Legal Opinion Letter

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SEC'S VIEW OF "SUPERVISORY LIABILITY" MAY DETER VIGILANT CORPORATE COMPLIANCE

by
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Over the last decade or so, the implementation of Sarbanes-Oxley, the incentives in the U.S. Sentencing Guidelines, and other factors have elevated the need for rigorous corporate compliance programs. Strong compliance program can prevent and deter violations of the law, and can at least partially mitigate penalties if a violation is found. But an unanticipated pitfall may exist in a gray area at the intersection of compliance programs and supervisory liability under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. A recent case in the Securities and Exchange Commission (SEC), which subjected the general counsel of a broker-dealer to a five-year investigation for failing to supervise a broker, highlights the uncertainty and risk that those charged with compliance responsibilities in the investment advisory business may face.

The SEC case involved Theodore Urban, who was the general counsel of registered broker-dealer Ferris, Baker Watts Inc. (FBW) until March of 2007. Beginning in 2003, Urban was involved in several reviews of suspicious trading activity by a broker named Stephen Glantz, who ultimately pleaded guilty to stock fraud and making a false statement to the government in September 2007. Glantz's direct supervisors were branch managers at the retail offices where he worked and at least two retail sales supervisors, and these managers repeatedly (and falsely) assured Urban that Glantz was being supervised. While Urban had encouraged inquiry into Glantz's conduct and strongly advocated for his termination, he had no authority to fire him.

Nonetheless, the SEC's Division of Enforcement argued that Urban had violated the antifraud provisions of the federal securities laws because he had failed to reasonably supervise him and prevent Glantz's securities law violations. It contended that Urban was a supervisor because he had the responsibility or authority to affect his conduct and had a significant, although shared, role in the broker-dealer's supervisory structure. The Division argued that Urban had failed to respond vigorously to numerous red flags by taking his concerns about Glantz's conduct to FBW's Board or Executive Committee, and further asserted that if those entities failed to act, Urban was required to resign and report the matter to regulators.

In a September 8, 2010 decision, an SEC Administrative Law Judge cleared Urban of the charges. This initial decision found that even though "Urban did not have any of the traditional powers associated with a person supervising brokers . . . the case law indicates that Urban be found to be Glantz's supervisor." (Initial Decision at 52). The ALJ went on to determine, however, that Urban acted reasonably under the circumstances and therefore was not subject to sanctions or other remedial action under "supervisory" responsibilities imposed by the Securities Exchange Act and the Investment Advisers Act.

The Division of Enforcement petitioned to the Commission for review of the ALJ's decision. More than one year later, on January 26, 2012, the Commission dismissed the proceeding against Urban in a brief order by two commissioners (due to the recusal of Chairman Schapiro and Commissioners Walter and Gallagher). In the order, the Commission declared that it was evenly divided as to whether the allegations

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against Urban had been established. This result put an end to the matter for Urban, but provides no comfort to counsel and compliance personnel for broker-dealers and investment advisors.

The test for whether a non-line person is a supervisor has been laid out most comprehensively by the SEC in a report of an investigation under Section 21(A) of the Exchange Act captioned *John H. Gutfreund*, 51 S.E.C. 93 (1992):

> [Determining if a person is a 'supervisor' depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue. Thus, persons occupying positions in the legal or compliance departments of broker-dealers have been found by the Commission to be 'supervisors' for purposes of Sections 15(b)(4)(E) and 15(b)(6) under certain circumstances.

In that case, a chief legal officer informed senior management of a criminal act concerning a bid in an auction of U.S. Treasury securities, but neither the CLO nor senior management took any disciplinary action or informed the government immediately about the conduct. The *Gutfreund* Section 21(A) report declared that a person in the CLO's position "shares in the responsibility to take appropriate action to respond to the misconduct . . . [and therefore] becomes a "supervisor" for purposes of Section 15(b)(4)(E) and 15(b)(6). As a result, that person is responsible, along with other supervisors, for taking reasonable and appropriate action." 51 S.E.C. at 113.

In the Urban case, the ALJ noted the incongruity between this definition of "supervisor"—which broadly encompasses the ability to investigate conduct—and the everyday definition of that term, which concerns oversight of day-to-day activities:[1] "Even though Urban did not have any of the traditional powers associated with a person supervising brokers and the facts and circumstances are very different than in *Gutfreund* and its progeny, case law dictates that Urban be found to be Glantz's supervisor." Thus, the ALJ analyzed whether Urban's conduct in "supervising" Glantz was reasonable and determined that Urban had passed the reasonableness test, thereby warranting dismissal of the proceeding.

With the recusals and split of the remaining Commissioners rendering the Commission unable to take up the petition to review this matter, the SEC missed an opportunity to clarify the standard for supervisory exposure for an employee's actions in light of the new realities of the responsibilities of in-house legal and compliance personnel. The Commission and the public should have a strong interest in ensuring that legal and compliance personnel are zealous in detecting, investigating and recommending disciplinary action for improper conduct, without fear that in pursuing possible wrongdoing by those over whom they have no day-to-day oversight, they are exposing themselves to supervisory liability. The Division of Enforcement's broad application of the vague *Gutfreund* standard potentially places legal and compliance personnel at risk of becoming the targets of enforcement actions concerning potentially fraudulent or manipulative action in which they played no role but which they should have strong incentives to root out. It is the underlying actions, not efforts to investigate them, that are and should be the proper concern of the supervisory liability provisions of the securities laws.

The absence of clear guidance for lawyers and compliance personnel in this area may well have a deterrent effect on vigilant compliance efforts—something that neither the Commission nor the public should want. Developing this guidance through enforcement actions that (as in Urban's case) can threaten the careers of gatekeepers who are simply trying to do the right thing would subject the Commission to the criticism that it is engaging in rulemaking by enforcement. Legal and compliance personnel deserve to have notice of what is expected of them.

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[1] Black's Law Dictionary, 1290 (4th ed. 1979), defines "supervisor" to be:

> any individual having authority, in the interest of the employer, to hire, transfer, suspend, lay off, recall, promote, discharge, assign, reward or discipline other employees, or responsibly to direct them, or to adjust their grievances, or effectively to recommend such action, if in connection with the foregoing the exercise of such authority is not of a merely routine or clerical nature, but requires the use of independent judgment.

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