacity with respect to a registered representative with a regional broker-dealer. Urban was the general counsel and performed several other important functions, such as head of the compliance, human resources, and internal audit departments.

Further, if a general counsel or compliance lawyer is determined to be the supervisor of business line-level employees, could this interfere with the lawyers’ ability to provide independent, unbiased advice concerning the securities laws and/or chill advocacy on behalf of clients before the Commission? Addressing these concerns, SEC Commissioner Daniel Gallagher recently stated that, “We must strive to ensure that failure-to-supervise liability never deters legal and compliance personnel from diving into the firm’s real-world legal and compliance problems.”

This outline discusses the Urban case and the Commission’s prior failure-to-supervise cases against non-line legal and compliance personnel. Given the murky state of the law, the

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1 The author gratefully acknowledges the contributions of Marilyn A. Sponzo, formerly a chief compliance officer and lawyer for an insurance affiliated broker-dealer and currently Of Counsel with Jorden Burt LLP, and Richard T. Choi, Gary O. Cohen, and Thomas C. Lauerman, all of Jorden Burt LLP, in reviewing and commenting on this outline. The author’s views do not necessarily reflect the views of her law firm, the law firm’s individual partners and other lawyers, or any of the firm’s clients.


outline attempts to draw a line between supervision and compliance and outlines steps for establishing a robust supervisory infrastructure and a system for implementing the structure.\(^5\) Anticipating the possibility that legal and compliance personnel may be deemed to be supervisors of line-level employees, the outline sets out best practices for a “supervisor” to avoid failure-to-supervise liability.

### II. A CASE STUDY: THEODORE W. URBAN

#### A. Summary

The SEC issued an order instituting administrative proceedings (“OIP”) against Urban on October 19, 2009, alleging that Urban ignored red flags and failed to supervise a registered representative at Ferris, Baker Watts, Inc. (“FBW”).\(^6\) At the time of the alleged events, Urban was general counsel of FBW where he headed three departments: compliance (which was part of the legal department), human resources, and internal audit. He also was a voting member on the firm’s board of directors, the firm’s credit committee, and executive committee of the board.\(^7\)

The OIP alleged that Stephen Glantz, a registered representative of FBW, violated the anti-fraud provisions of the securities laws, that Urban was Glantz’s supervisor, and that Urban failed to exercise supervision reasonably, within the meaning of Section 15(b) of the Securities Exchange Act of 1934, as amended (“Exchange Act”) and Section 203(f) of the Investment Advisers Act of 1940, as amended (“Advisers Act”).

FBW’s own written supervisory procedures provided that branch managers “were charged with direct supervision of brokers.”\(^8\) The head of retail sales, who “was the most powerful person at the firm,” recruited Glantz to FBW.\(^9\) Urban met with Glantz and the head of retail sales in 2003 to discuss a possible manipulative

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\(^5\) An attorney’s obligation under Section 307 of the Sarbanes-Oxley Act (15 U.S.C. § 7245) to report a material violation of the securities law by the company or certain individuals is beyond the scope of this outline. Also, confidentiality, the attorney-client privilege, and self-reporting of violations are beyond the scope of this outline.


\(^7\) The ALJ in the Initial Decision also noted that Urban was executive vice president of FBW. The OIP did not indicate that Urban held this position, but in several places referred to Urban as a “senior executive.” Urban served on the executive committee of the board, but his responsibilities as executive vice president are not at all made clear in the Initial Decision. If Urban had business-line responsibilities in his executive vice president position, query whether the Commission could have avoided bringing a failure-to-supervise case against Urban as general counsel.

\(^8\) Prior to joining FBW, Urban worked for the Commission as a staff attorney, branch chief, and assistant director in the Division of Market Regulation, and at the Commodities Futures Trading Commission. Initial Decision at 2.

\(^9\) Id. at 6 & 50.

\(^10\) Id. at 3 - 4.
trading incident. Following additional unauthorized trading in accounts that carried significant margin debits, Urban recommended in 2004 that Glantz be terminated, which suggestion was met with vehement opposition by the head of retail sales. Following additional unauthorized trading in accounts that carried significant margin debits, Urban recommended in 2004 that Glantz be terminated, which suggestion was met with vehement opposition by the head of retail sales. The head of retail sales prevailed, and over Urban’s opposition, Glantz was put on special supervision in 2005. Glantz left FBW in December 2005 and pleaded guilty to one count of securities fraud and one count of making a false, fictitious or fraudulent statement. Urban resigned from FBW on March 1, 2007.

The Division of Enforcement argued that Urban “failed to respond reasonably to red flags that Glantz’s conduct was illegal.” Relying on Gutfreund, the Division contended that “Urban was required to take concerns about Glantz’s conduct to FBW’s Board or Executive Committee, and if they did not act, he was required to resign and report the matter to regulatory authorities.”

In a 57-page decision issued on September, 8, 2010, the Commission’s chief administrative law judge (“ALJ”) found that (i) Glantz engaged in securities law violations, (ii) Urban was Glantz’s supervisor, and (iii) Urban “performed his responsibilities in a cautious, objective, thorough and reasonable manner.” Thus, the ALJ concluded that Urban did not fail to supervise Glantz.

The Enforcement Division filed a petition for review of the ALJ’s decision. Urban filed a motion asking the Commission to deny the Division’s petition or, alternatively, to grant his own cross-petition for review of the ALJ’s decision. The

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11 Id. at 25 - 26.

12 The Commission also brought a failure-to-supervise case against the head of retail sales, which was settled with the head of retail sales agreeing to a bar from association in a supervisory capacity with any broker-dealer or investment adviser, with the right to reapply, and payment of a $75,000 civil penalty plus disgorgement and prejudgment interest. See Louis K. Akers, SEC Admin. Proc. No. 3-13612, Exchange Act Release No. 60628 (Sept. 4, 2009).

13 Id. at 38 - 39. Glantz admitted lying about his actions to the SEC and FBI and “was sentenced to thirty-three months in prison, followed by three years of supervised release, and ordered to pay $110,000 in restitution.”

14 Id. at 38 (“Urban estimates that he lost between $800,000 and $1.3 million in terms of his ownership interest because of the timing and conditions of separation from FBW.”).

15 Id. at 47.

16 See In re John H. Gutfreund, 51 S.E.C. 93, Exchange Act Release No. 31554 (Dec. 3, 1992) (Section 21(a) Report finding that general counsel was a supervisor of the head of the government securities trading desk) (“Gutfreund”).

17 Initial Decision at 47 (emphasis added.) The Initial Decision cites the Enforcement Division’s Post-Hearing Brief for this statement, but does not otherwise state why the Division thought Urban would be required to resign or how he could report the matter consistent with his ethical obligations as a lawyer.

18 The ALJ held “Negligence is the applicable standard in assessing whether supervision was reasonable under the prevailing circumstances.” Id. at 52. See also infra Section IV.B.5.
parties argued different positions on the ALJ’s so-called “futility defense,” i.e., going to the CEO, the Board or the Executive Committee was not a reasonable alternative for Urban because the record showed that he did not have the CEO’s support, and without the CEO’s support, it would have been futile. Urban argued that the ALJ’s recognition of a “futility defense” is consistent with current law and Commission precedent “noting that attorneys have not been sanctioned ‘in litigated enforcement proceedings based on alleged negligent acts or omissions they may have committed in providing non-public legal advice to clients.’”\(^\text{19}\) The Enforcement Division objected to the ALJ “legally excusing Urban” from elevating the supervisory breakdown and red flags regarding Glantz to FBW’s CEO and Board of Directors, thus creating “an entirely new ‘futility’ defense within the law of supervision cases” which would “eviscerate the protections provided by existing law and permit supervisors at even the most corrupt firms to escape liability.”\(^\text{20}\)

The Commission granted the parties’ cross-petitions to review the ALJ’s decision, noting that ALJ determinations are “not sacrosanct” and

the proceeding raises important legal and policy issues, including whether Urban acted reasonably in supervising Glantz and responded reasonably to indications of his misconduct, whether securities professionals like Urban are, or should be, legally required to “report up,” and whether Urban’s professional status as an attorney and the role he played as FBW’s general counsel affect his liability for supervisory failures.\(^\text{21}\)

Industry trade organizations filed briefs of amicus curiae in support of Urban, urging the Commission to set aside the ALJ’s Initial Decision and take the “opportunity to enunciate a clear standard that compliance professionals can follow.”\(^\text{22}\) Instead of enunciating a clear standard, the Commission dismissed the case against Urban on January 26, 2012. Chairman Mary Schapiro and Commissioners Elisse Walter and Daniel Gallagher recused themselves without explanation.\(^\text{23}\) Commissioners Troy Paredes and Luis Aguilar could not agree. As

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\(^\text{19}\) \textit{Urban}, Order Denying Motion for Summary Affirmance at 2 (\textit{citing Scott G. Monson, supra n. 3}).

\(^\text{20}\) \textit{Id.}

\(^\text{21}\) \textit{Id.} at 4.


\(^\text{23}\) In recent remarks on the topic, Commissioner Gallagher stated that, “I was informed by the Commission’s ethics office that I would need to recuse myself from the case, and thus I did not participate in the matter.” \textit{Gallagher Remarks, supra n. 4}. 


a result, the case was dismissed pursuant to Commission Rule of Practice 411(f) and the ALJ’s opinion has no effect.\textsuperscript{24}

B. Urban as Supervisor

1. ALJ Observations. In assessing Urban’s status as a supervisor, the ALJ noted that Urban:

- “was not responsible and had no authority for hiring, assessing performance, assigning activities, promoting, or terminating employment of anyone, outside of the people in the departments he directly supervised.”\textsuperscript{25}
- “did not have any of the traditional powers associated with a person supervising brokers.”\textsuperscript{26}
- “did not direct FBW’s response to dealing with Mr. Glantz.”\textsuperscript{27}
- “did not believe he was Glantz’s supervisor or that he had authority to hire, fire, discipline, or direct the conduct of Retail Sales personnel.”\textsuperscript{28}

2. ALJ Determination. Notwithstanding the above observations, the ALJ determined that Urban was Glantz’s supervisor because:

- as General Counsel, Urban’s “opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in FBW’s business units.”\textsuperscript{29}
- Urban “was a member of the Credit Committee, and dealt with Glantz on behalf of the committee.”\textsuperscript{30}

\textsuperscript{24} Rule 411(f) provides “In the event a majority of participating Commissioners do not agree to a disposition on the merits, the initial decision shall be of no effect, and an order will be issued in accordance with this result.”

\textsuperscript{25} Initial Decision at 35.

\textsuperscript{26} \textit{Id.} at 52.

\textsuperscript{27} \textit{Id.}

\textsuperscript{28} \textit{Id.} There is objective evidence to support Urban’s belief. The Initial Decision notes that FBW’s own written supervisory procedures charged branch managers “with direct supervision of brokers.” \textit{See supra} text accompanying n. 9.

\textsuperscript{29} \textit{Id.}

\textsuperscript{30} \textit{Id.}
C. Administrative History

A summary of the administrative history in the *Urban* case follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>SEC Order / Decision</th>
<th>Allegations / Findings</th>
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| October 19, 2009   | Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940 | ● Urban was the general counsel, a member of the board of directors of FBW, and head of the compliance, human resources, and internal audit departments.  
● Glantz engaged in unauthorized and unsuitable trading in his customers’ accounts through a Ponzi scheme.  
● Urban failed reasonably to supervise Glantz with a view to detecting and preventing Glantz’s securities law violations. |
| September 8, 2010  | Initial Decision By Brenda Murray, Chief ALJ                                         | ● Glantz violated the anti-fraud provisions of the federal securities laws.  
● Urban was Glantz’s supervisor.  
● Urban acted reasonably in connection with the supervision of Glantz.  
● Urban did not fail to supervise Glantz given Section 15(b)(4)(E)(i) safe harbor.  
● No remedial action is appropriate under the Exchange Act and Advisers Act; proceeding dismissed. |
| October 22, 2010   | Cross petitions for review of ALJ’s decision granted; briefing schedule established.  |                                                                                                                                                        |
| December 7, 2010   | Order Denying Motion for Summary Affirmance                                            | ● Urban urged the Commission to summarily affirm the ALJ’s decision, “after having ‘lived under a cloud for four years.’”  
● Enforcement Division urged the Commission to review the initial decision. |
III. DUTY TO SUPERVISE

A. Supervisor, Supervisory Employees, and Supervised Persons

1. Exchange Act and Advisers Act

The Exchange Act does not define the term “supervisor.” Section 15(b)(7)(B) provides, with respect to the term “supervisory employees,” that the “term may be defined by the Commission’s rules and regulations and as so defined shall include branch managers of brokers or dealers.”
So, although to date the Commission has not amended its rules and regulations to define “supervisory employees,” the Exchange Act can be read to treat branch managers as supervisors. The SEC’s reading of the Exchange Act in this way is illustrated in SEC enforcement actions.  

The Advisers Act does not define “supervisor,” but in Section 202(a)(25) defines “supervised person” to mean “any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.”

2. Commission Interpretations

In a series of failure-to-supervise enforcement actions, the Commission has applied a facts and circumstances test to determine whether a particular legal or compliance officer is a “supervisor.” The Urban case illustrates the consequences of an overbroad interpretation of “supervisor.” As Commissioner Gallagher has observed, an overbroad interpretation “risks tacitly deputizing as a supervisor, with concomitant liability, anyone who becomes actively involved in assisting management in dealing with problems.”

B. Duty to Supervise under the Exchange Act

If a general counsel, compliance lawyer, or chief compliance officer is found to be the supervisor of line-level employees, it follows that he or she would be potentially subject to failure-to-supervise liability under the Exchange Act and/or the Advisers Act.

1. Broker- Dealers

Section 15(b)(4)(E) imposes on broker-dealers a duty to supervise persons subject to their supervision. This Section authorizes the Commission to impose sanctions against a broker-dealer if it finds that the broker-dealer, or its associated persons, “has failed reasonably to supervise, with a view to preventing violations of [the federal securities] statutes, rules, and


32 See infra Section IV.A.

33 Gallagher Remarks, supra n. 4.
regulations, another person who commits such a violation, if such other person is subject to his supervision.”

As Commissioner Gallagher put it: “As several decades of failure-to-supervise cases illustrate, the devil is in the details of the last ‘if’ clause.”

2. Safe Harbor

Section 15(b)(4)(E) contains a safe harbor, which provides that, “no person shall be deemed to have failed reasonably to supervise any other person, if –

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent to be associated with a broker, dealer, security–based swap dealer, or a major security-based swap participant.”

3. Associated Persons

Section 15(b)(6)(A) imposes on associated persons who have been given supervisory duties a duty to supervise persons subject to their supervision. This Section does not specify when one person is “subject to” the supervision of another. This Section authorizes the Commission to impose sanctions against supervisors associated with a broker-dealer “if the Commission finds . . . that such person . . . has committed or omitted any act, or is subject to an order or finding enumerated in [Section 15(b)(4)(E)].”

4. Legislative History

Sections 15(b)(4)(E) and (b)(6)(E) were added to the Exchange Act in the Securities Acts Amendments of 1964. The Senate Banking Committee report notes:

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34 See Exchange Act § 21B (setting forth possible civil penalties in administrative proceedings) (emphasis added).

35 Gallagher Remarks, supra n. 4.

36 Congress imposed the same duty to supervise, and sanctions for failure reasonably to supervise, on associated persons of nationally recognized statistical rating organizations. See Exchange Act § 15E(d)(1)(F).
With respect to failure to supervise, the Commission has consistently held that partners, branch managers, and other supervisory personnel of a broker or dealer have a responsibility to supervise employees and that revocation or other appropriate sanctions may be imposed upon a broker or dealer whose employees violate “that responsibility.” The primary purpose of inserting failure to supervise as an independent ground of disciplinary action would be to enable the Commission to reach more directly supervisory personnel who fail to discharge their responsibilities.


Citing to the legislative history of Section 15(b)(4)(E) in their brief of amici curiae in support of Urban, SIFMA and the Association of Corporate Counsel noted “One cannot be ‘subject to’ the supervision of another if the latter has no authority or ability to control the actions of the former” and that

Both the House and Senate legislative reports confirm that the phrase “person subject to his supervision” was intended to limit the imposition of supervisory liability. . . . The addition of the language “subject to his supervision” plainly must be read as a limiting clause – fully consistent with the notion that there should be some awareness on the part of the “supervisor” as to who is within his or her supervisory authority and some concreteness to the supervisory relationship.37

C. Duty to Supervise under the Advisers Act

1. Investment Advisers

Section 203(e)(6) imposes on any investment adviser a duty to supervise persons subject to their supervision. This Section authorizes the Commission to impose sanctions against any investment adviser if it finds that the investment adviser, or its associated persons, “has failed reasonably to supervise, with a view to preventing violations of the [federal securities] statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.”

2. **Safe Harbor**

Section 203(e)(6) contains a safe harbor, which provides that, “no person shall be deemed to have failed reasonably to supervise any person, if—

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.”

3. **Associated Persons**

Section 203(f) imposes on any person associated with an investment adviser a duty to supervise persons subject to their supervision. This Section does not specify when one person is “subject to” the supervision of another. This Section authorizes the Commission to sanction any associated person “if the Commission finds . . . that such person has committed or omitted any act or omission enumerated in [Section 203(e)(6)].”

D. **FINRA Rules**

1. **Supervisory System**

   NASD Rule 3010(a) requires each FINRA member to “establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.”

   In Rule 3010(a)(1)-(7), FINRA lists the minimum components of a firm’s supervisory system. Of note, Rule 3010(a)(2) requires that a firm’s supervisory systems include the “designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member.”

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38 In July 2007, the National Association of Securities Dealers, Inc. (“NASD”) and certain functions of the New York Stock Exchange were consolidated into the Financial Industry Regulatory Association (“FINRA”).
2. Supervisory Control System

NASD Rule 3012, adopted in 2004, sets out requirements for a broker-dealer’s supervisory control system. Among other things, the Rule requires broker-dealers to “designate and specifically identify to [FINRA] one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that –

(A) test and verify that the member’s supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and

(B) create additional or amend supervisory procedures where the need is identified by such testing and verification.”

3. Annual Certification of Compliance and Supervisory Processes

FINRA Rule 3130 (formerly NASD Rule 3013) requires a firm’s chief executive officer (or equivalent) to certify annually that, the firm has in place “processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations.” The scope and nature of the Rule 3130 CEO compliance certification requirement was an issue in the Urban case. 39

4. When is a General Counsel Required To Register?

Broker-dealer general counsels who are also chief compliance officers are required to hold a principal (or limited principal) registration. For insurance company affiliated wholesale broker-dealers, and other non-retail wholesale broker-dealers, a question arises whether the general counsel of a principal underwriter broker-dealer, who is not also serving as chief compliance officer, is required to register. In NASD Notices to Members 99-49 and 01-51, FINRA provided guidance on when a broker-dealer’s general counsel is required to register as a principal or registered

39 See Initial Decision, supra n. 2, at 34. Apparently FBW’s CEO “lacked confidence in Urban” and was angry that he (the CEO) signed a FINRA certification that did not mention the fund involved in the Glantz matter. “Urban, however, believed, based on NASD pronouncements and conversations with colleagues, that the CEO Compliance Certification was to assure regulators that the firm had policies and procedures in place, and the Compliance Report was not to document instances where the policies and procedures did, or did not, work.” Id. How SEC and FINRA Rules otherwise interface is beyond the scope of this outline. But see infra n. 60 and accompanying text.
Although status determinations require analysis of the facts on a case-by-case basis, FINRA set out the following general principles.

Principal and registered representative registration is not required if the firm’s general counsel:

- does not participate in the management of the firm or have management level supervisory responsibilities.
- advises the firm’s executive management, or operations committees if he or she only provides counsel and does not vote.

Principal and registered representative registration is required if the firm’s general counsel:

- is involved in the day-to-day management of the firm’s business;
- has management-level responsibilities for supervising any aspect of the firm’s investment banking or securities business (principal registration required);
- serves as a voting member of the firm’s executive, management, or operations committees; or
- sits on the firm’s board of directors (an employee of a broker-dealer who sits on the firm’s board is “presumed to be involved in the day-to-day management of the member’s business”).

Registered representative registration does not suggest supervisory obligations. Principal registration, on the other hand, implicates supervisory obligations, but not for everyone at lower levels. As discussed below in Section V.A.2., principal registration does not implicate a supervision obligation on registered principals to supervise every employee.

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40 NASD Regulation Provides Interpretive Guidance on Registration Requirements, NASD Notice to Members 99-49 (Jun. 1999); Registration of Chief Compliance Officers, NASD Notice to Members 01-51 (Aug. 2001).
IV. SUPERVISION VERSUS COMPLIANCE

A. Pre-Urban SEC Decisions

A determination of supervisory responsibility/liability requires a fact-intensive analysis. In a series of failure-to-supervise cases prior to the Urban case, the SEC established general principles for determining supervisory authority.

1. Authority to Authorize Activities

In one case, the SEC concluded that a senior registered options principal (“SROP”), who was responsible for establishing compliance procedures for options transactions, did not have “line” responsibility over a branch salesman, but had authority to authorize the salesman to open discretionary options accounts even though the firm prohibited them. However, the SEC determined that the SROP was the branch salesman’s supervisor because “he assumed responsibility for ensuring that this grant of authority, over which he continued to exercise control, was not being abused.”

2. Authority for Exercising Control over Specific Activities

In another case, the concurring opinion to the opinion of the Commission concluded that, for a non-line employee to be a supervisor, the non-line employee must have “been given (and knows or reasonably should know he has been given) the authority and the responsibility for exercising . . . control over one or more specific activities of a supervised person . . . so that such person could take effective action to prevent a violation of the Commission’s rules.”

3. Legal and Compliance Personnel Generally

In another case that was cited in Urban and in other failure-to-supervise cases, the SEC concluded that legal and compliance personnel “do not become ‘supervisors’ for purposes of Sections 15(b)(4)(E) and 15(b)(6)(A) solely because they occupy those positions.”

41 In re Michael E. Tennenbaum, Exchange Act Release No. 18429 (Jan. 19, 1982) (options department head who had authority to permit and withhold authority for traders to trade in discretionary accounts held to be a supervisor, because “having given the necessary permission to [the salesman], one of the few persons in the firm so selected, Tennenbaum failed to fulfill his concomitant responsibility to ensure that the special authority he had conferred was not being abused.”) (“Tennenbaum”).

42 Huff, supra n. 31 (concurring opinion of Commissioners Schapiro and Lochner analyzing the phrase “subject to the supervision.”).

43 Gutfreund, supra n. 16.
4. **Ability or Authority to Affect the Conduct of an Employee**

The SEC also concluded in that case that “determining if a particular person is a ‘supervisor’ depends on whether, under the facts and circumstances of a particular case, that person has requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.”

5. **Authority to Take Disciplinary Action Against Registered Rep**

In a few cases, the SEC has concluded that a compliance officer was a supervisor because he possessed “the power to take disciplinary action against a registered representative who violated firm policy by removing commissions and imposing small fines.”

6. **Authority to Hire and Fire Business Employees**

In a number of cases, the SEC has concluded that a compliance officer was a supervisor because he had the ability to hire and fire business employees.

7. **As Stated in Written Supervisory Procedures: Delegation**

In a couple of cases, the SEC has concluded that a firm’s written supervisory procedures (“WSPs”) “expressly stated” that the chief compliance officer had responsibility for “home office supervision of branch office activities . . . and, in practice, the department he headed was the only Firm entity that administered applicable supervisory procedures. The supervisory responsibility assigned to [the CCO] remained with him because he never delegated it.”

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44 Id. (finding general counsel (and others) to be the supervisor of the head of the government securities trading desk who submitted false bids).

45 See, e.g., *In re First Albany Corp.*, Exchange Act Release No. 30515 (Mar. 25, 1992); *Huff, supra* n. 31 (“A supervisor is someone who has the power . . . to reward or punish.”).

46 See, e.g., *In re James J. Pasztor*, Exchange Act Release No. 42008 (Oct. 14, 1999); *Huff, supra* n. 31 (“A supervisor is someone who has the power to hire or fire. . . ”).

B. Legal and Compliance Officers as “Supervisors”

1. Common Understanding

As the Urban matter illustrates so well, most general counsels and compliance officers would not consider themselves to be “supervisors” of business line-level employees. Commissioner Gallagher recently described the situation as follows:

Broker-dealers and investment advisers employ legal and compliance personnel to provide advice and guidance to firms and their employees regarding the application of laws and regulations to their businesses. Almost by definition, legal and compliance personnel work outside the direct chain of supervision for business activities, and few, if any, would think of themselves as “supervising” day-to-day activity. A key question, therefore, is at what point can legal and compliance personnel be reasonably deemed “supervisors” as they carry out their responsibility to prevent and, if necessary, address violations of laws or regulations by firm employees and to provide advice and guidance to management?48

Moreover, as noted above, the Commission takes the position that, legal and compliance personnel do not become “supervisors” for purposes of Exchange Act liability “solely because they occupy those positions.”49

2. Where Do We Draw the Line Between Compliance and Supervision?

After Urban, the line between legal/compliance functions and supervisory functions is not easy to draw. Indeed, the Urban case blurred the line. As illustrated below, however, several factors tend to indicate the status of an individual.

<table>
<thead>
<tr>
<th>Traditional Legal / Compliance Personnel Functions</th>
<th>Traditional Supervisor Functions</th>
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</thead>
<tbody>
<tr>
<td>No express delegation of authority to supervise</td>
<td>Express delegation of authority to supervise</td>
</tr>
<tr>
<td>Ability to counsel, advise, and recommend action to business management</td>
<td>Ability to control, hire and fire</td>
</tr>
</tbody>
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48 Gallagher Remarks, supra n.4 (emphasis added).

49 Gutfreund, supra n. 16.
<table>
<thead>
<tr>
<th><strong>Traditional Legal / Compliance Personnel Functions</strong></th>
<th><strong>Traditional Supervisor Functions</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>No power to execute decisions regarding salesmen</td>
<td>Ability to discipline or restrict salesmen</td>
</tr>
<tr>
<td>Provide regulatory and compliance advice with respect to applicable laws and regulations</td>
<td>Voting member on firm board or committee</td>
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<tr>
<td>Develop policies, procedures, and guidelines designed to facilitate compliance</td>
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<tr>
<td>Monitor firm personnel to identify potential deviations from compliance</td>
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3. **Consequences of Not Being Able to Draw the Line**

The most important consequence of not being able to draw the line between legal/compliance functions, on the one hand, and supervisory functions, on the other hand, is the potential exposure to failure-to-supervise liability. If this liability attaches, the burden shifts to legal and compliance officers to establish that supervision was adequate. Stated differently, unless there is a clear line showing that legal and compliance personnel are not supervisors, legal and compliance personnel should take steps to ensure that supervision is adequate.

4. **Steps to Ensure Adequate Supervision**

The *Urban* case did not clarify what constitutes adequate supervision. The case demonstrates, however, what the SEC considers not to be adequate supervision (*e.g.*, failure to follow-up on red flags). SEC failure-to-supervise cases provide some guidance on adequate supervision, as follows.

- If informed of “red flags” or “suggestions” of irregularity, “there must be adequate follow-up and review when a firm’s own procedures detect irregularities or unusual trading activity.”

- “[I]f more than one supervisor is involved in considering the actions to be taken in response to possible misconduct, there must

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be a clear definition of the efforts to be taken and a clear assignment of those responsibilities to specific individuals within the firm.”

Don’t assume that someone else will act. Also, don’t assume that you don’t have responsibility.

- “In situations where supervisors are aware of wrongdoing, it is imperative that they take prompt and unequivocal action to define the responsibilities of those who are to respond to the wrongdoing.”

- Once an in-house lawyer or compliance officer becomes involved in formulating management’s response to a problem, he or she is obligated to take affirmative action to ensure that appropriate action is taken.

- In the face of specific warnings about improper activities, do not drag your feet to take or recommend action to investigate the activities.

5. Standard for Reasonable Supervision – Negligence

Liability attaches under the Exchange Act and Advisers Act if the Commission finds that a supervisor has “failed reasonably to supervise.” To determine reasonableness, according to the ALJ in Urban, “Negligence is the applicable standard in assessing whether supervision was reasonable under prevailing circumstances.” Negligence is “the failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation” and a reasonable person “acts sensibly, does things without serious delay, and takes proper but not excessive precautions.”

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51 Id. at text accompanying note 19 (emphasis added) (“Supervisors who know of wrongdoing cannot escape liability for failure to supervise simply because they have failed to delegate or assign responsibility to take appropriate action.”).

52 Id.

53 Id. (emphasis added) (“It is not sufficient for [a supervisor] to be a mere bystander to events that occurred.”)

54 Gallagher Remarks, supra n. 4 (citing “Gutfreund and other similar proceedings.”). This guidance raises an interesting question about compliance versus supervisory obligations. It seems to suggest that, just because a lawyer or compliance officer has an obligation to affirmatively act, that act constitutes “supervision” over a wrongdoer. Query whether that act should be a separate compliance violation rather than a failure-to-supervise? Otherwise, wouldn’t every compliance failure also be a supervision failure?

55 Tennenbaum, supra n. 41, at text accompanying note 23 (noting that Tennenbaum engaged in “foot-dragging” when faced with red flags).

56 Initial Decision, supra note 1, at 52 (citing Huff, supra n. 31, and other SEC cases).

57 Id. (citing Black’s Law Dictionary).
6. The “Dangerous Dilemma”

The Urban case also illustrates that legal and compliance personnel who are robustly engaged in legal and compliance activities may face an increased risk of supervisory liability, which Commissioner Gallagher dubbed this reality a “dangerous dilemma”:

*Unfortunately, robust engagement on the part of legal and compliance personnel raises the specter that such personnel could be deemed to be “supervisors” subject to liability for violations of law by the employees they are held to be supervising.* This creates a dangerous dilemma. A compliance officer or in-house attorney who stays ensconced in a dark corner of the firm drafting policies and sending out memoranda, but never interacting with the individuals governed by those policies or the recipients of those memos, risks diminished effectiveness or even irrelevance; but such a person would reduce his or her potential liability as a supervisor. On the other hand, *the more engaged a firm’s legal counsel or compliance personnel become* — the more they bring their expertise to bear in addressing important, real-world compliance issues and in providing real-time advice for concrete problems the firms and their employees face — *the more likely they are to be deemed to be playing a supervisory role.* Thus, the Commission’s position on supervisory liability for legal and compliance personnel may have had *the perverse effect of increasing the risk of supervisory liability in direct proportion to the intensity of their engagement in legal and compliance activities.*

Commissioner Gallagher identified the unintended consequences of the “dangerous dilemma”:

*Deterring such engagement is contrary to the regulatory objectives of the Commission,* and I am concerned that continuing uncertainty as the contours of supervisory liability for legal and compliance personnel will have a chilling effect on the willingness of such personnel to provide the level of engagement that firms need — and that the Commission wants. . . .

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58 Id. (emphasis added.)
We must strive to ensure, however, that the fear of failure-to-supervise liability never deters legal and compliance personnel from carrying out their own critical responsibilities. Such a result could only be described as perverse.\textsuperscript{59}  

V. STEPS TO CLARIFY SUPERVISORY AUTHORITY

A. Design an Effective Infrastructure

1. **Written Supervisory Procedures.** The firm’s WSPs should include a clear statement about the nature of the compliance function. For example, the WSPs could state that, “compliance is an advisory and audit function, not a business or sales function.” The WSPs also should clearly vest compliance responsibility in specific people or roles.\textsuperscript{60} It is worth noting that compliance is the job of everyone; compliance personnel are not the only ones responsible for compliance. While compliance personnel are responsible for advising on compliance, and perhaps auditing compliance, every associated person is responsible for incorporating compliance into the functions they perform.

2. **Chain of Command.** The WSPs should include a robust chain of command from the lowest level to highest level employee. Each person in the chain should know who reports to whom; each person should know his or her direct supervisor. Given frequent movement in positions, it is best to structure the chain with titles of individuals rather than names of individuals. Further, the functions should align with each individual’s real-life job functions. For example, the head of sales would likely be the supervisor of sales.

3. **The CEO.** The CEO should be high enough in the chain to have significant authority, but not so high that he or she is unreachable. In other words, the CEO has to be approachable at some point.

B. Design an Effective System to Implement the Infrastructure

1. **Feed Information to Supervisors.** Non-line lawyers and compliance personnel should inform supervisors on an ongoing basis how the people under the chain of command are operating. For example, if exception

\textsuperscript{59} **Id.** (emphasis added.)

\textsuperscript{60} The Commission has identified inadequate supervisory and compliance procedures in failure-to-supervise cases. See Gary W. Chambers, SEC Admin. Proc. Order Making Findings and Imposing Remedial Sanctions, Exchange Act Release No. 27963 (Apr. 30, 1990) (head of compliance department held liable for failure-to-supervise because, among other reasons, the supervisory procedures contained in the firm’s compliance manual “were not reasonably designed to prevent and detect . . . fraudulent activities” and did not “clearly vest compliance responsibility.”)
reports show unusual trading or exchange activity by a registered representative, lawyers and compliance personnel should point out the problems to the appropriate line personnel and recommend taking further action.

2. **Follow Up on Red Flags.** Once information is fed to supervisors, non-line lawyers and compliance personnel should follow up to make sure the supervisors have taken action. If it appears that the supervisor is not acting and has made a decision not to act on the information, escalate the issue up the chain of command. If it becomes necessary, “drive it up” to the CEO until the red flags have been addressed and supervisors have taken appropriate actions.

VI. **CONCLUSION**

The lines between legal and compliance functions, on the one hand, and supervisory functions, on the other hand, are not easy to draw and the state of failure-to-supervise law is, in Commissioner Gallagher’s words, “disturbingly murky.” The *Urban* case provides a warning to legal and compliance officers about the risks they face for failing to supervise business line-level employees. Until the Commission provides further guidance, legal and compliance officers of broker-dealers and investment advisers may find themselves well served by reviewing current procedures and taking steps to designate and implement compliance and supervisory roles. Taking steps to strengthen the firm’s compliance and supervisory infrastructure, and its system to implement the policies and procedures, should go a long way toward reducing future risk of failure-to-supervise liability for legal and compliance personnel.

A.B.F.
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