

## Legal, Compliance Employees on The Hook After Urban

Law360, New York (October 04, 2010) -- On Sept. 8 a U.S. Securities and Exchange Commission administrative law judge ruled that Theodore W. Urban, the former general counsel of the brokerage firm Ferris Baker Watts Inc., acted reasonably in his supervision of a rogue broker and dismissed the case brought by the SEC's Enforcement Division. See *In the Matter of Theodore W. Urban*, Adm. Proc. File No. 3-13655, Initial Decision (Sept. 8, 2010).

While this decision was certainly good news for Urban, it may not be good news for legal and compliance employees in the securities industry. While the ALJ did find that Urban, by acting reasonably, did not violate the supervision provisions, the judge also found that notwithstanding his lack of authority to hire or fire employees, Urban was, in fact, the supervisor of the rogue broker.

While not unexpected, this finding represents a significant extension of SEC precedent and significantly increases the real risk that members of the legal or compliance department of a financial services firm could be subject to liability for supervision deficiencies.

Below, we discuss the recent ruling in the Urban case and present several recommendations to minimize the likelihood that those employees will be found to be supervisors.

### Failure to Supervise Liability and the Urban Decision

Section 15(b)(4)(E) of the Securities Exchange Act of 1934 authorizes the SEC to take action when a person associated with a broker or dealer "has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision."

However, such a person will not be deemed to have failed to reasonably supervise if 1) there have been established procedures — and a system for applying such procedures — that would reasonably be expected to prevent and detect any such violation by another person, and 2) such person has reasonably discharged the duties and obligations incumbent upon him without reasonable cause to believe that the procedures in place were not followed.

In essence, a failure-to-supervise inquiry seeks answers to two basic questions: 1) Was the person at issue the supervisor of someone who violated the federal securities laws? And, if so, 2) did the supervisor act reasonably under the circumstances?

This article focuses on the first question — who is a supervisor?

While such a determination is fairly evident when dealing with line supervisors and their direct reports, the issue becomes murky with respect to nonline personnel such as Urban.

Urban was the general counsel of FBW, a registered broker-dealer. During the relevant time period, Urban headed three FBW departments: compliance, HR and internal audit. Urban had no authority to hire or fire employees outside of these departments, but he served on the board of directors and the firm's credit and risk committee as a full voting member.

In an administrative proceeding initiated by the SEC in October 2009, the SEC alleged that Urban failed to reasonably supervise Stephen Glantz, an FBW broker, in a manner sufficient to detect or prevent Glantz's violations of the anti-fraud provisions of the federal securities laws.

Concerns about Glantz and his supervision were brought to Urban's attention in the spring of 2003, and a memorandum from a compliance department employee addressing these concerns was ultimately considered by the credit and risk committee.

Specifically, the memorandum outlined issues with Glantz's trading activity, his use of margin in accounts (one account in particular) and Glantz's trading of Innotrac stock. Urban subsequently spoke to personnel in the retail sales department regarding Glantz's supervision and met with Glantz. The credit and risk committee imposed certain restrictions on Glantz at that time.

Similar concerns arose in January 2004. Urban scheduled a meeting of the credit and risk committee, which prohibited one of Glantz's accounts from buying Innotrac stock and adopted certain recommendations proposed by Urban.

Following several credit and risk committee meetings regarding these issues and the discovery that clients were not aware of Glantz's trades in their accounts, Urban initially recommended that Glantz be terminated.

Instead, FBW placed Glantz under "special supervision," but the commission alleged additional red flags became known to Urban before Glantz ultimately resigned in December 2005. Glantz was later charged with securities fraud arising from his conduct at FBW.

The SEC alleged that Urban was Glantz's supervisor because of the role he played in monitoring Glantz's actions. The SEC also alleged that Urban failed to follow up on numerous red flags and took inadequate action regarding other red flags.

Ultimately, the judge found that Urban was Glantz's supervisor but held that he had not failed to supervise Mr. Glantz because he performed his supervisory responsibilities "in a cautious, objective, thorough and reasonable manner."

### **Rationale Underlying Determination That Mr. Urban Supervised Mr. Glantz**

Acknowledging that Urban did not have the kind of power traditionally associated with a supervisor of brokers, the judge primarily relied on the commission's decision in *John H. Gutfreund*, 51 S.E.C. 93 (1992).

In *Gutfreund*, the commission stated that, under certain circumstances, legal or compliance officers of broker-dealers could be found to be supervisors for purposes of the supervision provisions.

The commission ultimately found that the in-house counsel at issue in Gutfreund was a supervisor because he was informed of serious misconduct so that he might provide guidance and participate in management's collective response to the misconduct and, thus, shared responsibility to take appropriate action.

The judge in the Urban case also cited post-Gutfreund cases in which both a manager and a manager who also served as an officer and board member were deemed to be supervisors because they participated in hiring and firing decisions. See Donald T. Sheldon, 51 S.E.C. 59 (1992); Steven F. Muth, 86 SEC Docket 1217 (October 3, 2005).

The judge in Urban adopted the Gutfreund test, focusing on whether Urban had the "requisite degree of responsibility, ability or authority to affect Mr. Glantz's conduct."

While noting that the facts and circumstances of Urban's situation "are very different from Gutfreund and its progeny", the judge, nevertheless, concluded that the case law dictated the finding that Urban served as Glantz's supervisor.

In particular, the judge highlighted two sets of facts. First, in his role as general counsel, the court found that Urban's opinions on legal and compliance matters were "viewed as authoritative and his recommendations were generally followed" by all business units.

Second, the judge cited Urban's active membership and involvement as a member of FBW's credit committee, where Urban dealt with Glantz on the committee's behalf.

In reaching these conclusions, we believe that the ALJ overread Gutfreund and its progeny. Gutfreund certainly held that legal and compliance employees could be held liable for failure to reasonably supervise employees. But the commission never said that all such personnel would be found to be supervisors each time a firm employee violates the securities laws.

The breadth of this holding would convert what the commission described as "certain situations" to every situation. We do not believe that this was the commission's intent in Gutfreund.

Given the high-profile nature of this case, it is certainly possible that the SEC Division of Enforcement will appeal this case to the commission. If that occurs, Urban may appeal the finding that he was a supervisor. That process could take a year. In the meantime, this decision will have a real impact on how cases are investigated and prosecuted by the SEC's Enforcement Division.

### **Recommended Steps for In-House Counsel and Compliance Personnel**

Given the holding in this case, what should legal and compliance personnel do?

First, and notwithstanding the broad nature of the holding in the Urban case, legal and compliance employees should take steps to forestall a conclusion that they are supervisors. These steps include:

--Ensuring that written supervisory policies and procedures, in addition to identifying the direct supervisors of all employees, specify: (a) that, absent unusual circumstances, it is not the firm's intention to make legal and compliance personnel the supervisors of line employees; and (b) that legal and compliance personnel do not themselves have the responsibility, ability or authority to impact line employee conduct.

--Documenting in a memorandum or by other means any significant issues regarding employee misconduct, including how the issue is to be handled going forward and which line supervisors will be responsible for implementing and monitoring the employees conduct.

--Ensuring that the direct supervisor of any employee whose conduct has raised red flags is aware of the issues and is implementing a plan to respond to the red flags.

--Ensuring that the role of the legal and compliance departments is to monitor and support line supervisory functions in cases where red flags are raised — as opposed to undertaking direct responsibility for supervision of employees.

--Thinking carefully before undertaking roles on firm committees. Service on firm committees and/or the board of directors by legal and compliance employees should only be advisory in nature.

While it is widespread practice in the industry for senior legal and compliance officials to serve on firm committees, Urban's service on the credit and risk committee was a key factor in the judge's finding that he was a supervisor.

Second, legal and compliance personnel should operate under the assumption that there is a good chance that, under the reasoning in Urban, they could be found to be supervisors of employees they are monitoring or investigating.

In those cases, legal and compliance employees must respond reasonably. In particular, legal and compliance employees should:

--Fully document red flags and the response to, and resolution of, these issues.

--Inform the line supervisor of the employee's misconduct and the response, including everyone's specific role in that response.

--Document any heightened supervisory plans and the nature and conclusion of any further investigation, with a particular emphasis on the delineation of supervisory responsibilities.

--Ensure that the line supervisor, with the assistance of legal and compliance staff, develops, implements and documents appropriate follow-up.

--Escalate unresolved issues up the chain.

## **Conclusion**

The Urban opinion makes it more likely that legal and compliance personnel will be found to be supervisors and subject to potential liability.

While the opinion may be an overreach, legal and compliance officials should take steps to minimize the likelihood that they will be found to be supervisors. Legal and compliance officials should also take steps to document their conduct so that a later finding of reasonableness can be supported.

--By William E. White and Heather J. Pellegrino, Akin Gump Strauss Hauer & Feld LLP

*William White (wwhite@akingump.com) is a partner in the Washington, D.C., office of Akin Gump Strauss Hauer & Feld LLP. Heather Pellegrino (hpellegrino@akingump.com) is counsel in the firm's Washington office.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients or Portfolio Media, publisher of Law360.*

*All Content © 2003-2010, Portfolio Media, Inc.*

**AKIN GUMP  
STRAUSS HAUER & FELD LLP**