

# Client Alert.

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## SEC Commissioner Gallagher Warns of Pitfalls of “Failure to Supervise” Liability of Legal and Compliance Personnel

By Jay G. Baris and Robert E. Putney, III

SEC Commissioner Daniel Gallagher warned that potential “failure to supervise” liability should not deter legal and compliance personnel employed by broker-dealer and investment adviser firms from carrying out their responsibilities.

In remarks to the SEC Speaks in 2012 conference on February 24, 2012, the Commissioner addressed concerns that failure to supervise cases brought against legal and compliance personnel did not clearly identify when legal or compliance officers cross the line and become supervisors. He acknowledged that what makes a legal or compliance officer a supervisor “remains disturbingly murky” and called for more clarity in defining what constitutes a supervisory role by legal and compliance personnel.

### BACKGROUND

Section 203(e)(6) of the Investment Advisers Act of 1940 provides for the imposition of sanctions on investment adviser personnel if a person:

. . . has failed reasonably to supervise, with a view to preventing violations of the provisions of [certain federal securities] 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 paragraph no person shall be deemed to have failed reasonably to supervise any person, if:

- (A) 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
- (B) 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.

Section 15(b)(4)(E) of the Securities Exchange Act of 1934 contains a similar provision with respect to personnel of broker-dealers. Past enforcement cases have typically been brought in the broker-dealer context.

### WHO IS A SUPERVISOR? A HISTORICAL PERSPECTIVE

Generally, advisers and broker-dealers establish clear reporting lines for business personnel. Business personnel understand to whom they report, who reports to them, and for whom they are responsible for supervising. Supervisors typically have input or authority to hire, fire, review, reward, penalize, and terminate their direct reports.

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Legal and compliance personnel generally provide advice and guidance on legal and regulatory requirements, and typically have no explicit supervisory authority over business personnel. While they may supervise other legal and compliance personnel within their own departments, they generally do not consider it their responsibility to “supervise” the day-to-day activities of businesspeople. Under some conditions, however, regulators may consider legal and compliance personnel to supervise business personnel, even when they have no explicit power to hire, fire, review, reward, penalize, or terminate those individuals.

In the *Gutfreund*<sup>1</sup> case, the SEC provided some clarity regarding when legal and compliance personnel may cross that line. The SEC said that an in-house lawyer can be deemed a supervisor when other members of senior management “involve him as part of management’s collective response to the problem.” In *Gutfreund*, the SEC issued a report that concluded that the general counsel of Salomon Brothers was a supervisor of the firm’s head trader, despite a lack of line reporting responsibility, and thus shared in the responsibility for the acts of a rogue trader.

Thus, any attorney or compliance person can become a supervisor solely “by virtue of the circumstances of a particular situation.” The SEC stated that “determining if a particular person is a ‘supervisor’ depends on whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.”<sup>2</sup>

## COMMISSIONER GALLAGHER’S COMMENTS

Commissioner Gallagher noted that *Gutfreund* and other cases make it clear that once legal or compliance personnel become “involved in formulating management’s response to a problem,” they are “obligated to take affirmative steps to ensure that appropriate action is taken.” Unfortunately, he said, there is no bright-line test measuring when one becomes a supervisor. Moreover, in deciding whether or not to bring an enforcement action, the SEC has the advantage of 20/20 hindsight.

Commissioner Gallagher said that the current standard creates a “dangerous dilemma” because legal and compliance personnel who avoid assisting in resolving compliance problems likewise avoid potential supervisory liability, while those who actively engage in trying to resolve actual compliance issues are “more likely . . . to be deemed to be playing a supervisory role. Thus, the Commission’s position on supervisory liability for legal and compliance personnel may have had the perverse effect of increasing the risk of supervisory liability in direct proportion to the intensity of their engagement in legal and compliance activities.”

Commissioner Gallagher said that “broker-dealer or investment adviser compliance personnel are, by default, not supervisors but rather *providers of support* for the firm’s other employees.” He recommended that the SEC and broker-dealer self-regulatory organizations (SROs) provide a framework that would encourage active participation by legal and compliance personnel in regulatory crises. He stated that “the system does not work if firm legal and compliance officers are too timid to jump into the difficult regulatory issues firms face on a regular basis.” He encouraged regulators to resolve the continuing uncertainty in this area, which he views as having “a chilling effect on the willingness of such personnel to provide the level of engagement that firms need – and that the Commission wants.”

<sup>1</sup> In the Matter of John H. Gutfreund; Thomas W. Strauss; and John Meriwether, Release 34-31554 (Dec. 3, 1992).

<sup>2</sup> *Id.*

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## COMMITTEE MEMBERSHIP

Commissioner Gallagher said, however, that legal and compliance personnel should be mindful of those activities that might indicate supervisory control addressed in *Gutfreund*. In particular, he encouraged legal and compliance personnel who sit on business and operating committees (e.g., credit committees) to serve as active, but *non-voting*, members in order to remain outside the realm of business line responsibility and supervisory control.

## CONCLUSION

Many would welcome additional regulatory guidance that would clarify when the activities of legal and compliance personnel rise to the level of a supervisory relationship. Lawyers and compliance officers of broker-dealer and investment adviser firms would benefit from enforcement policies that encourage active participation by legal and compliance personnel in seeking to resolve regulatory problems and issues. Commissioner Gallagher offered no hope that the *Gutfreund* dilemma will be resolved any time soon.

Meanwhile, legal and compliance personnel should be mindful that the regulators may consider them to be “supervisors” and thus subject them to failure to supervise liability if their participation in management decisions crosses a threshold. As Commissioner Gallagher implied, they should strive to ensure that fear of this liability does not deter them from carrying out their responsibilities to identify and resolve regulatory issues that come to their attention.

*Remarks at “The SEC Speaks in 2012,” by Commissioner Daniel M. Gallagher (Feb. 24, 2012), available at <http://www.sec.gov/news/speech/2012/spch022412dmg.htm>*

## Contact:

**Jay G. Baris**  
(212) 468-8053  
[jbaris@mofo.com](mailto:jbaris@mofo.com)

**Robert E. Putney, III**  
(212) 336-4451  
[rputney@mofo.com](mailto:rputney@mofo.com)

**Luke T. Bagley**  
(212) 336-4379  
[lbagley@mofo.com](mailto:lbagley@mofo.com)

**Isabelle Sajous**  
(212) 336-4478  
[isajous@mofo.com](mailto:isajous@mofo.com)

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