BROKER-DEALER SUPERVISION: A TROUBLESOME AREA*

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I. INTRODUCTION

The supervisory responsibilities of broker-dealer firms and their partners and/or officers and employees has been an issue of considerable importance and some controversy in recent years.[1] The main problem for broker dealer firms has been to establish, maintain, and enforce an effective supervisory system that will satisfy the requirements of the Securities Exchange Act of 1934[2] as well as the standards promulgated by the self-regulatory organizations (SROs) which oversee these broker-dealer firms under the mandate of that statute.[3] A related problem has been the expanding supervisory risk and accountability of the individual partners and/or officers and employees of these broker-dealer firms.[4]

In this article we will analyze the supervisory responsibilities of both broker-dealer firms and their individual personnel. First, we will examine the statutory provisions which address these supervisory responsibilities. Second, we will address the rules and policies of the self-regulatory organizations which deal with broker-dealer supervision. Third, we will discuss the decisional precedents which focus upon supervisory deficiencies of broker-dealer firms and the actions taken to ameliorate these deficiencies. Finally, we will analyze the expanding supervisory responsibilities and accountability of the individual employees of broker-dealer firms.

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1 ABA Comm. on Federal Regulation of Securities, *Broker-Dealer Supervision of Registered Representatives and Branch Office Operations*, 44 BUS. LAW 1361, 1361-98 (1989) [hereinafter *Broker-Dealer Supervision*]; RALPH C. FERRARA ET AL., STOCKBROKER SUPERVISION: MANAGING STOCKBROKERS AND SURVIVING SANCTIONS (1989).

2 15 U.S.C. §§ 78a-78jj (1994).

3 *See infra* notes 12-33 and accompanying text.

4 *See infra* notes 40-71 and accompanying text.

II. Statutory Supervisory Provisions

A. *SEA Sections 15(b)(4)(E) and 15(b)(6)*

The statutory provisions upon which the Securities and Exchange Commission (SEC) most commonly relies in enforcement proceedings seeking sanctions for broker-dealer supervisory violations are Securities Exchange Act (SEA) section 15(b)(4)(E) and section 15(b)(6). SEA section 15(b)(4)(E) authorizes the SEC to sanction broker-dealer firms, not individual violators and not the latter's individual supervisors. It should be noted, however, that the broker-dealer firm may be sanctioned under SEA section 15(b)(4)(E) for acts of an employee which occurred prior to his/her association with the firm — a possible basis for sanctions for hiring a "bad apple." Importantly, SEA section 15(b)(4)(E) contains an apparent safe harbor for adequate supervisory procedures properly followed. Section 15(b)(4)(E) reads in relevant part as follows:

> (4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated . . . .
> (E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or 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. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if . . . .
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> (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
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> (ii) 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 proce-

dures and system were not being complied with.[5]

SEA section 15(b)(6) authorizes the SEC to sanction individuals and their supervisors for violations of SEA section 15(b)(4)(E). SEA section 15(b)(6)(A) reads in relevant part as follows:

> With respect to any person who is associated, who is seeking to become associated, or, at the time of the alleged misconduct, who was associated or was seeking to become associated with a broker or dealer, or any person participating, or, at the time of the alleged misconduct, who was participating, in an offering of any penny stock, the Commission, by order, shall censure, place limitations on the activities or functions of such person, or suspend for a period not exceeding 12 months, or bar such person from being associated with a broker or dealer, or from participating in an offering of penny stock, if the Commission finds, on the record after notice and opportunity for a hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person—
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> (i) has committed or omitted any act or omission enumerated in subparagraph (A), (D), (E), or (G) of paragraph (4) of this subsection . . . .[6]

While SEA sections 15(b)(4)(E) and 15(b)(6) are the provisions most widely utilized by the SEC in sanctioning firms and individuals for supervisory violations, there are other statutory provisions which merit a brief reference in this connection.

B. SEA Section 15(b)(4)(D)

The SEC can bring enforcement proceedings against broker-dealer firms for supervisory deficiencies under the language of SEA section 15(b)(4)(D) if such firm or one of its employees:

> has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.[7]

This statutory language does not refer specifically to supervisory violations nor to the safe harbor supervisory defenses, but prior to 1964 the SEC used this statutory authority on occasion to sanction firms for violations involving supervisory deficiencies. The Securities Act Amendments of 1964, however, specifically addressed su-

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5 15 U.S.C. §§ 78a-78jj.

6 *Id.*

7 *Id.*

pervisory violations by both firms and individuals in SEA sections 15(b)(4)(E) and 15(b)(6) respectively. Therefore, since 1964 the SEC has rarely utilized SEA section 15(b)(4)(D) to impose sanctions upon broker-dealer firms for supervisory failures and instead, quite properly, has chosen to proceed under the express language of SEA section 15(b)(4)(E).[8]

C. SEA Section 20(a)

The SEC can probably bring an enforcement action for supervisory failures against a broker-dealer firm and/or certain controlling persons of such firms under the literal language of SEA section 20(a) on the grounds that the entity or the individual "controls" the predicate violator. This section, however, does not mention failure to supervise nor does it refer to reasonable supervisory defenses as are expressly provided in SEA section 15(b)(4)(E). To date, the SEC has not attempted to utilize SEA section 20(a) to impose sanctions upon firms or individuals for inadequate supervision.

D. Insider Trading and Securities Fraud Enforcement Act

In the context of misuse of material nonpublic information, the Insider Trading and Securities Fraud Enforcement Act section 3(b)(1),[9] requires broker-dealers to adopt supervisory policies and procedures designed to prevent insider trading and tipping. Congress found that "despite the general supervisory requirements under existing law, . . . it [is] necessary to institute a new affirmative statutory requirement for broker-dealers" to establish and enforce procedures to prevent the misuse of material, nonpublic information, which would complement existing SRO supervisory requirements and section 15(b)(4)(E). The new law reflects Congress's belief that broker-dealers "must not only adopt and disseminate written policies and procedures to prevent the misuse of material, nonpublic information, but also must vigilantly review, update and enforce them."[10]

E. SEA Rule 14e-3(b)

With respect to the misuse of material nonpublic information in the context of tender offers, SEA Rule 14e-3(b) provides certain

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[8] *Broker-Dealer Supervision, supra* note 1, at 1365.

[9] Pub. L. No. 100-704, 102 Stat. 4677 (1988).

[10] H.R. REP. No. 100-910, 100th Cong., 2d Sess. 23 (1988); *Broker-Dealer Supervision, supra* note 1, at 1388.

defenses for a broker-dealer firm which has implemented sufficient supervisory policies and procedures reasonably to insure that individuals do not misuse material nonpublic information about tender offers.[11] This rule may be viewed as an articulation in a specific context of the general requirements that a broker-dealer firm must meet to establish its defenses under SEA section 15(b)(4)(E).

F. SEA Section 19

Under SEA section 19(d)(2) the SEC has the power to review, upon the request of an SRO or upon its own motion, any final disciplinary sanctions imposed by the SROs upon their members for violations of their rules, including violations of their supervisory rules. SEA section 19(g) requires SROs to enforce their rules with respect to their members, including their supervisory rules; and SEA section 19(h)(1) authorizes the SEC to sanction any SRO that does not enforce member compliance with its rules.

III. Supervisory Requirements of Self-Regulatory Organizations

In addition to the statutory supervisory provisions described above, the SROs have rules and policies regulating broker-dealer supervision. In this section we will briefly examine the supervisory requirements of the National Association of Securities Dealers, Inc. (NASD), the New York Stock Exchange (NYSE or Exchange), and the American Stock Exchange (Amex).

A. NASD Supervisory Requirements

The NASD's primary supervisory requirements are contained in art. III, section 27 of the NASD Rules of Fair Practice.[12] Section 27 provides that each NASD member "shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of this Association."[13] Generally speaking, this system must provide, at a minimum, for the following: (1) the establishment and maintenance of written supervisory procedures and the designation of specific supervisory personnel responsible for imple-

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11 17 C.F.R. § 240.14e-3 (1994).

12 NASD Manual—Rules of Fair Practice (CCH) ¶ 2177 (1994).

13 *Id.*

menting each of these procedures; (2) the designation of a registered principal to carry out the supervisory responsibilities for each type of business for which the firm is required to be registered as a broker-dealer; (3) the designation of certain firm offices as "offices of supervisory jurisdiction" taking into consideration their functions and responsibilities which will assist in implementing the supervisory standards mandated by the NASD; (4) the assignment of each registered person to an appropriately designated supervisor; (5) the making of reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities; (6) the participation of each registered representative at least annually in an interview at which compliance matters relating to that registered representative are discussed; (7) the conducting of periodic internal inspections and reviews of all aspects of firm business including reviews of branch offices and customer accounts; (8) the review and endorsement in writing by a registered principal of all transactions and of all correspondence of the firm's registered representatives pertaining to the solicitation or execution of any securities transaction; and (9) the investigation of the character, reputation, qualifications, and experience of any person certified by the firm for registration in the NASD.

Additional NASD supervisory rules include art. III, section 40 of the NASD Rules of Fair Practice,[14] addressing member supervisory responsibilities with respect to the private securities transactions of associated persons of members; art. III, section 33 appendix E/section 20 of the NASD Rules of Fair Practice,[15] dealing with firm supervisory responsibilities concerning customer option accounts; and section 5 of the NASD Government Securities Rules,[16] governing the supervision of the government securities business of NASD members.

At the end of article III, section 27 of the NASD Rules of Fair Practice, the NASD Manual lists a number of Notices to Members that deal with supervisory issues including supervisory procedures on limit orders, supervisory practices of branch offices and "offices of supervisory jurisdiction," supervision of "off-site" personnel, and provisions for providing terminated employees with the termination Form U-5.[17]

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14 *Id.* at ¶ 2200.

15 *Id.* at ¶ 2183.

16 NASD Manual—Government Securities Rules (CCH) ¶ 2425 (1992).

17 NASD Manual—Rules of Fair Practice (CCH) ¶ 2177 (1994).

Finally, the NASD publishes a checklist of suggested supervisory and compliance procedures covering a number of specific operational areas. The *NASD Compliance Checklist* addresses financial and operational activities, market making and trading, underwriting and related activities, options, municipal securities, general sales practices, margin activities, registration requirements, and supervision. The checklist also includes a branch office compliance checklist covering recordkeeping oversight, selling activity, and general supervision.[18]

B. NYSE Supervisory Requirements

The NYSE's primary supervisory requirements are contained in NYSE Rules 342 and 351. Rule 342(a) and (b) provide:

> (a) Each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility.
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> The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.
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> (b) The general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall:
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> (1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.
>
> (2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.[19]

Firm supervisory personnel must be acceptable to the NYSE and, at the discretion of the NYSE, may be subject to certain examination requirements.[20]

Duties of supervisors of registered representatives should ordi-

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18 *Broker-Dealer Supervision, supra* note 1, at 1390.

19 2 N.Y.S.E. Guide (CCH) ¶ 2342 (1993).

20 *Id.* at ¶ 2342.13.

narily include at least approval of new accounts and review of correspondence of registered representatives, transactions, and customer accounts. Appropriate records should be maintained evidencing the carrying out of supervisory responsibilities such as a written statement of the supervisory procedures currently in effect and initialing of correspondence, transactions, blotters, or statements reviewed in the supervisory process.[21]

In order to assure compliance with the provisions of the Securities Exchange Act of 1934, the rules promulgated thereunder, and NYSE rules prohibiting insider trading and manipulative and deceptive devices, each NYSE member, in addition to its normal supervisory activities, must subject its individual member, employee, and member firm trades in NYSE listed securities and related financial investments to special review procedures every quarter. These review procedures must be reasonably designed to ferret out violations of such provisions.[22] Moreover, under NYSE Rule 351(e), each NYSE member must make detailed quarterly reports to the Exchange describing these special review procedures, their implementation, and the results obtained.[23]

Finally, Supplementary Material to NYSE Rule 342[24] provides that by April 1 of each year each member firm shall provide to its chief executive officer or to its managing partner (and under NYSE Rule 354, to its "control person,")[25] a report of the firm's overall supervision and compliance effort during the preceding year.

NYSE Rule 351 provides that each individual member or employee must promptly report the following to its member organization and the latter must promptly report the following to the Exchange: (i) any violations of law or of self-regulatory or business or professional organization rules or standards by a member or any of its employees; (ii) any written customer complaints of which a member or any of its employees is the subject involving allegations of theft, misappropriation of funds or securities or forgery; (iii) any governmental or self-regulatory proceeding, denial of registration or association or disciplinary action naming a member or any of its employees as a respondent involving alleged violations of securities, commodities or insurance laws, rules or SRO standards; (iv) any arrest, arraignment, indictment, guilty plea, criminal convic-

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21 *Id.* at ¶ 2342.16.
22 *Id.* at ¶ 2342.21.
23 *Id.* at ¶ 2351 (1994).
24 *Id.* at ¶ 2342.30 (1993).
25 *Id.* at ¶ 2354 (1994).

tion or no contest plea to a criminal offense other than minor traffic violations of a member or any of its employees; (v) the suspension, expulsion or revocation of registration of any broker, dealer, investment company, investment adviser or insurance company by any agency, jurisdiction or organization or the criminal conviction or no contest plea of any bank or financial institution with which a member or any of its employees is associated; (vi) the disposition of any securities or commodities related arbitration or civil litigation in which an individual member or employee is a respondent for more than $15,000 or in which a member firm is a respondent for more than $25,000; (vii) the settlement of any damage claim by a customer, broker or dealer of which an individual member or employee is the subject for more than $15,000 or of which a member firm is the subject for more than $25,000; (viii) the association of a member or one of its employees in any business or financial activity with a person who is subject to a statutory disqualification under the 1934 Act; and (ix) the disciplining or significant limitation upon the activities of any member or employee by a member organization.[26]

Additional NYSE supervisory provisions include: NYSE Rule 382, addressing the allocations of functions including supervisory responsibilities in agreements involving the "carrying" of customer accounts by one firm for another "introducing" firm[27]; NYSE Rule 405(2), requiring members to "supervise diligently all accounts handled by registered representatives of the organization"[28]; and NYSE Rule 722, relating to supervision of customer option accounts.[29] Finally, additional guidance with respect to NYSE supervisory responsibilities is referenced in Supplementary Material to NYSE Rule 342, which summarizes suggested supervisory procedures in a number of specific operational areas.[30]

C. *Amex Supervisory Requirements*

The American Stock Exchange (Amex) general supervisory requirements are contained in Amex Rule 320.[31] Additional Amex supervisory requirements are contained in both Amex Rule 411,[32] requiring members "to supervise diligently all accounts handled by

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[26] *Id.* at ¶ 2351 (1994).
[27] *Id.* at ¶ 2382 (1994).
[28] *Id.* at ¶ 2405.
[29] *Id.* at ¶ 2722 (1992).
[30] *Id.* at ¶ 2342.16 (1993).
[31] 2 Am. Stock Ex. Guide (CCH) ¶ 9374 (1987).
[32] *Id.* at ¶ 9431 (1994).

an employee," and Amex Rule 922,[33] addressing supervision of customer option accounts. Generally speaking, all of these provisions are similar to their NYSE counterparts.

IV. Supervisory Deficiencies of Broker-Dealer Firms

SEA section 15(b)(4)(E) authorizes the SEC to sanction a broker-dealer firm for failing reasonably to supervise persons subject to its supervision with a view to preventing violations of the securities and commodities laws. SEA section 15(b)(4)(E) also contains a safe harbor provision which states:

> For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if —
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> (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
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> (ii) 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.[34]

There is, however, no one standard, uniform system of procedures which all brokerage firms can adopt and implement, and thereby automatically fall within the protections of this safe harbor. Rather, each firm must develop its own particular supervisory system and its own particular procedures for the implementation of that system, tailored to the dictates and requirements of its own particular type and mix of business.

In our opinion, a firm is best advised to study carefully the supervisory procedures required by its particular self-regulatory organization. The firm can then construct its own supervisory system with a view to implementing these supervisory procedures and concomitantly falling within the safe harbor of SEA section 15(b)(4)(E). In addition, the firm and its counsel should study SEC and SRO administrative decisional precedents which have focussed upon past supervisory deficiencies and attempt to avoid similar pitfalls in the conduct of its own business. In this section we will analyze recent administrative decisions which highlight certain firm supervisory deficiencies. In the following sections we will ana-

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[33] *Id.* at ¶ 9722 (1989).

[34] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1994).

lyze recent administrative and court decisions and focus upon the expanding supervisory responsibilities of individuals employed by a broker-dealer. In reading these sections one must not forget that the great majority of the administrative decisions discussed were consent decrees in which the SEC's findings were neither admitted nor denied by the respondents.

A. Broker-Dealer Firm Supervisory Decisions

The recent settlement between Prudential Securities and the SEC in which Prudential consented to findings that it violated certain provisions of the federal securities laws in connection with the retail sales of limited partnership interests, highlighted both key supervisory deficiencies in a major broker-dealer and the procedures required to be adopted and implemented to eliminate those deficiencies.[35]

First, Prudential sold $8 billion in limited partnership interests to thousands of public investors through its Direct Investment Group using materially false and misleading statements and omissions. In virtually every aspect of its operations and particularly with respect to its marketing and promotional activities, the Direct Investment Group was permitted to operate outside of Prudential's existing supervisory and compliance structure. A similar problem surfaced in the Dallas branch office where one of Prudential's top producing salesmen was permitted to operate his own "department" within the Dallas branch office without adequate supervision. The settlement provided that in the future all Prudential personnel were to operate within Prudential's supervisory and compliance structure.

Second, Prudential failed in certain important respects to adopt, implement, or maintain procedures sufficient to achieve compliance with the requirements of a prior SEC order regarding improved supervision. In particular, the prior order had directed that decisions of the compliance department were to be implemented by the regional directors and branch office managers. In practice, compliance requests, instructions, and directives to regional directors and branch office managers were often disregarded or otherwise rendered ineffective. To prevent a similar breakdown in the future and to provide adequate supervisory procedures which were previously lacking above the branch office manager level, the settlement provided an elaborate compliance

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[35] *In re* Prudential Sec. Inc., Exchange Act Release No. 34-33082, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,238 (Oct. 21, 1993).

structure consisting of branch managers overseen by regional compliance officers, who were overseen by a director of compliance, who was in turn overseen by a compliance committee of the broker-dealer's board of directors, who reported on a regular basis directly to the board of directors of the broker-dealer's sole parent stockholder. This structure was designed to ensure that compliance decisions, a carefully defined term, were enforced in a timely and effective manner.

Third, under the prior SEC order Prudential had undertaken to implement and maintain procedures designed to correct all failures and violations uncovered by the firm's internal audits within thirty days after completion of the audit report. The firm had never implemented and maintained such procedures. The settlement provided that Prudential implement and maintain procedures to accomplish distribution of audit reports to the director of compliance and to achieve timely correction of the deficiencies identified in these audit reports. The elaborate compliance structure described in the preceding paragraph was designed to ensure that this was accomplished.

Fourth, Prudential's procedures required that accounts reflecting a particular level of trading activity appear in an active account report. The procedures further required that the branch office manager personally contact the customers holding such active accounts to confirm that the customer was suitable for the trading in the account and was aware of the profits and losses being generated by the account. The branch office managers failed to implement these procedures. Moreover, certain senior management officials learned of the widespread noncompliance with the active account procedures and failed to correct the problem in a timely fashion. The compliance structure provided by the settlement was designed to prevent a recurrence of this problem.

Fifth, certain Prudential salesmen recommended to customers that they switch mutual funds for trading purposes without obtaining signed letters from the customers authorizing such activity. The settlement specifically provided that the firm establish adequate supervisory procedures with respect to trading in mutual funds to detect and prevent failures to comply with "switch letter" procedures, to detect and prevent trading designed to avoid breakpoints which would lower the salesman's commission, and to ensure that customers received the benefits of lower commissions afforded by accumulated investments in the particular mutual fund being purchased.

Sixth, certain Prudential salesmen had been the subject of an inordinate number of customer complaints concerning conduct at their previous employers; these complaints surfaced during their employment at Prudential. Prudential, however, made no effort to increase supervision of these salesmen. The settlement specifically provided for the development of standards to identify those salesmen with disciplinary or complaint histories, for written approval by designated compliance personnel of the hiring of such salesmen, and for systems to record and follow up additional significant disciplinary actions or customer complaints against such salesmen and to terminate their employment if justified.

Without admitting or denying violations of the federal securities laws, Prudential agreed to pay $330 million into a fund to compensate injured investors, as well as any additional amount required to make full compensation.[36] As discussed above, Prudential also settled the related SEC administrative allegations, agreeing to pay a $10 million civil penalty, and to undertake certain remedial measures. In addition, the firm agreed to pay up to $26 million to the fifty states, Puerto Rico, and the District of Columbia, and $5 million to the National Association of Securities Dealers.

In *In re PaineWebber, Inc.*,[37] salesmen of a major broker-dealer in a number of branch offices violated the antifraud provisions of the federal securities laws by engaging in unsuitable, unauthorized and excessive trading in customer accounts, misrepresenting and failing to disclose to customers material facts concerning the risks involved in trading index options, obtaining trading approval from the firm for customer accounts by falsifying customer forms, misrepresenting to customers the values of their accounts, entering orders without designating the accounts to which the orders related and then allocating the profitable trades to their own accounts and the losing trades to customer accounts, misappropriating customer funds, and selling almost one million shares of restricted securities in violation of Securities Act (SA) section 5. In addition to consenting to the above findings, the broker-dealer firm also consented to findings that it failed to supervise its salesmen in five branch offices within the meaning of SEA section 15(b)(4)(E). The supervisory failures included findings that the

[36] S.E.C. v. Prudential Sec. Inc., Litigation Release No. 13840, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,780 (Oct. 21, 1993).

[37] Exchange Act Release No. 34-31889, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,110 (Feb. 18, 1993).

firm failed to monitor the salesmen's trading activities, failed to follow existing procedures requiring the branch managers to review and take certain actions (including direct customer contact) with respect to active account reports, failed to investigate after being notified of compliance problems, and approved sales of restricted stock despite the absence of required documents. The firm consented to a censure, an order to retain an outside consultant to review its supervisory policies and practices, and an order to conduct two-day training seminars for all supervisory and managerial employees in its branch and regional offices apprising them of the firm's policies and practices.

In *In re First Albany Corp.*,[38] First Albany consented to findings that it lacked adequate supervisory and compliance policies and procedures, and lacked an adequate system for applying those supervisory and compliance procedures that were in place. More specifically, although the compliance department reviewed salesmen's daily trading activity, none of the firm's trading reports specifically identified wash sales or cross trades. As a result, the execution of wash sales and cross trades by a salesman, for the purpose of creating a false or misleading appearance of active trading, went undetected and unprevented. In addition, the firm's Procedures Manual required the branch manager to approve order ticket changes such as cancels and rebills only after determining the facts necessitating the change. The firm's system of follow-up and review to determine whether the branch manager exercised these responsibilities consisted of asking him, during the annual internal compliance audit, what his procedures were. This system was inadequate. The repeated cancellations and rebills by a salesman which were present in this case engendered the necessity for additional procedures and specification of responsibility for review. Finally, the firm had no procedures beyond the branch level that were reasonably designed to review the branch manager's fulfillment of his responsibility to detect and prevent the violation of a trading restriction imposed by the firm on a salesman. The firm consented to findings that it failed to supervise a salesman within the meaning of SEA section 15(b)(4)(E), a censure, and an order to retain an outside consultant to review its supervisory procedures.[39]

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[38] Exchange Act Release No. 34-30515, 51 S.E.C. Docket 87 (Mar. 25, 1992).

[39] For additional authorities which highlight firm supervisory deficiencies, see *In re* Dean Witter Reynolds, Inc., Exchange Act Release No. 34-26144, 41 S.E.C. Docket 1307 (Sept. 30, 1988). The SEC stated that:

'There must be adequate follow-up and review when a firm's own proce-

V. EXPANDING SUPERVISORY RESPONSIBILITIES OF INDIVIDUALS EMPLOYED BY BROKER-DEALER FIRMS

In addition to targeting broker-dealer firms for enforcement activities with respect to supervisory issues, in recent years the SEC has focussed upon expanding the supervisory responsibilities and accountability of the individual employees of such firms. In this section we will focus upon recent administrative and court decisions as well as other authorities which attempt to define the supervisory responsibilities of branch office managers, heads of

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> dures detect irregularities or unusual trading activity in a branch office . . . .' A firm must have adequate procedures to assure that trading restrictions issued by its Compliance Department are not ignored by the branch managers or other personnel. A broker-dealer is not meeting its supervisory obligations under the federal securities laws if its Compliance Department can be disregarded or otherwise rendered ineffective by a branch manager.

Id. The firm consented to findings of supervisory violations within the meaning of SEA § 15(b)(4)(E), a censure, and an order to upgrade and supplement certain supervisory procedures. *See also In re* Wedbush Securities, Inc., Exchange Act Release No. 34-25504, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,330, at 89,483-84 (Mar. 24, 1988). In that action, the SEC stated:

> In large organizations it is especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention . . . . Here, despite [salesman's] efforts at concealment and [branch manager's] inadequacies in supervising him, the firm's top management had substantial indications of irregularity with respect to [the salesman's] activities. Yet, . . . it continually ignored warning signals or took inadequate action when confronted with information indicating that customers of the [branch] office were being defrauded.

Id. The SEC affirmed NASD sanctions which included a censure and a $50,000 fine. Furthermore, in another, unrelated matter, Smith Barney, Harris Upham & Co., consented to censure for failing to reasonably supervise salesman who engaged in uncovered options transactions for customers who were unsuitable for such investments. Smith Barney, Harris Upham & Co., Exchange Act Release No. 34-21813, [1984-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,745 (Mar. 5, 1985). The firm's procedures were inadequate to detect and prevent the salesman's conduct. In *Thomson McKinnon Securities, Inc.*, the firm consented to censure and to remedial sanctions for failure to supervise employees who violated antifraud provisions of the federal securities laws. Thomson McKinnon Securities, Inc., Exchange Act Release No. 34-20908, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,620 (Apr. 30, 1984). The supervisory failures related to branch managers, a regional vice-president, and the surveillance section of the compliance department.

For a comprehensive discussion of broker-dealer firm supervisory problems as viewed in 1989, see *Broker-Dealer Supervision, supra* note 1, at 1361-98. Broker-dealer firm supervisory problems not previously discussed in this section which were in the forefront in 1989 include: (i) failure to detect heavy trading in non-firm-recommended securities or to investigate the reasons for such trading; (ii) protection against abuses and wrongful disbursement of customer funds; and (iii) failure to supervise in connection with violations of net capital rules and customer securities possession rules.

functional areas, chief executive officers, compliance officers, and general counsel.

A. *Branch Office Managers*

The present director of the SEC's Division of Enforcement has written:

> The real base of the supervisory pyramid is occupied not by the broker-dealers but by their individual supervisory personnel, who are governed by an independent statutory duty to supervise. This statutory duty requires broker-dealer personnel to supervise reasonably those employees subject to their supervision. Of all the supervisory personnel governed by this duty, none occupies a more critical position than the branch office manager, and it is with the branch office manager that customer protection truly begins . . . . [T]he Commission has brought supervision cases against branch office managers in connection with many types of violative conduct by broker-dealer employees, including misappropriations of customer funds or securities, market manipulations, excessive mark-ups and/or mark-downs, fraudulent sales representations, and record-keeping violations. The underlying violations in some of these cases were committed by just one employee and in others by several employees. Moreover, the Commission has brought cases against branch office managers employed at both large and small broker-dealers. [The] number of more recent failure-to-supervise actions reflects the Commission's continued commitment to a strong enforcement presence in this area.[40]

The referenced McLucas and Morse article contains a history of SEC actions against branch office managers and surveys in depth the various types of supervisory deficiencies for which the SEC has sanctioned branch office managers.The branch office manager is the paradigm of the supervisor and it is not surprising that branch

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[40] *William R. McLucas & William E. Morse, Liability of a Branch Office Manager for Failure to Supervise*, 23 REV. SEC. & COMMOD. REG. 1, 5 (Jan. 10, 1990) (citing *In re* William L. Vieira, Exchange Act Release No. 34-26575, 42 S.E.C. Docket 1392 (Feb. 28, 1989); *In re* Nicholas A. Boccella, Exchange Act Release No. 34-26574, 42 S.E.C. Docket 1388 (Feb. 27, 1989); *In re* Charles Allen Refkin, Exchange Act Release No. 34-26312, 42 S.E.C. Docket 409 (Nov. 25, 1988); *In re* Dale E. Barlage, Exchange Act Release No. 34-25563, 40 S.E.C. Docket 897 (Apr. 8, 1988); *In re* E.F. Hutton & Company, Inc., Exchange Act Release No. 34-25054, 39 S.E.C. Docket 570 (Oct. 22, 1987); *In re* Phillip Huber, Exchange Act Release No. 34-23542, 36 S.E.C. Docket 384 (Aug. 18, 1986)). *See also In re* Albert Vincent O'Neal, Exchange Act Release No. 34-34116, 56 S.E.C. Docket 2093 (May 26, 1994); *In re* Patricia A. Johnson, Exchange Act Release No. 34-33664 [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,340 (Apr. 14, 1994); *In re* First Albany Corp., Exchange Act Release No. 34-30515, 51 S.E.C. Docket 87 (Mar. 25, 1992).

office managers have long been the subject of failure to supervise actions. It is with broker-dealer employees above the level of branch manager, however, that the law with respect to supervisory responsibilities is expanding.

B. Heads of Functional Areas

A person cannot be held responsible for failing to supervise another person within the meaning of SEA sections 15(b)(4)(E) and 15(b)(6) unless the latter is "subject to his supervision." The most common form of supervision is line responsibility — the power to hire, fire, reward or punish — as seen, for example, in the relationship between a branch office manager and his/her brokers. The head of a particular functional area of a brokerage firm, however, may not have line responsibility, yet still may be subject to an action for supervisory failure because he/she may in the ordinary sense be expected to supervise that particular functional area of brokerage firm activity.

> An important element in these cases is the extent to which they focus on the fact that the employees had particular authority and responsibility for the salespersons' violative conduct (apparently even more so than did the branch and regional managers who were also responsible for supervision of the salespersons), and had the employees wished to exercise it could have prevented the salespersons from continuing their activities in those areas in which they exercised that authority and responsibility, even if they did not have the power to fire, demote or reduce the pay of the salespersons in question.[41]

Thus, in *In re Michael E. Tennenbaum*,[42] a general partner of a broker-dealer firm who was the senior principal in charge of the firm's options trading was suspended from association with any broker or dealer for one month for failing to exercise reasonable supervision over a broker who had churned customer option accounts. The Commission held that since the partner was the only official of the firm who could give a salesman the authority to handle discretionary options accounts, he had a concomitant duty to ensure that the special authority he had conferred was not being abused.

> In sum, we think it clear that Tennenbaum failed to exercise

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41 *In re* Arthur James Huff, Exchange Act Release No. 34-29017, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,719, at 81,401 (Mar. 28, 1991) (concurring opinion).

42 Exchange Act Release No. 34-18429, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,092 (Jan. 19, 1982).

> reasonable supervision over Graham with a view to preventing his churning of customers' accounts. Although other Bear, Stearns officials had supervisory authority over Graham, Tennenbaum, as SROP [Senior Registered Options Principal], was the firm's highest official in the options area, and admittedly had "personal regulatory responsibility" with respect to options transactions by firm personnel. He was the only official who could give a salesman authority to handle discretionary options accounts, and he had the power to revoke that authority. But, having given the necessary permission to Graham, 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.
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> In this connection, we note that although Tennenbaum designed compliance procedures, he did not adhere to them. He stressed the need for effective supervision by qualified local personnel, including a local ROP [Registered Options Principal], but was well aware that the San Francisco office not only lacked an ROP but that supervision over its personnel was seriously deficient. Despite specific warnings that Graham might be engaging in excessive trading, and Tennenbaum's own conclusion as early as March 1975 that such was the case in two of Graham's accounts, he [Tennenbaum] failed to take or recommend any action to investigate Graham's activities. And he never sought to place any meaningful restraints on Graham's authority to handle discretionary accounts. Rather, as aptly stated by Hyman, he engaged in "foot-dragging."
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> As we have previously pointed out, "in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention." Here it is clear that Tennenbaum had far more than "a remote indication of irregularity" with respect to Graham's activities. Yet he did not take appropriate action.
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> We conclude that Tennenbaum failed to exercise proper supervision over Graham with a view to preventing Graham's churning of customer accounts.[43]

Similarly, in *In re Robert J. Check*,[44] Check was the manager of a broker-dealer firm's mutual fund sales department. The underlying violations were failures by salespersons to process properly mutual fund sales orders. The Commission rejected Check's contention that he did not have supervisory obligations because he

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[43] *Id.* at 84,813-14 (footnotes omitted).

[44] Exchange Act Release No. 34-26367, 42 S.E.C. Docket 651 (Dec. 16, 1988).

did not occupy a line position. Rather, supervisory obligations were found in Check's ability to control the behavior of sales personnel in the specific category of activity in which the violations took place.

> Check was uniquely positioned to exercise effective supervisory control in the specialized area of mutual fund sales, and . . . he did exercise control on certain occasions when he received inconsistent information on sales orders. It was Check . . . who by his control over mutual fund orders had the power and obligation to see to it that customers received the benefits to which they were entitled, and Check who had, and sometimes exercised, the power to reject mutual fund orders.[45]

Check was suspended from association with any broker or dealer for thirty days.

C. *Chief Executive Officers*

The supervisory responsibilities of chief executive officers of broker-dealer firms have expanded in recent years. A traditional supervisory responsibility of broker-dealer chief executives has been to see that a proper supervisory system is set up in the firm and to delegate particular supervisory functions to appropriate firm personnel. If no proper system is set up or no proper delegation is made, the chief executive officer has total supervisory responsibility. In affirming a New York Stock Exchange disciplinary proceeding sanctioning a member firm's chief executive officer for failing to provide for supervision of a trader, the Second Circuit recently stated:

> [T]he SEC has held that the president of a broker-dealer "'is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient.'"[46]

Similarly, in *In re James Michael Brown*,[47] the SEC held that the president of an inactive broker-dealer firm was responsible for its record keeping violations despite the president's contention that he had

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[45] *Id.* at 654.

[46] Patrick v. S.E.C., 19 F.3d 66, 69 (2d Cir. 1994) (citing *In re* Kochcapital, Inc., Exchange Act Release No. 34-31652, 53 S.E.C. Docket 205, 210 n.18 (Dec. 23, 1992) (quoting *In re* Universal Heritage Invs. Corp., Exchange Act Release No. 34-19308, 26 S.E.C. Docket 1232 (Dec. 8, 1982))).

[47] Exchange Act Release No. 34-31223, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,048 (Sept. 23, 1992).

no control of the firm, was not paid for his services, and lacked hiring, firing, and certain check writing authority. The Commission wrote:

> We have consistently stated that the president of a firm is responsible for its compliance efforts unless and until he reasonably delegates a particular function to another person at the firm and neither knows nor has reason to know that such person is not performing his duties.[48]

A different kind of chief executive officer supervisory responsibility has recently been articulated by the SEC in *In re John H. Gutfreund*.[49] Salomon Brothers, Inc. submitted false $3.15 billion bids — in the names of each of two customers who had not authorized them — for United States Treasury notes in the auction of February 21, 1991. The bids, together with Salomon's $3.15 billion bid in its own name, exceeded the maximum limit of 35% for bids at the same auction. Salomon made similar excessive bids at other auctions, totalling some $15.5 billion and resulting in the firm's purchase of $9.5 billion more securities than allowed by the 35% limit. The SEC charged violations of SA section 17(a), SEA sections 10(b), 15(c)(1) and 17(a), and SEA Rules 10b-5 and 15c1-2 and record keeping rules, as well as a false press release about the events, and alleged prearranged trades to create improper losses for income tax purposes.

Salomon and its parent (Salomon Inc.) consented to pay $290 million including $190 million to the United States ($122 million as Securities Enforcement Remedies and Penny Stock Reform Act penalties and $68 million as forfeiture and for Justice Department claims) and $100 million as a fund for civil claims. Additional sanctions were a permanent injunction, censure, and required policies and procedures designed to prevent recurrence. In the related administrative proceeding the SEC found that Salomon failed reasonably to supervise.[50] Salomon paid another $4 million to settle

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[48] *Id.* at 83,343 (citing *In re* Kirk A. Knapp, Exchange Act Release No. 34-30391, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,933 (Feb. 21, 1992); *In re* Charles A. Campbell, Exchange Act Release No. 34-26510, 42 S.E.C. Docket 1391, 1395 (Feb. 1, 1989); *In re* Mark James Hankoff, Exchange Act Release No. 34-24390, 38 S.E.C. Docket 223 (Apr. 24, 1987); *In re* C. Brock Lippitt, Exchange Act Release No. 34-23495, 36 S.E.C. Docket 277 (Aug. 4, 1986); *In re* Carroll P. Teig, Exchange Act Release No. 34-12812, 10 S.E.C. Docket 509 (Sept. 17, 1976); *In re* Jerome H. Shapiro, Exchange Act Release No. 34-12615, 10 S.E.C. Docket 10 (July 12, 1976)).

[49] Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067 (Dec. 3, 1992).

[50] S.E.C. v. Salomon Inc., Litigation Release No. 13246, 51 S.E.C. Docket 817 (May

securities law claims of thirty-nine states.[51] But it was not criminally prosecuted, presumably because of its cooperation and change of management, although perhaps because of its importance to the markets.

The SEC also sued Paul W. Mozer — the managing director who submitted the false bids — for the violations charged against Salomon and for selling his Salomon Inc. shares with material nonpublic information about the false bids and potential liabilities arising from them.[52] He ultimately pleaded guilty to two felony counts.[53] He previously agreed to pay $500,000 into escrow to satisfy any SEC judgment against him.

The SEC found that Salomon's chairman and chief executive officer (John H. Gutfreund), president (Thomas W. Strauss) and vice chairman (John W. Meriwether) failed reasonably to supervise. The SEC imposed sanctions under SEA sections 15(b)(4)(E) and 15(b)(6), summarizing their transgressions this way:

> In late April of 1991, three members of the senior management of Salomon — John Gutfreund, Thomas Strauss and John Meriwether — were informed that Paul Mozer, the head of the firm's Government Trading Desk, had submitted a false bid in the amount of $3.15 billion in an auction of U.S. Treasury securities on February 21, 1991. The executives were also informed by Donald Feuerstein, the firm's chief legal officer, that the submission of the false bid appeared to be a criminal act and, although not legally required, should be reported to the government. Gutfreund and Strauss agreed to report the matter to the Federal Reserve Bank of New York. Mozer was told that his actions might threaten his future with the firm and would be reported to the government. However, for a period of months, none of the executives took action to investigate the matter or to discipline or impose limitations on Mozer. The information was also not reported to the government for a period of months. During that same period, Mozer committed additional violations of the federal securities laws in connection with two subsequent auctions of U.S. Treasury securities.[54]

Pursuant to SEA section 21B(a)(4), Gutfreund was ordered to

20, 1992); *In re* Salomon Brothers Inc., Exchange Act Release No. 34-30721, [1991-92 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,948 (May 20, 1992).

51 John Connor, *Salomon Brothers Will Pay $4 Million to Settle States' Complaint in Scandal*, WALL ST. J., Jan. 6, 1993, at B6.

52 S.E.C. v. Mozer, Litigation Release No. 13453, 52 S.E.C. Docket 2916 (Dec. 2, 1992).

53 *Ex-trader for Salomon Pleads Guilty*, N.Y. TIMES, Oct. 2, 1993, at A6.

54 *In re* John H. Gutfreund, Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,599 (Dec. 3, 1992).

pay a $100,000 civil penalty and comply with his undertaking not to be a chairman or chief executive officer of a broker-dealer firm; Strauss was ordered to pay a $75,000 civil penalty and was suspended for six months; Meriwether was ordered to pay a civil penalty of $50,000 and was suspended for three months. The three executives had earlier resigned under pressure.[55]

In the administrative proceeding addressing failure to supervise, the SEC found that the three supervisors, Gutfreund, Strauss, and Meriwether, should have done the following: (1) directed or monitored an appropriate investigation into what had occurred; (2) pending the outcome of the investigation, increased supervision of Mozer and placed appropriate limitations upon his activities; (3) defined the respective responsibilities of those persons who were to respond to the wrongdoing; and (4) if justified, following the investigation introduced new procedures and followed up to see that these new procedures were properly implemented. With respect to the chief executive officer individually, the SEC wrote:

> As Chairman and Chief Executive Officer of Salomon, Gutfreund bore ultimate responsibility for ensuring that a prompt and thorough inquiry was undertaken and that Mozer was appropriately disciplined. A chief executive officer has ultimate affirmative responsibility, upon learning of serious wrongdoing within the firm as to any segment of the securities market, to ensure that steps are taken to prevent further violations of the securities laws and to determine the scope of the wrongdoing. He failed to ensure that this was done. Gutfreund also undertook the responsibility to report the matter to the government, but failed to do so, although he was urged to make the report on several occasions by other senior executives of Salomon. The disclosure was made only after an internal investigation prompted by other events. Gutfreund's failure to report the matter earlier is of particular concern because of Salomon's role in the vitally-important U.S. Treasury securities market. The reporting of the matter to the government was also the only action under consideration within the firm to respond to Mozer's actions. The failure to make the report thus meant that the firm failed to take any action to respond to Mozer's misconduct.
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> Once improper conduct came to the attention of Gutfreund, he bore responsibility for ensuring that the firm responded in a way that recognized the seriousness and urgency of

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[55] Micheal Siconolfi & Laurie P. Cohen, *The Treasury Action Scandal at Salomon—Sullied Solly: How Salomon's Hubris and a U.S. Trap Led to Leaders' Downfall*, WALL ST. J., Aug. 19, 1991, at A1.

> the situation. In our view, Gutfreund did not discharge that responsibility.[56]

Milder sanctions were similarly imposed on the chief executive officer and the executive vice president of Drexel Burnham Lambert Inc. for failure to supervise Michael R. Milken, manager of Drexel's High Yield and Convertible Bond Department.[57]

D. Compliance Officers

It takes no particular flash of insightful analysis to conclude that compliance officers of broker-dealers are in a particularly vulnerable position. As a practical matter, compliance officers will frequently be liable for supervisory failures if the SEC chooses to pursue them.

> First, they are usually responsible for carrying out a number of compliance procedures which have a supervisory nature. Failure to perform these procedures may be actionable if as a result a broker is permitted to carry on violations. Second, compliance officers are most likely to hear about misdeeds and because of their stated responsibilities, failure to follow-up on information about those misdeeds may be deemed a failure to supervise if the result is that the employee or others can continue to perpetrate the misdeeds. Finally, if the compliance officer has responsibility for the overall adequacy of supervisory policies and procedures, the SEC maintains . . . that this puts the responsibility on the compliance officer for any inadequacies in the policies or procedures.[58]

In its "SEA section 21(a) report of investigation" section of the *Gutfreund* administrative release, the Commission wrote as follows with respect to the supervisory responsibilities of compliance officers:

> Employees of brokerage firms who have legal or compliance responsibilities do not become "supervisors" for purposes of Sections 15(b)(4)(E) and 15(b)(6) solely because they occupy those positions. Rather, determining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of

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56 *In re* John H. Gutfreund, Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 83,607-08.

57 *In re* Frederick H. Joseph, Exchange Act Release No. 34-32340, 54 S.E.C. Docket 266 (May 20, 1993); *In re* Edwin Kantor, Exchange Act Release No. 34-32341, 54 S.E.C. Docket 270 (May 20, 1993) (barring Kantor from association in a supervisory capacity, but allowing him to reapply after three years).

58 Budd, *Expanding Liability for the Misdeeds of Broker-Dealer Employees*, A.L.I.-A.B.A. Course of Study 235, 239 (1993).

> responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.[24] 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.
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> [24]Although it did not represent an opinion of the Commission, the concurring opinion in *Arthur James Huff*, Exchange Act Release No. 29017 (March 28, 1991) [(1990-1991 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 84,719], is consistent with this principle. The operative portion of the *Huff* opinion, Part VI, explains that in each situation a person's actual responsibilities and authority, rather than, for example, his or her "line" or "non-line" status, will determine whether he or she is a "supervisor" for purposes of Sections 15(b)(4)(E) and (6).[59]

The vagueness of the "requisite degree of responsibility, ability or authority to affect the conduct of the employee" test for determining whether a compliance officer is a supervisor for purposes of SEA sections 15(b)(4)(E) and 15(b)(6) articulated above in *Gutfreund* is further confused by the reference in *Gutfreund's* footnote 24 to Part VI of the concurring opinion in the *Huff* decision as "consistent with this principle." Part VI reads in its entirety as follows:

> We do not find that Huff was not Greenman's supervisor merely because of Huff's position as a staff compliance officer (*i.e.*, he was not one of Greenman's "line" supervisors); however his lack of authority to affect Greenman's violative behavior (by firing, demoting or disciplining him or by any other means) is, it seems to us, the most compelling factor in determining whether Huff was Greenman's supervisor, irrespective of what department Huff worked in. Given the absence of such authority, we merely find that, based on the facts in this record, Huff was never clearly given authority or responsibility for any of Greenman's violative activities and that Huff's authority otherwise to control Greenman's violative conduct was, for all practical purposes, nonexistent. Thus Huff was not Greenman's supervisor for purposes of Section 15(b)(4)(E).[60]

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[59] *In re* John H. Gutfreund, Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 83,608-09 (citing *In re* First Albany Corporation, Exchange Act Release No. 34-30515, 51 S.E.C. Docket 87 (Mar. 25, 1992); *In re* Gary W. Chambers, Exchange Act Release No. 34-27963, 46 S.E.C. Docket 183 (Apr. 30, 1990); *In re* Michael E. Tennenbaum, Exchange Act Release No. 34-18429, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,092 (Jan. 19, 1982)).

[60] *In re* Arthur James Huff, Exchange Act Release No. 34-29017, [1990-1991 Trans-

It seems at best unclear how to reconcile the "authority . . . to control" language of the concurring opinion in *Huff* with the "requisite degree of responsibility, ability or authority to affect the conduct of the employee" language of *Gutfreund*.[61] Only adding to the uncertainty is the Commission's "majority" opinion in *Huff* representing the views of Chairman Breeden and Commissioner Roberts which seems to assume that a compliance officer has supervisory responsibility only if he fails reasonably to perform a duty that is assigned to him.

In *In re Huff*,[62] a senior registered options principal in a broker-dealer firm's compliance department was found by the Commission not to have failed reasonably to supervise a salesman's options trading activities and thereby prevent his antifraud violations within the meaning of SEA sections 15(b)(4)(E) and 15(b)(6). Although the options principal took no action with respect to questions raised concerning a number of the salesman's accounts, identical questions had arisen previously and had been resolved to the satisfaction of the compliance department before the options principal had arrived at the firm. Moreover, within nine months of his arrival at the firm, the options principal, on the basis of his own research, had recommended that the salesman be fired, but his recommendation was not followed. For purposes of its opinion the Commission (per Chairman Breeden and Commissioner Roberts) assumed, but specifically did not rule, that the salesman was subject to the options principal's supervision. In a concurring opinion, two commissioners (Lochner and Shapiro) preferred first to address the supervisory issue and found that the salesman was not subject to the options principal's supervision.[63]

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fer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,719, at 81,402 (Mar. 28, 1991) (concurring opinion).

61 *See* Commissioner Richard Y. Roberts, *Failure to Supervise Liability for Legal and Compliance Personnel*, Remarks to the Securities Law Committee of the Federal Bar Association, Washington, D.C. (Dec. 7, 1992). Commissioner Roberts suggested that the decision in *Gutfreund* "is somewhat broader" than prior Commission cases. Further, Commissioner Roberts expressed doubt that the concurring opinion in *Huff* was consistent with the SEA § 21(a) report of investigation in *Gutfreund*. He stated, "it is unclear to me how 'the authority and the responsibility for exercising such control' language of the concurring opinion [in *Huff*] is consistent with the 'a requisite degree of responsibility, ability, or authority to affect the conduct' language" contained in the SEA § 21(a) report of investigation in *Gutfreund*. We agree with Commissioner Roberts.

62 Exchange Act Release No. 34-29017, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,719 (Mar. 28, 1991).

63 *See also In re* First Albany Corp., Exchange Act Release No. 34-30515, 51 S.E.C. Docket 87 (Mar. 25, 1992).

Lindburg as Chief Compliance Officer was responsible for ensuring that

In *In re Alfred Bryant Tallman*,[64]

while [the decision] involved a compliance officer, it appears that he had formal responsibilities far beyond those typically assigned to a staff employee. For example, the opinion notes that the compliance officer's stated compliance duties included supervision of salesmen and branch office supervision and inspection. Interestingly, despite these stated responsibilities, the Commission declined to accept the compliance officer's consent

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registered representatives complied with firm policy. Lindburg had the power to take disciplinary action against a registered representative who violated firm policy by removing commissions and imposing small fines.

Although he knew that the registered representative was restricted from soliciting purchases of Central, Lindburg failed to take any actions or put in place or implement any procedures, either at the Boston branch or in the Compliance Department, to provide a sufficient system of review to determine whether this restriction was enforced, even after he had reasonable cause to believe that the registered representative had violated this restriction. . . .

. . . .

Lindburg failed to respond reasonably to another apparent indication that the registered representative was engaged in improper conduct: the registered representative's repeated cancelling and rebilling of Central trades. . . .

. . . .

. . . After the Margin Department Manager told Lindburg that the registered representative was not following [a specific procedure designed to ensure compliance with margin requirements] . . . Lindburg failed either to perform a reasonable inquiry, or to establish any other procedure to determine whether the registered representative complied with firm margin policy, and Lindburg thereby failed reasonably to supervise the registered representative.

Id. at 91. Lindburg was censured and suspended from associating with a regulated entity in a supervisory capacity for one year.

See also In re Gary W. Chambers, Exchange Act Release No. 34-27963, 46 S.E.C. Docket 183 (Apr. 30, 1990).

In *Chambers*, a broker-dealer's senior vice-president of compliance and operations consented to an order of the Commission finding that he was responsible for a failure to supervise. Though the basis for the order is not entirely clear, it does state that (1) Chambers was responsible for developing adequate supervisory procedures for the broker-dealer and failed to do so; (2) by his own procedures, Chambers was charged with performing certain duties and failed to discharge those duties or to ensure that someone else discharged them; and (3) within the administrative structure of the broker-dealer, Chambers had an obligation to supervise two salespersons and his deficient supervision allowed their violations to occur.

In re Huff, Exchange Act Release No. 34-29017, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 81,400 n. 10 (concurring opinion). Chambers was suspended from associating with a regulated entity in a supervisory capacity for six months and subjected to certain undertakings.

64 Exchange Act Release No. 8830, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,800 (Mar. 2, 1970).

> to a censure for failure to supervise. The Commission's opinion states that, despite having apparently broad responsibilities, the officer "in fact had very limited authority, and the power to implement his recommendations concerning compliance was retained by [the broker-dealer's vice-president]." Consequently, in addition to youth and inexperience, the compliance officer's lack of actual authority was relevant to the Commission's determination not to impose a sanction for a failure to supervise.[65]

In *In re Louis R. Trujillo*,[66]

> the Commission expressly did not rule on whether the salesman was "subject to his [Trujillo's] supervision," but rather "assumed" he was — for the purposes of the analysis. The Commission looked beyond Trujillo's job title as "administrative manager" and examined his specific responsibilities and his authority vis-a-vis subordinate employees. The Commission found determinative that although Trujillo was given specific authority to detect problems, he had very limited authority to correct them. He did not have the power to discharge, suspend, or fine a salesperson, place a written censure in a salesperson's record, or restrict a salesperson's activities as a precautionary measure. The Commission noted that the limited scope of Trujillo's authority was critical to its decision and that to the extent his functions were advisory, he exercised his function and went beyond it in responding to indications of wrongdoing.[67]

E. General Counsel

The most controversial part of the *Gutfreund* administrative release dealt with Donald M. Feuerstein, Salomon's chief legal officer and a former SEC staff member. It should be noted that the portion of the Commission's Release addressing Feuerstein is a "report of investigation" by the Commission under SEA section 21(a) as contrasted with an order instituting proceedings or an order making findings. Feuerstein was not named as a respondent or sanctioned. He advised Strauss and Gutfreund that the false $3.15 billion bid was a criminal act and should be reported to the government, and he urged on several occasions that it be reported. But he was criticized by the Commission for failure to supervise on essentially the same grounds as the three senior executives: he did

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65 *In re* Huff, Exchange Act Release No. 34-29017, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 81,400 n.10 (concurring opinion).

66 Exchange Act Release No. 34-26635, 43 S.E.C. Docket 735 (Mar. 16, 1989).

67 William R. McLucas & Hiller, *The Salomon Case and The Supervisory Responsibilities of Lawyers and Compliance Personnel* (PLI Corp. L. & Practice Course Handbook Series No. 828, 1993).

not "direct or monitor an investigation of the conduct at issue, make appropriate recommendations for limiting the activities of the employee or for the institution of appropriate procedures, reasonably designed to prevent and detect future misconduct, and verify that his or her recommendations, or acceptable alternatives, [were] implemented."[68] This criticism was rendered despite the fact that he was not a direct supervisor of Mozer. The SEC took occasion to express its view of legal and compliance officers like Feuerstein:

> Employees of brokerage firms who have legal or compliance responsibilities do not become "supervisors" for purposes of Sections 15(b)(4)(E) and 15(b)(6) solely because they occupy those positions. Rather, determining if a particular 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.[24] 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.[25]
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> In this case, serious misconduct involving a senior official of a brokerage firm was brought to the attention of the firm's chief legal officer. That individual was informed of the misconduct by other members of senior management in order to obtain his advice and guidance, and to involve him as part of management's collective response to the problem. Moreover, in other instances of misconduct, that individual had directed the firm's response and had made recommendations concerning appropriate disciplinary action, and management had relied on him to perform those tasks.
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> Given the role and influence within the firm of a person in a position such as Feuerstein's and the factual circumstances of this case, such a person shares in the responsibility to take appropriate action to respond to the misconduct. Under those circumstances, we believe that such a person becomes a "supervisor" for purposes of Sections 15(b)(4)(E) and 15(b)(6). As a result, that person is responsible, along with the other supervisors, for taking reasonable and appropriate action. It is not sufficient for one in such a position to be a mere bystander to the events that occurred.
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> Once a person in Feuerstein's position becomes involved in

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68 *In re* John H. Gutfreund, Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,608-09 (Dec. 3. 1992).

formulating management's response to the problem, he or she is obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct. For example, such a person could direct or monitor an investigation of the conduct at issue, make appropriate recommendations for limiting the activities of the employee or for the institution of appropriate procedures, reasonably designed to prevent and detect future misconduct, and verify that his or her recommendations, or acceptable alternatives, are implemented. If such a person takes appropriate steps but management fails to act and that person knows or has reason to know of that failure, he or she should consider what additional steps are appropriate to address the matter. These steps may include disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities.[26]

These responsibilities cannot be avoided simply because the person did not previously have direct supervisory responsibility for any of the activities of the employee. Once such a person has supervisory obligations by virtue of the circumstances of a particular situation, he must either discharge those responsibilities or know that others are taking appropriate action.

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[24]Although it did not represent an opinion of the Commission, the concurring opinion in *Arthur James Huff*, Exchange Act Release No. 29017 [(1990-1991 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 84,719] (March 28, 1992) is consistent with this principle. The operative portion of the *Huff* opinion, Part VI, explains that in each situation a person's actual responsibilities and authority, rather than, for example, his or her "line" or "non-line" status, will determine whether he or she is a "supervisor" for purposes of Sections 15(b)(4)(E) and (6).

[25]*See, e.g.*, First Albany Corp., Exchange Act Release No. 30515 [51 S.E.C. Docket 87] (March 25, 1992); Gary W. Chambers, Exchange Act Release No. 27963 [46 S.E.C. Docket 183] (April 30, 1990); Michael E. Tennenbaum, Exchange Act Release No. 18429 [24 S.E.C. Docket 676] (January 19, 1982).

[26]Of course, in the case of an attorney, the applicable Code of Professional Responsibility and the Canons of Ethics may bear upon what course of conduct that individual may properly pursue.[69]

The Feuerstein section of *Gutfreund* appears designed to impose new responsibilities on legal personnel based upon some sort of vague "involved" test. Contrary, however, to the implication in the text accompanying the Commission's footnote 25 above, the

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69 *Id.*

Commission has never sanctioned a legal officer as a supervisor under either SEA section 15(b)(4)(E) or section 15(b)(6). Indeed, neither Chambers nor Tennenbaum was a lawyer; and in *First Albany*, while Lindburg was both general counsel and chief compliance officer of First Albany, the Commission was careful to sanction him only in the latter capacity. In *Gutfreund*, however, while the Feuerstein section is clearly segregated as a SEA section 21(a) report of investigation and Feuerstein was not sanctioned, the Commission appears to be issuing a warning with respect to its position vis-a-vis legal personnel. If so, the warning lacks precision and predictability. To add to the confusion, in the first paragraph of the above excerpt, the Commission appears to apply the "requisite degree of responsibility, ability or authority to affect the conduct of the employee" test to determine if a person is a supervisor to both legal and compliance personnel, while the four remaining paragraphs of the excerpt refer only to legal personnel and appear to embrace an even more nebulous "involved" test for them.

The Feuerstein section of *Gutfreund* has overtones of a resurgence of SEC belief in a duty to report violations to it. In *SEC v National Student Marketing Corp.*,[70] the SEC alleged in its complaint that lawyers violated SA section 17(a) and SEA sections 10(b) and 14(a) when, discovering a violation in financial statements being used to solicit approval of a merger, the lawyers "failed to refuse to issue their opinions . . . and failed to insist that financial statements be revised and shareholders be resolicited, and failing that, to cease representing their clients and, under the circumstances, notify the plaintiff Commission concerning the misleading nature of the nine month financial statements."[71] The SEC's thrust in National Student Marketing was highly controversial and was later dropped.

VI. CONCLUSION

A careful review of the authorities addressing the supervisory responsibilities of broker-dealer firms, as well as their branch office managers, heads of functional areas, chief executive officers, compliance officers, and general counsel, engenders a sense of disquiet. The standards are vague and amorphous; the sanctions unpredictable and often harsh. As regards a broker-dealer firm, there is no approved, uniform standard of supervisory procedures

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[70] Civ. No. 225-72, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360, at 91,913-17 (D.D.C. Complaint filed Feb 3, 1972).

[71] *Id.* at 91,914.

that can be adopted with the confidence that their adoption will bring the firm within the safe harbor provisions of SEA section 15(b)(4)(E). Rather, as discussed above, each firm must develop a set of supervisory procedures uniquely tailored to its particular type and mix of business. The adequacy of these procedures will then be judged in the clear light of hindsight often by regulatory authorities bent upon an ex post facto justification of their own conduct.

The supervisory standards with respect to individuals are, if anything, less predictable. Branch office managers, heads of functional areas, chief executive officers, compliance officers, general counsel — all are vulnerable. The authorities, as discussed above, are too often confused and contradictory; the lines between acceptable and unacceptable conduct shifting and indeterminate. Indeed, as a practical matter, whether any or all of these individuals will be held responsible for supervisory failures frequently depends almost solely upon whether or not the SEC or the SROs choose to pursue them. This is a rather unsatisfactory state of affairs and, unfortunately, a realistic assessment portends little change in the foreseeable future.