Legal and Compliance Officers Left in Doubt about their Personal Liability

On October 19, 2009, the SEC instituted an administrative proceeding against Theodore Urban, the former general counsel of a broker-dealer, alleging that he had "failed to supervise" a registered representative of the firm. Urban was alleged to have been alerted to possible wrongdoing by a registered representative of the firm, to have tried to investigate and to stop any misconduct, but to have done too little to stop this misconduct. On first glance, it is difficult to identify a theory of liability under which Urban could be charged. He did not commit illegal acts, did not aid and abet or cause others to commit illegal acts, and was not the line supervisor of any wrongdoer. Nonetheless, the SEC asserted a theory of liability first articulated two decades ago under which a legal or compliance officer holding a senior position within the firm can be held liable for a failure to take affirmative action to investigate and to prevent misconduct that such officer had reason to suspect was taking place. Application of this failure to supervise theory is of particular concern to those within the legal and compliance community because, under such a theory of secondary liability, once a person is found to be a supervisor of a wrongdoer, the supervisor is subject to liability, with the burden shifting to the supervisor to prove the defense that supervision had in fact been adequate. Although the Urban case involved claims brought against the general counsel of a registered broker-dealer, the case potentially has important implications for a broader group of legal and compliance personnel, including chief compliance officers of registered broker-dealers and registered investment advisers.

The Urban case has a somewhat unusual procedural history. The SEC's claims were initially tried before an administrative law judge, who accepted the theory of supervisory liability but found that Urban met his burden of proving he had adequately supervised the wrongdoer. A year ago, the SEC Commissioners denied summary affirmance of this decision. Just a few weeks ago, the SEC Commissioners scheduled, then cancelled, oral argument on the appeal of this decision. On January 26, 2012, the case was finally resolved, but without in any way clarifying the theory under which legal and compliance officers can be held liable. Instead, the SEC dismissed the case because all but two of the Commissioners had recused themselves from the case, and the two remaining Commissioners were split in their views of the case. Urban has now been vindicated, but with legal and compliance officers left with no clear guidance as to the standard of liability that applies to their conduct in carrying out their duties and responsibilities.

Background on Supervisory Liability of Legal and Compliance Officers

The theory of liability under which Urban was charged was first asserted in *In re John Gutfreund*, 51 S.E.C. 93, Release No. 34-31554, 1992 WL 362753, *15-16 (1992), where the SEC stated in dictum that a firm's chief legal counsel, who directly supervised the firm's CCO, could be disciplined for a failure to supervise based on the misconduct of employees for whom he was not the direct supervisor but where the CLO/CCO had knowledge of possible misconduct and the authority to intervene to prevent it. *Gutfreund* represents an expansion of traditional failure to supervise claims to non-line supervisors. This theory was most clearly and forcefully advocated in a 1993 speech by then SEC Commissioner Mary Schapiro, who said "the facts and circumstances which may make you 'become' a supervisor vis-a-vis a particular employee, when formerly you were not, are (1) your knowledge and awareness of allegedly improper conduct, and (2), being so situated within a firm that you have some ability to affect the conduct at issue." Mary L. Schapiro, Commissioner, U.S. Securities and Exchange Commission, SIA Compliance and Legal Seminar: Broker-Dealer Failure to Supervise: Determining Who is a "Supervisor", at 15 (Mar. 24, 1993).

According to the SEC, under this theory of supervisory liability, two obligations are imposed on legal and compliance professionals when they learn of possible wrongdoing – a duty to investigate and a duty to prevent misconduct:

> "The 'supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing.' In re John H. Gutfreund, Exchange Act Release No. 31554, 1992 SEC LEXIS 2939, at *34 (Dec. 3, 1992). Thus, supervisors must respond not only when they are 'explicitly informed of an illegal act,' but also when they are 'aware only of 'red flags' or 'suggestions' of irregularity.' See id. at *34-35. In addition, '[e]ven where the knowledge of supervisors is limited to 'red flags' or 'suggestions' of irregularity, they cannot discharge their supervisory obligations simply by relying on the unverified representations of employees.' Id. at *35. 'Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.' In re Edwin Kantor, Exchange Act Release No. 32341, 1993 SEC LEXIS 1240, at *16 (May 20, 1993)." In the Matter of George M. Lintz, Exchange Act Rel. 43961 (Feb. 14, 2001).
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> "Once a person in [the general counsel's] position becomes involved in 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." *In re John Gutfreund*, 51 S.E.C. 93, Release No. 34-31554, 1992 WL 362753, *15-16 (1992) (emphasis added).

Decisions in the Urban Litigation

In the Urban case, an administrative law judge held that Urban should be deemed the supervisor of a registered representative (Glantz) under the *Gutfreund* standard, although the judge found that the general counsel had acted reasonably in response to indications of misconduct. *In re Urban,* File No. 13835 (Sept. 8, 2010).

On December 7, 2010, the SEC Commissioners refused to grant summary affirmance of the administrative law judge's decision and indicated that the Commissioners would consider many important issues in reviewing this appeal: "the proceeding raises important legal and policy issues, including whether Urban acted reasonably in supervising Glantz and responded reasonably to indications of his misconduct, whether securities professionals like Urban are, or should be, legally required to 'report up,' and whether Urban's professional status as an attorney and the role he played as FBW's general counsel affect his liability for supervisory failure." Exchange Act Rel. 63456. It is interesting that Chairman Shapiro and Commissioner Walter did not recuse themselves from this decision since their participation in this decision would seem to be inconsistent with their recent recusal from this matter. On November 29, 2011, the Commissioners announced that they would hear oral argument on the Urban appeal on December 6, 2011, although they quickly cancelled that oral argument. Again, there was no indication Chairman Shapiro or Commissioner Walter would recuse themselves.

On January 26, 2012, without ever holding oral argument, the Commission dismissed the Urban case because only two Commissioners, Paredes and Aguilar, had not recused themselves from the case and they were divided in their views on how to decide the appeal.

Lessons for Legal and Compliance Officers

The SEC's resolution of the Urban case leaves legal and compliance officers with great uncertainty as to their responsibilities and potential liability. Legal and compliance officers will continue to operate with the risk that they could be liable under a failure to supervise theory, which imposes on them liability with the burden of proving the defense of adequate supervision. To meet this burden they would have to prove that they (1) reasonably investigated allegations of possible misconduct and (2) took effective action to prevent the misconduct, including the possibility that they must resign or report to the SEC if their efforts, however vigorous, are not supported by senior management.

An alternative theory of liability for legal and compliance officers would be that they are liable only if they participate in misconduct, aid and abet such misconduct, or fail to supervise persons who report directly to them. Although this view of the liability of legal and compliance officers would impose sensible limitations on such liability, the SEC's resolution of the Urban case leaves serious questions about whether it recognizes such sensible limitations.