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Clarity For Supervisory Liability?

Law360, New York (March 14, 2012, 2:06 PM ET) -- In a significant speech at the Practicing Law Institute's SEC Speaks program on Feb. 24, 2012, SEC Commissioner Daniel M. Gallagher attempted to clarify when legal and compliance personnel are "supervisors" for purposes of failure-to-supervise liability. This issue has been murky since the U.S. Securities and Exchange Commission brought failure-to-supervise charges against Theodore Urban, the former general counsel of the brokerage firm Ferris Baker & Watts Inc. (FBW) in 2009.

At the time the case was brought, many commentators viewed the case as overreaching because it seemed to penalize Urban for simply doing his job. Observers noted that the interests of legal and compliance personnel and the SEC are typically aligned and that subjecting such an ally to liability was counterproductive to preventing future violations of the federal securities laws.

The initial decision from the commission's administrative law judge confirmed that Urban did nothing wrong but did find that Urban was a supervisor for purposes of failure-to-supervise charges.[1] This finding and the rationale behind it has caused great concern among legal and compliance personnel at broker-dealers and investment advisors.

The message of the ALJ's opinion seemed to suggest that if senior legal and compliance personnel injected themselves into a problem, they would be looked at as a potential violator — in essence, part of the problem, rather than part of the solution. On appeal, the action was dismissed because the commission split with a 1-1 vote as to liability with three commissioners (including Gallagher) not participating. In the wake of these decisions, there remains uncertainty as to when such personnel are supervisors and what the members of the commission are actually thinking on this important issue.

In his speech, Gallagher clearly articulated his view that the SEC should show restraint in bringing failure-to-supervise actions against legal and compliance personnel. In the key takeaway from the speech, Gallagher stated: "To put it simply, if a firm employee in a traditionally non-supervisory role has expertise relevant to a compliance matter, that employee shouldn't fear that sharing that expertise could result in a Commission action for failure to supervise."

Given the ALJ's decision and the lack of visibility into the views of the other commissioners, Gallagher's speech is important and is, at a minimum, a roadmap for others at the commission and for attorneys defending legal and compliance personnel. Below, we discuss in more detail the Urban decisions and Gallagher's speech, and we address going-forward recommendations for legal and compliance personnel.

The Urban Decisions

The context for Gallagher's speech is the Urban case. Urban was the general counsel of FBW. In an administrative proceeding initiated by the SEC in October 2009, it 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 spring 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 his 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.

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

Acknowledging that Urban did not have the kind of power traditionally associated with a supervisor of brokers, the ALJ primarily relied on the commission's decision in In the Matter of John H. Gutfreund et al.[2] In Gutfreund, the commission stated that, under certain circumstances, legal or compliance officers of broker-dealers could be found to be supervisors. 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 ALJ 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 ALJ, nevertheless, concluded that the case law dictated the finding that Urban served as Glantz's supervisor.

In particular, the ALJ 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 ALJ 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.

We believe that such a conclusion is at odds with the commission's intent in Gutfreund. Nowhere in the Gutfreund report was there even the slightest suggestion by the commission that legal and compliance personnel should routinely be considered supervisors. Rather, Gutfreund would seem to limit the supervisor designation to those legal and compliance personnel who take on roles akin to actual managers, with knowledge of illegal conduct, and who ultimately fail to stop it.

In perhaps an unwise move, the commission staff appealed the ALJ's finding that Urban acted reasonably. On appeal, three commissioners (including Gallagher) did not participate in the case, presumably on ethical grounds. The remaining commissioners split 1-1 as to whether Urban was liable. One commissioner would find liability and presumably would agree with the ALJ's conclusion that Urban was a supervisor. The other commissioner would not find liability, and it is unclear whether that commissioner would agree or disagree with the ALJ's finding.

Commissioner Gallagher's Speech

Into this setting came Gallagher's speech. Speeches by commissioners at the SEC Speaks conference are typically devoted to policy issues that are of particular concern to each individual commissioner. It is significant, therefore, that Gallagher chose to devote his first SEC Speaks speech to the issue of whether legal and compliance personnel are supervisors.

While he did not say how he would have ruled in the Urban case, Gallagher's speech clearly sent the message that he would be in favor of at least limiting the liability of legal and compliance personnel in failure-to-supervise actions. Underpinning Gallagher's views is his conclusion that "we must be mindful of the importance of the legal and compliance role and, critically, the ability of legal and compliance personnel to carry out their responsibilities.

As Gallagher explained, broker-dealers and investment advisors 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, he said, "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."

Gallagher observed that the commission's position on supervisory liability may have had the perverse effect of increasing liability in direct proportion to the intensity of engagement in legal and compliance activities.

As a result, Gallagher states that: "Any understanding of the issue must begin with the fact that broker-dealer or investment adviser compliance and legal personnel are, by default, not supervisors but rather providers of support for the firm's other employees."

In addition, in what will be the most quoted statement in the speech, Gallagher stated: "To put it simply, if a firm employee in a traditionally non-supervisory role has expertise relevant to a compliance matter, that employee shouldn't fear that sharing that expertise could result in a Commission action for failure to supervise."

In other words, Gallagher stated "that the fear of failure-to-supervise liability never deters legal and compliance personnel from carrying out their own critical responsibilities."

Conclusions and Recommendations

Gallagher's speech is significant because it provides a clearly articulated view that legal and compliance personnel should not ordinarily be considered supervisors. The speech also provides a policy roadmap that others at the commission (and defense counsel) may follow in the future (including the one commissioner who did not find liability in Urban). At a minimum, the speech likely means at least one vote against future failure-to-supervise cases against legal and compliance personnel.

Also significant is Gallagher's description of legal and compliance personnel as providers of support. This is a clever attempt to remove most legal and compliance personnel from the Gutfreund test — because if they are only providers of support, they are not participants in management's collective response to the misconduct and would not share responsibility to take action. Such a rationale seemingly would limit the number of circumstances in which legal and compliance personnel can be found to be supervisors.

But Gallagher represents only one vote on the five-member commission. At least one other commissioner would have found that Urban was a supervisor. Gallagher's speech has brought some clarity to this issue for legal and compliance personnel, but the waters still remain murky.

In light of the ALJ's ruling in Urban and notwithstanding Gallagher's views, legal and compliance personnel should still take steps to minimize the likelihood that they will be found to be supervisors. Those steps include:

- ensuring that written supervisory policies and procedures specify: (1) that, absent unusual circumstances, it is not the firm's intention to make legal and compliance personnel the supervisors of line employees; and (2) 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 are to 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 responsible for implementing a plan to respond to the red flags;

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

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

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[1] See In the Matter of Theodore W. Urban, Admin. Proc. File No. 3-13655. Initial Decision Rel. 402 (Sept. 8, 2010).

[2] Exchange Act Release No. 31554 (Dec. 3, 1992).