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Managing CCO Risk Without A Liability Standard From SEC

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(December 17, 2020, 5:27 PM EST)

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Chief compliance officers are often referred to as gatekeepers because of the critical role they play in helping to prevent, detect and remediate potential regulatory and internal policies and procedures violations. In connection with this role, CCOs sometimes face difficult decisions in areas where formal guidance is unclear or nonexistent.

There have been cases where these decisions have been second-guessed by regulators, with career-implicating consequences for the CCOs involved. Over the years, there have been periodic debates over the appropriateness of liability for CCOs in these U.S. Securities and Exchange Commission actions.[1]

On Oct. 19, Commissioner Hester Peirce reopened the discussion during remarks to the National Society of Compliance Professionals, flagging the uncertainty CCOs face and the need for clarity under the SEC's rules.[2]

Peirce's remarks followed the publication of a report by the New York City Bar Association in February that asserted that CCOs have been facing a "growing risk of personal liability from the day-to-day performance of the compliance function." The bar report recommended that, among other things, the SEC provide formal guidance regarding the standards for CCO liability.[3]

This article examines the history of the policy debate concerning CCO liability under the federal securities laws. Next, it reviews the various theories of liability that the SEC has pursued in these types of cases, with a focus on CCOs of investment advisers. The article then concludes by providing practical recommendations for CCOs to minimize their risk of personal liability in the current environment.

The Policy Debate on CCO Liability

In her remarks, Peirce set out a useful framework for analyzing the types of enforcement actions that the SEC has brought against CCOs. First, the SEC has pursued actions against CCOs who have personally participated in clearly unlawful conduct.[4] Second, the SEC has sanctioned

CCOs who obstruct or mislead the SEC.[5] Third, the SEC has pursued cases involving a "wholesale failure" of CCOs to carry out their responsibilities.

The first and second categories, where the CCO was found to be a direct participant in unlawful conduct, are not particularly controversial. By contrast, the third category — CCOs whose only alleged failure is not doing enough to prevent a violation by someone else — has been far more contentious.

Currently, there is no formal guidance as to how the SEC evaluates CCO conduct in such situations. This has given rise to concerns that well-intentioned CCOs could have their good faith efforts second-guessed by the SEC Division of Enforcement staff with career-ending consequences.[6]

Peirce's recent comments echo concerns that were aired out several years earlier in a public debate between former SEC Commissioners Daniel Gallagher and Luis Aguilar.

In June 2015, Gallagher issued a public statement regarding his dissents in two SEC enforcement actions, Blackrock Advisors LLC and SFX Financial Advisory Management Enterprises.[7] Both of these matters involved charges against investment adviser CCOs based on allegedly negligent conduct related to the implementation of their firms' compliance procedures.

Gallagher saw these enforcement actions as demonstrating a "trend toward strict liability for CCOs"[8] and expressed concern that they could prompt other CCOs to limit their responsibilities in implementing certain procedures "to avoid liability when the government plays Monday morning quarterback."[9]

On June 29, 2015, Aguilar issued a dueling statement disagreeing with Gallagher.[10] Aguilar insisted that:

In the seven years that I have served as a Commissioner, it has been my experience 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.[11]

Evolution of the SEC's Theories of CCO Liability

Failure to Supervise

Over the years, the SEC has relied on a number of different legal theories to bring enforcement cases against legal and compliance professionals who were not involved in misconduct, but allegedly failed to do enough to prevent it. Until the early 2000s, the SEC primarily relied on "failure to supervise" charges, which are premised on the assertion that the compliance professional functioned as a supervisor of the wrongdoer.

In 1992, the SEC provided guidance regarding these types of cases In the Matter of John H. Gutfreund, et al. In Gutfreund, the SEC found that a broker-dealer's chief legal officer could be deemed a supervisor because he was involved in the firm's "collective response" to employee misconduct.[12] The SEC then criticized the chief legal officer for failing "to ensure that appropriate action [was] taken to address the misconduct."[13]

The Gutfreund standard is controversial because it arguably penalizes compliance professionals who take an active role in trying to respond to potential red flags. This issue was front and center In the Matter of Theodore Urban, a subsequent failure-to-supervise action against the general counsel of a

registered broker-dealer and investment adviser.[14]

In Urban, an administrative law judge determined that the general counsel was a supervisor because he issued "opinions on legal and compliance issues were viewed as authoritative."[15] The ALJ did not impose any sanctions, however, finding that the general counsel satisfied his supervisory obligations.[16]

On appeal, the commission issued a summary order dismissing the proceeding without addressing the merits.[17] This outcome created even more uncertainty in an already murky area.

Following Urban, the SEC published frequently asked questions stating that compliance personnel do not become supervisors solely because they provide advice to management and that a "person's actual responsibilities and authority ... determine whether he or she is a 'supervisor.'"[18] In the aftermath of Urban, the SEC has shied away from bringing actions against compliance professionals under a failure to supervise theory.

Investment Advisers Act Rule 206(4)-7 — A New Enforcement Tool Against CCOs

In 2004, the SEC adopted Rule 206(4)-7, which requires investment advisers to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation[s]" of the Investment Advisers Act.[19] Rule 206(4)-7 does not enumerate the specific elements that investment advisers must include in their policies and procedures in order to meet this requirement.[20]

Since its adoption, the SEC has primarily relied on Rule 206(4)-7 to bring enforcement actions against CCOs, often on the theory that the CCO caused their firm's violations by failing to implement a reasonably designed compliance program. In doing so, the SEC has been able to sidestep the challenges it faced in Urban because Rule 206(4)-7 does not require that the CCO acted as a supervisor.

For example, in Blackrock Advisors, the SEC brought an action against an investment adviser under Rule 206(4)-7 for failing to disclose a conflict of interest.

In its order, the SEC also held Blackrock's CCO personally liable, reasoning that he "was responsible for the design and implementation of Blackrock's written policies and procedures" and "knew and approved of numerous outside activities" by Blackrock's employees, but nonetheless "did not recommend written policies and procedures to assess and monitor those outside activities and to disclose conflicts of interest."[21]

Similarly, in SFX Financial Advisory, the SEC found that SFX's CCO caused SFX's failure to implement compliance policies that were reasonably designed to prevent a senior executive's misappropriation of client funds.[22] In its order, the SEC cited the CCO's failure to review cash flows from client accounts, even though SFX's Form ADV stated that such reviews were being done regularly.[23]

The SEC also held SFX's CCO responsible for failing to conduct an annual compliance review following the discovery of the executive's misappropriation.[24]

Gallagher and Peirce have criticized the SEC's application of Rule 206(4)-7 in matters such as these. Peirce expressed particular concern that the rule's broad requirements could be used to support negligence-based charges against CCOs for allegedly causing violations through their roles in designing and implementing their firms' compliance programs.[25]

Gallagher warned that such actions could lead to an almost strict liability standard for CCOs because, if CCOs take ownership of their firm's compliance policies, they are then often held accountable whenever there is a violation of the securities laws by the firm.[26]

Practical Advice

Given the breadth of Rule 206(4)-7 and the lack of practical guidance regarding its application, the concerns raised by Peirce and Gallagher should be reckoned with. There are, however, steps that CCOs can take to reduce their risk of personal liability, even in the current environment.

First, CCOs should ensure that they have the requisite skills to perform their role. CCOs who assume the designation without prior experience should complete a specialized training program and consider obtaining one or more designated compliance certifications. Both new and experienced CCOs should continue to add to their professional skills by attending training sessions to learn about new regulatory developments and industry best practices.

Second, CCOs should ensure that their firm's compliance program is up to date and tailored to the firm's business. In developing the firm's compliance program, CCOs should ensure that all aspects of the firm's operations, including actual and potential conflicts of interest, are considered.

Third, establish and maintain a robust record-keeping system. A key method of demonstrating understanding of applicable regulations and firm policies is to ensure records are kept of (1) updates to the firm's compliance policies and procedures, (2) ongoing and periodic reviews and testing, (3) oversight of vendors and other third parties, and (4) prompt and thorough responses to any compliance deficiencies.

CCOs should be sure to document key compliance decisions, such as whether or not to add or change firm's policies and procedures. In documenting compliance deficiencies, care should be taken to include sufficient detail regarding the facts surrounding the matter that was brought to the CCO's attention, as well as any advice received from external counsel, auditors, consultants or other third parties.

A record of the decision-making process can be essential in defending a CCO's actions if questioned later by a regulator.

Fourth, CCOs should ensure that reporting lines are clear at the firm and that the CCO's job description covers both areas of the CCO's responsibility, as well as limitations, to ensure that the CCO is not deemed to be a supervisor of others outside of the compliance department.

CCOs should consider the use of attestations from firm employees to document the CCO's oversight role in monitoring compliance with policies and procedures.

Finally, CCOs should review their firm's director's and officer's insurance coverage to verify that (1) there is sufficient coverage in the event of a claim, and (2) the CCO is listed as covered officer of the firm. A CCO should also ensure he or she understands the standard of care that must be met in order to be covered by the policy.

Conclusion

Presently, the main check on Rule 206(4)-7's application to CCOs appears to be the assurances that certain SEC officials have given over the years that the agency will not target compliance professionals who act in good faith and take their jobs seriously.

However, the question of whether a CCO has met this standard in situations where the organization has fallen down is often in the eye of the beholder. This uncertainty breeds fear — CCOs are asked to make difficult decisions without adequate guidance and potential severe consequences.

The risk for CCOs is compounded by the SEC's greater focus in recent years on individual accountability for violations. The SEC will continue to be tempted to charge CCOs, as well as the firms, to hold someone accountable for alleged wrongdoing. Yet the SEC has failed to recognize and address the conflicting loyalties of CCOs. CCOs are expected to serve as the SEC's eyes and ears at their firms, even though their compensation depends upon the success of the business.

Without publishing clear standards, there will be questions about whether the SEC has evaluated a CCO's conduct fairly in these sorts of enforcement actions.

Peirce at least appears to be willing to grapple with this issue. In her remarks, she declared: "I am considering developing a draft framework to share with my colleagues. I welcome your input on what factors you believe are relevant to the decision about whether to charge compliance personnel."[27]

However, with the impending administration change, it remains to be seen whether the SEC's soon-to-be new slate of commissioners will follow her advice.

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[1] See, e.g., Daniel M. Gallagher, Statement on Recent SEC Settlements Charging Chief Compliance Officers With Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), available at https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html; Luis A. Aguilar, The Role of Chief Compliance Officers Must be Supported (June 29, 2015), available at https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html.

[2] See Hester Peirce, When the Nail Fails — Remarks before the National Society of Compliance Professionals (Oct. 19, 2020), available at https://www.sec.gov/news/speech/peirce-nscp-2020-10-19.

[3] New York City Bar, Report on Chief Compliance Officer Liability in the Financial Sector, at 1, available at https://s3.amazonaws.com/documents.nycbar.org/files/Report_CCO_Liability_vF.pdf (hereinafter "Bar Report").

[4] See, e.g., Alphabridge Cap. Mgmt., Investment Advisers Act Release No. 4135, 2015 WL 3982040 (July

1, 2015) (settled action where SEC found that the investment adviser's co-portfolio manager, who also served as its compliance officer, actively participated in a scheme to inflate the valuations of securities held in the portfolio managed by the investment adviser); Alicia M. Diaz, Exchange Act Release No. 78274, 2016 WL 4363461 (July 11, 2016) (settled action where the SEC held liable a chief compliance officer who became aware of a theft of funds from a pension fund, did not report the theft, and participated in the attempted cover-up).

[5] See, e.g., Meredith A. Simmons, Investment Advisers Act Release No. 5603 (Sept. 30, 2020), available at https://www.sec.gov/litigation/admin/2020/34-90061.pdf (settled action where SEC found that a chief compliance officer for an investment adviser who had created inaccurate, backdated memoranda in response to an SEC inquiry); Gilder Gagnon Howe & Co. LLC, Exchange Act Release No. 5582 (Sept. 17, 2020), available at https://www.sec.gov/litigation/admin/2020/ia-5582.pdf (compliance officer misled the Commission's examiners and enforcement staff by producing altered documents).

[6] Bar Report at 1.

[7] Gallagher, supra note 1.

[8] Id.

[9] Id.

[10] Aguilar, The Role of Chief Compliance Officers Must be Supported, supra note 1.

[11] Id.

[12] John H. Gutfreund, Exchange Act Release No. 31554, 1992 WL 362753, at *16 (Dec. 3, 1992).

[13] Id.

[14] Theodore W. Urban, SEC Admin. Proceeding File No. 3-13655, Initial Decision Release No. 402 (Sept. 8, 2010), available at https://www.sec.gov/litigation/aljdec/2010/id402bpm.pdf, dismissed by Exchange Act Release No. 66359 (Jan. 26, 2012).

[15] Id. at 51-52.

[16] Id. at 52-56.

[17] Theodore W. Urban, Investment Advisers Act Release No. 3366 (Jan. 26, 2012), available at https://www.sec.gov/litigation/admin/2012/34-66259.pdf.

[18] See SEC Division of Trading and Marketing, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act (Sept. 30, 2013), available at https://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

[19] 17 C.F.R. § 275.206(4)-7.

[20] See Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-

2204, IC-26299, File No. S7-03-03 (Feb. 5, 2004).

[21] Blackrock Advisors, LLC, Exchange Act Release No. 4065, 2015 WL 1776222, at *6 (Apr. 20, 2015).

[22] SFX Fin. Advisory Mgmt. Enterprises, Inc., Exchange Act Release No. 4116 (June 15, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4116.pdf.

[23] Id.

[24] Id.

[25] Peirce, supra note 2.

[26] Gallagher, supra note 1.

[27] Peirce, supra note 2.