Fordham Journal of Corporate & Financial Law

Volume 8 | Issue 1 Article 8

2003

A Tangled Web: Compliance Director Liability Under the Securities Laws

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A TANGLED WEB: COMPLIANCE DIRECTOR LIABILITY UNDER THE SECURITIES LAWS

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INTRODUCTION

The current economic environment is ripe with dissatisfaction. Investors are disappointed with the performance of the stock exchanges and are skeptical of the advice offered by brokers and their associates.[1] The bankruptcy of Enron and the subsequently revealed accounting scandals have exacerbated the apprehension and distaste investors currently feel for management.[2] These scandals have focused not only the attention of investors but also that of regulatory agencies on firms' compliance with regulations. The attention is sure to result in increased litigation and investigation in both the private and public sectors regarding compliance supervisory systems implemented by the various corporations.[3] Among the targets will almost certainly be the legal compliance director of the broker-dealer firm, to whom the firm usually delegates the responsibility of investigating and preventing violations.[4]

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1. *See* Gretchen Morgensen, *Economy Is Surging, but Wall Street Is Down in the Dumps*, N.Y. TIMES, Apr. 27, 2002, at A1 (noting that consumers remain uneasy over "corporate profits and investigations into Wall Street practices"); *Jitters About Corporate Accounting Push Down Shares*, N.Y. TIMES, Feb. 13, 2002, at C12.
2. *See Jitters About Corporate Accounting Push Down Shares, supra* note 1.
3. *See* Linda Stern, *The Claims Games*, NEWSWEEK, May 7, 2001, at 77 (stating that aggrieved customers are filing a new case every 20 minutes at the National Association of Securities Dealers dispute resolution office).
4. *Id.*

The role of the compliance director is a product of the securities laws passed by Congress in the early 1930s[5] and the rules promulgated by the Securities and Exchange Commission ("SEC" or "Commission"). Congress inserted provisions in the securities laws that required broker-dealers to supervise their subordinates.[6] Specifically, § 15 of the Securities Exchange Act of 1934 ("1934 Act") permitted the sanctioning of a broker-dealer who inadequately supervised the firm's employees.[7] Section 15 of the 1934 Act also permitted sanctions against authorized agents of broker-dealers for the agents' failure to supervise.[8] Congress included these provisions to initiate in-firm mechanisms ensuring the compliance of brokerages with the securities laws.[9]

In fulfilling this mandate, brokerages have created departments dedicated to analyzing the securities laws and investigating the internal workings of the brokers' offices to assess whether the employees and procedures comply with the securities laws.[10] As the importance of these departments increase in the wake of accounting and reporting scandals, the directors of such departments shoulder a greater burden. This increased burden and responsibility seems to place them at greater risk for SEC enforcement actions and private litigation.

This Note discusses the requirements of the supervisory mandate of the federal securities regulations and the liability imposed on brokerage compliance directors through the courts and the administrative process. In addition, this Note addresses some contradictions and concerns apparent in the multiple roles often assumed by compliance directors. Part I discusses the current regulatory scheme regarding supervisory structures elaborated by the SEC. Part II discusses the sanctions the SEC can impose on those who breach their duty to supervise. Part III sets forth particular considerations relevant when an attorney or other

5. *See* 15 U.S.C. § 77h-1 (1990); 15 U.S.C. §§ 78u-3, 78o (1990).

6. *See* 15 U.S.C. § 78o (1990).

7. *Id.*

8. *See id.*

9. *See id.* (stating the sanctions must be applied with a "view to preventing violations of such statutory provisions, rules, and regulations . . . .").

10. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 72 (2002).

professional is serving as the compliance director or compliance department staff member. Finally, Part IV attempts to distill a satisfactory supervisory structure from the SEC cases that will allow the brokerages and the compliance director to avoid liability.

I. SUPERVISORY REQUIREMENTS UNDER THE SECURITIES LAWS AND ADMINISTRATIVE CASELAW

Broker-dealer firms often attempt to satisfy their regulatory duty of supervision by creating compliance departments.[11] The departments are staffed with individuals who analyze the supervisory structure of the firm, investigate alleged violations by employees, and draft recommendations on the path the firm should follow to comply with the federally imposed mandates.[12] The compliance department is sometimes staffed with attorneys, accountants, or other professionals,[13] which brings up additional considerations that will be addressed later in this Note.

Compliance directors and department staff are often included in administrative proceedings before the SEC because of their role in ensuring compliance with the securities laws.[14] In most cases, the Division of Enforcement ("Division"), the body that acts as prosecutor in SEC administrative actions, alleges that the compliance officer or director failed to adequately supervise the firm's employees.[15] However, for liability to issue, the compliance officer must inhabit a supervisory role within the framework of the corporate structure.[16] This finding is necessary because inherent in a supervisory role is the duty to reasonably oversee the subordinate and ensure the subordinates' compliance with the securities laws.[17] After proving that the respondent is a supervisor, the Division must then prove that the brokerage house and the supervisor failed to manage the subordinate in a manner

11. *Id.*
12. *Id.*
13. *Id.*
14. *See infra* Part I.A.
15. *See infra* Part I.A.
16. *See* 15 U.S.C. § 78o (1990).
17. *Id.*

reasonably expected to prevent violations of the securities laws.[18]

A. The Evolving Standard of Compliance Directors and Personnel As Supervisors Within the Meaning of § 15(b)(4)

Before the Division of Enforcement will succeed in its failure-to-supervise claim, the Division must show that the compliance officer was a supervisor of the individual who violated the securities laws.[19] Compliance personnel do not become supervisors merely because they occupy positions in the compliance department.[20] Instead, the determination of whether a compliance director can be labeled a supervisor for purposes of §§ 15(b)(4)(E) and 15(b)(6) is quite factual and rests on the particularities of each case.[21] The Commission has elaborated on a framework that can assist in assessing whether the compliance director was in a supervisory position vis-à-vis the offender.[22]

Traditionally, the Commission has used the "line" approach to determine supervisor status.[23] Using this approach in *In re Arthur James Huff*, the Commission considered whether the alleged supervisor was in the same supervisory structure as the violator.[24] In other words, the Commission determined whether the individual was in the violator's direct supervisory chain in the hierarchical scheme of the firm.[25] Thus, the Commission found that Huff was a line supervisor within the meaning of § 15(b)(4).[26]

Two commissioners in *Huff* proposed an expanded definition of supervision in a concurring opinion.[27] The concurrence stated

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18. *See id.*

19. *See In re* Arthur James Huff, Exchange Act Release No. 29,017, 48 S.E.C. Docket 767, at *7 (Mar. 28, 1991).

20. *See In re* John H. Gutfreund, Exchange Act Release No. 31,554, 51 S.E.C. 93, 113 (Dec. 3, 1992).

21. *Id.* (analyzing the specifics of the relationship between the "supervisors" and their subordinates).

22. *Id.*

23. *See In re* George J. Kolar, Initial Decisions Release No. 152, 70 S.E.C. Docket 2382, at *28 (Oct. 28, 1999) (citing *Huff*, 48 S.E.C. Docket 767, at *7).

24. *Huff*, 48 S.E.C. Docket 767, at *7.

25. *Id.*

26. *Id.* at *3.

27. *Id.* at *7.

that the ability to control the conduct of the other individual was the most important consideration in determining who was a supervisor under § 15(b)(4).[28] Without the requisite control, the concurrence argued, supervision would not exist.[29]

The concurrence distilled this new method of analysis from the few cases where the Commission held non-line supervisors liable for failing to supervise the violator.[30] In *Check*, the Commission had imposed liability on a non-line supervisor because of Check's unique position to exercise supervisory control.[31] In *In re Michael Tannenbaum*, the Commission had held a non-line supervisor liable because he had sole authority to permit subordinates to engage in a particular transaction.[32] The concurrence in *Huff* used these two cases to illustrate that control was the true essence of the line approach and, therefore, the appropriate consideration.[33] Commissioners Lochner and Schapiro further concluded that the statutory language of § 15(b)(4) and the common meaning of supervision substantiated this interpretation.[34]

Arguably, this more generally applicable definition of "supervisor" would allow the Division to go after compliance directors who were not line supervisors. This control analysis was used in *Gutfreund*, where the Commission instituted proceedings against several senior executives of Salomon Brothers, Inc. ("Salomon Brothers").[35] John H. Gutfreund, Thomas W. Strauss, John W. Meriwether and Donald M. Feuerstein were high-level executives of Salomon Brothers.[36] The Division alleged that these four executives failed to supervise Paul Mozer, an employee in the

28. *Id.* (stating that "In our view, the most probative factor that would indicate whether a person is responsible for the actions of another is whether that person has the power to control the other's conduct.").

29. *Id.*

30. *Id.* at *8.

31. *In re* Robert J. Check, Exchange Act Release No. 26,367, 42 S.E.C. Docket 760, at *4 (Dec. 16, 1988).

32. *In re* Michael E. Tennenbaum, Exchange Act Release No. 18,429, [1981–82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,092 (Jan. 19, 1982).

33. *Huff*, 48 S.E.C. Docket 767, at *7.

34. *Id.*

35. *In re* John H. Gutfreund, Exchange Act Release No. 31,554, 51 S.E.C. 93, 113 (Dec. 3, 1992).

36. *Id.* at 94–95.

firm's Government Trading department.[37] Paul Mozer ("Mozer") was the head of the Government Trading department and had submitted numerous false bids and traded in clients' accounts without authorization.[38] The Division claimed that the four individuals oversaw Mozer in a supervisory capacity and therefore were required to reasonably ensure that Mozer complied with the securities laws.[39]

Of particular note was the Commission's analysis of Feuerstein's supervisory role.[40] Donald Feuerstein was the firm's chief legal officer and oversaw the compliance department of Salomon Brothers.[41] In this role, he was not a line supervisor of Mozer.[42] Using the traditional definition, the Commission may not have been able to impose sanctions on Feuerstein. However, the Commission stated that the requisite analysis of whether an individual is a supervisor considers whether the person had the "responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue."[43] Thus, instead of remaining with the rigid line/non-line distinction, the Commission moved to the more flexible test that used control as the determining factor.[44]

Using this analysis, the Commission found that Feuerstein exercised the requisite control over Mozer and was his supervisor for purposes of § 15(b)(4).[45] Specifically, the opinion noted that Feuerstein was the firm's chief legal officer and controlled the

37. *Id.* at 95.

38. *Id.*

39. *Id.* at 108.

40. *Id.* at 112–14.

41. *Id.*

42. *Id.* at 112.

43. *Id.* at 113.

44. *Id.* (stating that 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.").

45. *Id.* at 113 (stating that Feuerstein shared the responsibility for Mozer because of Feuerstein's "role and influence within the firm . . . and the factual circumstances of this case. 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.").

compliance department.[46] The firm had placed Feuerstein in a position of power concerning Mozer and the firm relied on Feuerstein to recommend action.[47] Moreover, the Commission noted that Feuerstein had taken the lead role in other instances of alleged misconduct and had disciplined other violators.[48] Therefore, Feuerstein held a powerful position within the firm and could affect Mozer's conduct.[49]

This new analysis was affirmed in *Lysiak*, a case adjudicated by the Commission subsequent to the issuance of the settlement order in *Gutfreund*.[50] In *Lysiak*, the Commission stated that the *Gutfreund* criteria accurately reflected its opinion regarding the matter.[51] However, the Commission's clearly stated position in its settlement order and report of investigation in *Gutfreund* was challenged in a subsequent case.

In *In re George J. Kolar*, the respondent argued that the *Gutfreund* analysis was not applicable because *Gutfreund* was a settlement order, not a litigated case.[52] In making this ultra vires objection, the respondent argued that the Division is able to obtain greater sanctions and incorrectly expand its reach through settlement proceedings, while the actual powers granted to the SEC are not as broad.[53] The Division would not have been able to obtain such sanctions if not for the fact that the respondent had settled the case.[54] Therefore, the respondent argued, *Gutfreund*

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46. *Id.* at 112.

47. *Id.*

48. *Id.*

49. *Id.*

50. *In re* Conrad C. Lysiak, Exchange Act Release No. 33,245, 51 S.E.C. 841, 844 n.13 (Nov. 24, 1993), *aff'd*, 47 F.3d 1175 (9th Cir. 1995).

51. *Id.*

52. *In re* George J. Kolar, Initial Decisions Release No. 152, 70 S.E.C. Docket 2382, at *26 (Oct. 28, 1999).

53. *Id.*

54. *See* Roberta S. Karmel, *Creating Law at the Securities and Exchange Commission: The Lawyer As Prosecutor*, 61 LAW AND CONTEMP. PROBS. 33, 42 (1998) (criticizing "frequent use of settlements to announce Commission policy in borderline cases" and "use of leverage by the SEC to settle novel cases" in which it is unclear or doubtful that a court would uphold the Commission's legal theory); Norman S. Johnson & Ross A. Albert, *Déjà Vu All Over Again: The Securities and Exchange Commission Once More Attempts to Regulate the*

could not be used as precedent.[55]

In response to the respondent's claims, Administrative Law Judge ("ALJ") James T. Kelly noted that a settlement order by the SEC is usually accompanied by an opinion and finding of fact.[56] These orders are issued after an extensive review by the Commission and are as authoritative as opinions in contested cases.[57] The ALJ acknowledged that the order issued in *Gutfreund* was accompanied by an investigatory report, which lessened its authority.[58] However, ALJ Kelly noted that the *Gutfreund* decision, along with the subsequent use of the new standard in *Lysiak*, was sufficient to form a basis to use the new analysis of supervision.[59] Having settled this question, ALJ Kelly found that Mr. Kolar was the violator's supervisor and could affect the violator's actions.[60] ALJ Kelly further found that Mr. Kolar had failed to reasonably supervise Mr. Turner, the violator, by not investigating red flags and allegations of impropriety.[61] Therefore, Mr. Kolar was liable for the breach of his duty to supervise.[62]

In an administrative action concerning Louis R. Trujillo, the SEC held that the standard for determining whether a compliance officer was deficient in his duties is "reasonable supervision under the attendant circumstances."[63] Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") employed Louis R. Trujillo ("Trujillo") as a supervisor in its San Francisco office.[64] His

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Accounting Profession Through Rule 102(e) of Its Rules of Practice, 1999 UTAH L. REV. 553, 579 (1999).

55. *In re* George J. Kolar, Initial Decisions Release No. 152, 70 S.E.C. Docket 2382, at *26 (Oct. 28, 1999).

56. *Id.*

57. *Id.* (citing *In re* Carl L. Shipley, Investment Advisors Act Release No. 419, 45 S.E.C. 589, 591–92 n.6 (June 21, 1974)).

58. *Id.*

59. *Id.*

60. *Kolar*, 70 S.E.C. Docket 2382, at *28 (stating that Mr. Kolar was considered a full supervisor despite his inability to unilaterally hire and fire an individual).

61. *Id.* at *29.

62. *Id.* at *32–*34 (imposing a six month suspension on Mr. Kolar).

63. *In re* Louis R. Trujillo, Exchange Act Release No. 26,635, 1989 SEC LEXIS 480, *10 (Mar. 16, 1989).

64. *Id.* at *1–*2.

position involved various compliance and administrative duties, including the review of client complaints and new accounts.[65] The Division of Enforcement commenced an administrative action against Trujillo, alleging that he had failed to supervise salesperson Victor G. Matl ("Matl"), who had been found guilty of violating the antifraud provision of the 1934 Act.[66]

The Division asserted that Trujillo had failed to adequately supervise Matl, as required under §§ 15(b)(4)(E) and 15(b)(6) of Exchange Act.[67] In reviewing the complaint, the Commission analyzed Trujillo's actions, or, more accurately, inaction, "under all the circumstances."[68] The Commission considered the alleged violations of Matl, the structure of the office, and the power invested in Trujillo.[69] The Commission restricted its investigation to the information and circumstances available to Trujillo at the time of the violation.[70] Information and circumstances viewed in hindsight must not affect the analysis.[71]

In finding Trujillo not guilty of failing to supervise Matl, the Commission emphasized Trujillo's lack of disciplinary power.[72] Trujillo was an administrative manager in Merrill Lynch's San Francisco office and directly supervised Matl.[73] However, Trujillo reported to a supervisor himself.[74] Trujillo was not given extensive power to regulate the actions of his subordinates.[75] Instead, he was merely the "'eyes and ears'" of the branch manger.[76] His lack of power to correct any violations or improper behavior ultimately saved him from an administrative sanction.[77] The Commission, in looking at all attendant circumstances, realized that Trujillo was

65. *Id.* at *3.
66. *Id.*
67. *Id.* at *9.
68. *Id.* at *10.
69. *Id.*
70. *Id.*
71. *In re* Dean Witter Reynolds Inc., Initial Decisions Release No. 179, 74 S.E.C. Docket 522, at *49 (Jan. 22, 2001).
72. *Trujillo*, 1989 SEC LEXIS 480, at *9.
73. *Id.*
74. *Id.* at *11 (describing Trujillo's functions as "largely advisory").
75. *Id.*
76. *Id.* at *4.
77. *See id.*

constrained by his position and did not act unreasonably.[78]

Thus, determination of supervisory status is fact intensive.[79] The inquiry considers whether the alleged supervisor could control the actions of the subordinate.[80] Although an individual may not have been granted supervisory duties in the past, the circumstances of the current situation might lead to a finding that the individual was indeed a supervisor of the violator.[81] The determination of whether an individual is a supervisor in the current instance rests on the particularities of the relationship existing at that point.

The establishment of the compliance director as a supervisor allows the Division to proceed in its case.[82] The SEC has set forth three additional elements that the Division of Enforcement must prove to be successful in an action against a compliance officer for failure to supervise.[83] The Division must prove (1) the underlying securities laws violations, (2) the affiliation of the violator with the compliance officer and broker-dealer firm, and (3) a failure to reasonably supervise the violator by the compliance officer.[84] The last prong tends to evoke the most controversy[85] and will be addressed in detail in the next section.

B. Reasonable Supervision and the Requirements of Qualifying for

78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.*
82. *See* 15 U.S.C. § 78o (1990).
83. *In re* Dean Witter Reynolds Inc., Initial Decisions Release No. 179, 74 S.E.C. Docket 522, at *38 (Jan. 22, 2001) (citing Philadelphia Investors, Ltd., Initial Decisions Release No. 123, 66 S.E.C. Docket 2645, 2657 (Mar. 20, 1998)).
84. *See Dean Witter*, 74 S.E.C. Docket 522, at *38. The second and third elements of the test elaborated by the SEC were not disputed in the Dean Witter action. *Id.* After analyzing the first and fourth elements, ALJ Mahony found that the supervisory structure established by Dean Witter was sufficient. *Id.* at *54. Further, the ALJ reaffirmed the warning set forth by Commissioner Unger in James Harvey Thornton, Exchange Act Release No. 41,007, 69 S.E.C. Docket 49, 58 (Feb. 1, 1999). *Id.* In his concurring opinion, Commissioner Unger stated that the supervision must be assessed with the information available at the time of the violations and not with information gleamed through hindsight. *Thornton*, 69 S.E.C. Docket at 58.
85. *Dean Witter*, 74 S.E.C. Docket 522, at *38.

the Safe Harbor

The violation of securities laws by employees may result in liability for the supervisor.[86] However, § 15(b)(4) provides the firm and the compliance director with a safe harbor.[87] If the firm or brokerage house can prove that:

> (1) there were in place "procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect" the securities violations in question, and
>
> (2) the person responsible for administering such procedures and system "reasonably discharged [his] duties and obligations . . . without reasonable cause to believe that such procedures and system were not being complied with . . ."[88]

then liability does not extend to the firm or the supervisor.[89] Thus, formation of a supervisory system reasonably believed to ensure compliance with the securities laws is of utmost importance.

The securities laws themselves are not particularly instructive on the type of supervisory compliance system sufficient to comply with the safe-harbor provision. The SEC, however, has analyzed many systems in its administrative adjudication of claims brought by the SEC's Division of Enforcement.[90] Through these administrative proceedings, the SEC has elaborated on the required supervisory systems and the standards that are applied in evaluating these systems.[91]

When analyzing failure-to-supervise cases, the Commission tailors its investigation to whether the supervisory system in place at the brokerage house was sufficient to reasonably prevent the violations committed by the subordinates.[92] The Commission does

86. *Id.*

87. *Id.*

88. *Id.* at *42 (quoting Exchange Act § 15(b)(4)(E), codified at 15 U.S.C. § 78o(b)(4)(E) (1990)).

89. *Id.*

90. *See supra* Part I.A.

91. *See supra* Part I.A.

92. *In re* Albert Vincent O'Neal, Exchange Act Release No. 34,116, 56 S.E.C. Docket 2093, at *4 (May 26, 1994).

not look at the ability of the supervisory structure to prevent all securities violations.[93] Instead, the reasonableness and efficacy of the supervisory structure must be analyzed in light of the particular violations at issue.[94]

The Commission used this approach in *In re Albert Vincent O'Neal* to bar Albert Vincent O'Neal ("O'Neal") from associating with any broker or dealer for failing to supervise adequately four sales representatives.[95] O'Neal was a branch manager of the Dean Witter Reynolds, Inc. ("Dean Witter") office in Fort Worth, Texas.[96] He was entrusted to supervise sales representatives in the office and ensure their compliance with the securities laws and Dean Witter policy.[97] In fact, he was considered the "front-line compliance officer" of the Fort Worth office.[98] However, four of his subordinates had violated the securities laws while managing customers' accounts.[99] The representatives had falsified options agreement forms, engaged in unsuitable trading, churned the customers' accounts, traded in unapproved options, and materially misrepresented the safety of the trades to customers.[100]

After analyzing O'Neal's actions regarding the four representatives and the violations committed by them, the Commission found that O'Neal was grossly deficient in his supervisory and compliance duties.[101] In the Commission's opinion, O'Neal failed to see obvious suitability issues and disregarded blatant violations by the representatives of Dean Witter policy.[102] O'Neal also failed to adequately review trading activity on customers' accounts even after being warned of excessive trading activity by lower level employees.[103] In all, the structure employed

93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at *1.
97. *Id.* at *3.
98. *Id.* at *3.
99. *Id.* at *1–*6.
100. *Id.*
101. *Id.* at *4–*6 (stating that O'Neal failed to contact customers to inquire about a broker's alleged wrongdoing and refused to investigate red flags).
102. *Id.*
103. *Id.* at *3.

by O'Neal at the branch office was not capable of preventing the violations.[104] O'Neal did not review accounts, respond to requests for additional information from the main office or delegate supervisory responsibilities to others.[105] The Commission, finding against O'Neal, barred him from the industry for one year and from a proprietary or supervisory position for life.[106]

In *O'Neal*, the Commission used a subjective, fact-intensive test to analyze the firm's supervisory structure. In 1992, the Commission put forth a more concrete rule, stating that supervisory systems relying solely on the branch manager are not sufficient.[107] This pronouncement came after an analysis of the management structure created by Donald Sheldon.[108] Donald Sheldon ("Sheldon") was the president of a registered broker-dealer firm and an associated government securities firm.[109] The Division of Enforcement brought a proceeding against him because Sheldon had not adequately delegated the supervisory duties to subordinates and, therefore, retained the obligation to ensure that the employees were complying with the securities laws.[110]

The Commission found that Sheldon's employees were guilty of selling inappropriate securities to individuals, excessively marking-up securities, and misappropriating investors' money.[111] In addition, the SEC held that Sheldon had failed to supervise his employees and had not established a supervisory structure sufficient to remove his liability.[112] Specifically, the Commission found that Sheldon unreasonably relied on the branch managers

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104. *Id.*
105. *Id.* at *4–*6.
106. *Id.* at *6.
107. *In re* Donald T. Sheldon, Exchange Act Release No. 31,475, 1992 SEC LEXIS 3052 (Nov. 18, 1992).
108. *Id.*
109. *Id.* at *4.
110. *Id.* at *5 (stating that Sheldon increasingly ignored the violations that were occurring within his firm).
111. *Id.* at *22–*30.
112. *Id.* (finding that Sheldon delegated supervisory duties to managers who were unqualified and did not institute internal controls to guarantee that the managers were fulfilling their responsibilities).

while failing to ensure that they were carrying out their supervisory duties.[113] Furthermore, he failed to establish a training program to ensure compliance.[114]

Even after the establishment of a management structure, an individual in a supervisory position must not "be a mere bystander to the events that occurred."[115] The supervisor is obligated to take steps to ensure that the firm and the compliance department give appropriate attention to any alleged misconduct and investigate accordingly.[116] The SEC has stated that the president and compliance director of a broker-dealer firm are ultimately responsible for ensuring that the firm's employees comply with the relevant regulations.[117] The supervisor can reduce his liability if he reasonably delegates these duties to lower-level employees and if he "neither knows or has reason to know that such person's performance is deficient."[118] Therefore, a supervisory structure must not only reasonably detect and prevent violations but also be strengthened by attentive supervisors.

II. SANCTIONS ASSESSED IN AN ADMINISTRATIVE PROCEEDING

After finding a failure to supervise, the Commission or ALJ must decide on the appropriate sanction.[119] A wide variety of sanctions are available to the SEC, including, among others, cease-and-desist orders, suspensions, and bars.[120] With the large number of sanctions available, deciding which sanction to impose is often difficult. The Fifth Circuit has stated that the public interest must

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113. *Id.*

114. *Id.* at *51. The Commission reiterated its warning that mere reliance on branch mangers to ensure compliance, without the establishment of a supervisory or compliance system, is insufficient. *Id.* Ultimately, liability will remain with the president of the broker-dealer firm, making the president a ripe target for an administrative proceeding and applicable sanctions. *Id.* at *50.

115. *In re* John H. Gutfreund, Exchange Act Release No. 31,554, 51 S.E.C. 93, 113 (Dec. 3, 1992).

116. *See id.*

117. *See Sheldon*, 1992 SEC LEXIS 3052, at *50.

118. *Id.*

119. *See* Steadman v. Sec. and Exch. Comm'n, 603 F.2d 1126 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981).

120. *See* 15 U.S.C. § 77h-1 (1990); 15 U.S.C. §§ 78u-3, 78o (1990).

dictate the severity of the sanction.[121] The court also set forth factors that the Commission or ALJ should use in deciding what sanctions are in the public interest.[122] The factors are: (1) the egregiousness of the defendant's actions; (2) the likelihood that the defendant's occupation will present opportunities for future violations; and (3) the degree of scienter involved.[123]

The Remedies Act of 1990 added Section 8A to the Securities Act of 1933 and Section 21C to the 1934 Act, which granted the power to issue cease-and-desist orders to the SEC.[124] A cease-and-desist order ("order") is the administrative equivalent of an injunction.[125] The Commission can order an individual to cease and desist from violating the securities laws after finding that the person violated, or caused a violation of, the securities regulations.[126] A compliance director's breach of his duty to supervise is sufficient for the SEC to issue an order.[127]

Furthermore, the Commission recently settled a long-standing controversy concerning the proof required to impose an order.[128] In *In re KPMG Peat Marwick LLP*, the Commission held that a propensity to commit a future violation is necessary to issue an order, but simultaneously held that a past violation is normally sufficient to establish this element.[129] Thus, the mere finding of a past violation can lead to the imposition of an order.[130] The SEC may issue an order irrespective of whether there exists additional evidence that the director is likely to violate the securities laws in the future.[131] This increase in the power of the Commission extends the potential sanction of a cease-and-desist order to a

121. *Steadman*, 603 F.2d 1126.
122. *Id.* at 1140.
123. *Id.*
124. *See* 15 U.S.C. § 77h-1 (1990); 15 U.S.C. § 78u-3 (1990).
125. *See* KIRKPATRICK & LOCKHART, THE SECURITIES ENFORCEMENT MANUAL, TACTICS AND STRATEGIES 137 (Richard M. Phillips ed., American Bar Assoc. 1997) [hereinafter KIRKPATRICK & LOCKHART].
126. *See* 15 U.S.C. § 77h-1 (1990); 15 U.S.C. § 78u-3 (1990).
127. *See* 15 U.S.C. § 77h-1 (1990); 15 U.S.C. § 78u-3 (1990).
128. *In re* KPMG Peat Marwick LLP, Exchange Act Release No. 43,862, 2001 WL 47245 (Jan. 19, 2001).
129. *Id.*
130. *See id.*
131. *Id.*

compliance officer who has only once violated the securities laws by failing to supervise his employees adequately.[132]

A compliance director can also be suspended or barred from the industry.[133] A bar is usually reserved for more serious, egregious violations, while suspensions are used in cases that are more benign.[134] In fact, a bar may be the most severe administrative sanction available to the SEC.[135] The institution of a bar or suspension against a broker/dealer or associated entity has severe consequences, often forcing the individual to completely withdraw from the securities industry.[136] In many instances, the SEC feels this severe sanction is justified by the circumstances under investigation.[137] Most of the aforementioned cases resulted in the imposition of a bar or lengthy suspension after finding the compliance director or broker guilty of failing to supervise.[138]

III. SPECIAL CONSIDERATIONS FOR ATTORNEYS AND ACCOUNTANTS SERVING AS COMPLIANCE PERSONNEL

Despite the powerful nature of the above sanctions, attorneys and accountants who serve as compliance directors face additional sanctions. The placement of these professionals in compliance directorships raises particular concerns that may not arise for other compliance personnel. Attorneys and accountants are bound by special ethical and professional duties.[139] Violation of these

132. *Id.*
133. *See* 15 U.S.C. § 78o(b)(4) (1994).
134. *See* KIRKPATRICK & LOCKHART, *supra* note 125, at 158.
135. *See id.*
136. *See id.*
137. *See In re* Donald T. Sheldon, Exchange Act Release No. 31,475, 1992 SEC LEXIS 3052 (Nov. 18, 1992); *In re* Albert Vincent O'Neal, Exchange Act Release No. 34,116, 56 S.E.C. Docket 2093, at *6 (May 26, 1994); *In re* Gary W. Chambers, Exchange Act Release No. 27,963, 46 S.E.C. Docket 183 (Apr. 30, 1990).
138. *See Sheldon*, 1992 SEC LEXIS 3052 (imposing an unqualified bar on Donald Sheldon); *O'Neal*, 56 S.E.C. Docket 2093, at *6 (finding a one year suspension with a lifetime bar from supervisory positions necessary to the public interest); *Chambers*, 46 S.E.C. Docket 183 (barring Gary Chambers for six months).
139. *See infra* Part III.B.

professional standards can lead to sanctions by the professional board and the SEC. Furthermore, as a collateral consequence of wrongdoing, the SEC can bar attorneys and accountants from practicing before it in any capacity.[140]

A. The Commission's Additional Powers Over Professionals

Rule 102(e) of the Commission's Rules of Practice provides that the Commission may suspend, limit, or bar "an attorney, accountant, engineer or other professional or expert" from practicing before it in "any way."[141] The rule defines "practice" as "transacting any business before the Commission" or participating in the drafting or filing of any statement, notification or application.[142] A Rule 102(e) bar restricts the ability of a professional from participating in almost any aspect of a broker-dealer's business.[143]

Despite the general unwillingness of the Commission to impose Rule 102(e) sanctions absent a willful violation,[144] the Commission has taken a rather expansive view of the application of this rule.[145] In a recent amendment to Rule 102(e), the Commission lessened the gravity of conduct necessary to invoke sanctions under the rule.[146] This amendment provided that the mere negligence of an attorney would be sufficient to impose sanctions in some circumstances.[147] Thus, a finding of willful conduct may not be necessary to impose Rule 102(e) sanctions. For accountants, one instance of negligence, if highly unreasonable, or repeated instances of unreasonable conduct could

140. Rule 102(e), 17 C.F.R. § 201.102(e) (2001).
141. *Id.*
142. *Id.*
143. *Id.*
144. The Commission's actions generally are based on the misconduct or willful violations of the federal securities laws by the professional. *See* KIRKPATRICK & LOCKHART, *supra* note 125, at 173.
145. *See id.*
146. *See* 17 C.F.R. § 201.102(e)(iv)(B).
147. THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 7.15[2] (4th ed. 2002).

form the basis of sanctionable conduct under Rule 102(e).[148]

A finding of the compliance officer's failure to supervise, with or without scienter, could satisfy the requirement under Rule 102(e).[149] The attorney or accountant would be barred from practicing before the Commission, not just as a compliance officer, but in any role.[150] Furthermore, despite the SEC's reluctance to bring a proceeding under Rule 102(e) absent a finding that the professional has violated the securities laws,[151] the SEC has consistently indicated that it has the authority to adopt a general negligence standard.[152] Thus, compliance director conduct that is not sufficiently egregious to violate the securities laws may still result in a Rule 102(e) ban.

B. Schism Between Ethical Duties and Representative Responsibilities

Ethical considerations also impose constraints on the actions of professionals, especially attorneys, and the breach of these considerations can lead to sanctions.[153] These ethical considerations are particularly problematic in the realm of compliance, where the attorney may have conflicting duties.[154] Violation of the ethical considerations can lead to sanctions by the professional board and the Commission due to the establishment of an extremely low threshold by the Commission under Rule 102(e).[155]

Various states have promulgated codes of professional conduct, including New York,[156] based on the ABA Model Rules of

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148. *Id.*

149. The essence of a failure to supervise claim against a compliance director is the compliance director's negligent performance of his duties. *See* 15 U.S.C. § 78o (1990). Therefore, the negligent nature of the compliance director's inaction may be sufficient to impose a sanction under § 102(e).

150. *See supra* notes 140–43 and accompanying text.

151. *See* Michael J. Connell, *SEC Sanctions of Securities Counsel*, 1286 PLI/CORP 685 (2002).

152. *See id.* at 713. *But see* Johnson & Albert, *supra* note 54.

153. *See* N.Y. COMP. CODES R. & REGS. tit 22, §§ 1200–1210.1 (2001).

154. *See infra* notes 177–83 and accompanying text.

155. *See* Johnson & Albert, *supra* note 54, at 579.

156. *See* N.Y. COMP. CODES R. & REGS. tit 22, §§ 1200–1210.1 (2001)

Professional Conduct ("Model Rules").[157] The American Bar Association published the Model Rules to set forth principles of ethical and professional conduct.[158] Deviation from these rules by an attorney can lead to sanctions from the state, including suspension and disbarment.[159] These rules, however, do not only affect the attorney in the state of enactment but can also affect him before the Commission under Rule 102(e).[160]

Rule 102(e) allows the suspension or bar of an attorney from practicing before the Commission.[161] An Associate Director of Enforcement for the SEC has remarked that professional misconduct, presumably arising from violations of the professional code, can invoke Rule 102(e).[162] The Commission has reaffirmed that a lawyer's failure to act professionally can lead to the suspension of activities before the Commission.[163]

Ordinarily, such a mandate of professionalism is positive. It would reaffirm the need for attorneys to adhere to the duties of professionalism in all respects,[164] both before the Commission and in its activities with clients. However, compliance directors and officers serve a particular function within a brokerage firm.[165] The compliance director must investigate the firm's supervisory systems and the firm's employees and create reports and analyses regarding the adequacy of the systems.[166] The peculiarities of this position

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157. MODEL RULES OF PROF'L CONDUCT (2001).

158. *See* THOMAS D. MORGAN & RONALD D. ROTUNDA, PROFESSIONAL RESPONSIBILITY (Foundation Press 7th ed. 2000). References to codes of professional conduct will cite to the Model Rules and the New York Code of Professional Responsibility.

159. *See id.*

160. *See infra* notes 161-63.

161. *See* 17 C.F.R. § 201.102(e) (2001).

162. *See* W. Loeber Landau, *Legal Opinions Rendered in Securities Transactions*, 9 INST. SEC. REG. 3, 37 (1977) (citing the remarks of Theodore Sonde).

163. *See In re* William R. Carter, Exchange Act Release No. 17,597, 47 S.E.C. 471 (Feb. 28, 1981).

164. Jessica Taylor O'Mary, *When Business Decisions of a Client Create a Current Client Conflict of Interest: Implications in a Complex Ethical Landscape*, 43 B.C. L. REV. 1203 (2002).

165. *See infra* notes 177–83 and accompanying text.

166. *See infra* notes 177–83 and accompanying text.

may sometimes be at odds with the rules of professionalism and other duties imposed on compliance directors by the SEC.[167]

Primary among an attorney's ethical duties is the duty of confidentiality as enumerated in Rule 1.6 of the Model Rules.[168] Model Rule 1.6 requires an attorney to maintain the confidentiality of information obtained in the representation of the client.[169] Exceptions to this rule are very few.[170] An attorney may disclose confidential information if the client impliedly authorizes the attorney to reveal the information.[171] In addition, the attorney may reveal information to prevent the client from committing a criminal act that the attorney "believes is likely to result in imminent death or substantial bodily harm."[172] However, a compliance director who is an attorney is unlikely to encounter instances of bodily harm in the corporate context; most harm will be financial, which is not a covered exception to the duty of confidentiality.[173]

The discovery of illegal conduct may require an attorney who is employed as a compliance director to notify outside individuals, sometimes to the detriment of the client.[174] Model Rule 1.13 deals

167. *See infra* notes 177–83 and accompanying text.

168. *See* MODEL RULES OF PROF'L CONDUCT 1.6 (2001); *see also* N.Y. COMP. CODES R. & REGS. tit 22, § 1200.19 (2001) (containing substantially similar requirements as Model Rule 1.6).

169. *See* MODEL RULES OF PROF'L CONDUCT 1.6 (2001).

170. *See id.*

171. *See id.*

172. *Id.*

173. *See* Jenny B. Davis, *The Enron Factor: Experts Say the Energy Giant's Collapse Could Trigger Changes in the Law That Make It Easier to Snare Professionals*, 88 A.B.A. J. 40, 45 (2002).

174. *See* Martha Neil, *SEC Posts Attorney Disclosure Rules*, A.B.A. J. E REPORT (Nov. 8, 2002). Pursuant to the recently passed Sarbanes-Oxley Act, the SEC has drafted attorney conduct rules. *Id.* The draft rules would require corporate attorneys to report "up the ladder" and disaffirm any submission to the SEC that the lawyer believes is tainted. *Id.* Anastasia D. Kelly, Senior Vice President and General Counsel of Sears, Roebuck & Co., stated that this could potentially lead to a "'very difficult and strained relationship.'" *Id.* A proposed rule requiring reporting to the SEC if the corporate directors are unwilling to address the infractions has been tabled for now. Jenny B. Davis, *SEC Releases Final Attorney Conduct Rule, But Extends Comment Period on Noisy Withdrawal*, A.B.A. J. E REPORT (Jan. 31, 2003).

with attorneys who are employed by an organization.[175] The rule addresses instances where an employee of an organization, in this instance, a trader or associate of the brokerage firm, "intends to act" in a manner that violates a law and where the violation would be imputed to the organization.[176] If this act or failure to act is likely to result in substantial harm to the organization, the lawyer is dutybound to respond.[177] The rule requires the attorney to consider the seriousness of the violation and the responsibility of the organization.[178] Then, depending on the seriousness of the matter and the receptiveness of the organization's hierarchy, the attorney must appeal to the executives of the company or resign if the executives insist on illegal action or inaction.[179]

Despite the attempt by compliance directors to abide by their professional responsibilities and advise their client of the appropriate actions,[180] the organization may not be receptive to the changes. The executives may feel differently than the attorney or selectively ignore the transgressions of a valuable employee.[181] The need to have the executives act is especially important where the attorney has few powers over employees.[182] In such a situation, where the executives refuse to act, the compliance director may be forced to resign from the organization or report the situation to the

175. *See* MODEL RULES OF PROF'L CONDUCT 1.13 (2001).

176. *Id.*

177. *See id.*

178. *See id.*

179. *See id.*

180. The Model Rules also require competent and diligent representation. *See* MODEL RULES OF PROF'L CONDUCT 1.1 and 1.3 (2001); *see also* 22 N.Y. COMP. CODES R. & REGS. tit 22, 1200.31 (2001) (requiring an attorney to zealously represent a client). For a compliance officer who is employed by a brokerage firm, these professional mandates would likely translate into a duty to investigate and discover failures within the supervisory structure and employees who have violated the securities laws. Through fulfilling their duty to investigate diligently, attorneys may place themselves at odds with other professional rules and duties of their position within the firm. *See supra* note 139.

181. *See In re* Albert Vincent O'Neal, Exchange Act Release No. 34,116, 56 S.E.C. Docket 2093, *6 (May 26, 1994) (noting that O'Neal overlooked the transgressions of Mr. Johnson because he was a "big producer").

182. *See In re* William R. Carter, Exchange Act Release No. 17,597, 47 S.E.C. 471 (Feb. 28, 1981).

Securities and Exchange Commission.[183]

This schism between the requirement placed on attorneys by the SEC and those placed on attorneys by the Model Rules is disconcerting. An attorney who acts as a compliance director is being pulled in two directions at once. Moreover, reports generated by the compliance director on how to prevent future wrongdoing may be discoverable in litigation.[184] In *Spectrum Systems*, the New York Court of Appeals noted that the attorney-client privilege does not apply to a report focusing on business recommendations.[185] It has been argued that a report on how to prevent future violations is a business consideration and not subject to the privilege.[186]

Furthermore, even where the Model Rules are silent, morality may cause the attorney to report the violations to protect investors, who will likely be harmed by the violations of the securities laws by employees of the firm. The compliance director's conscience may compel him to warn investors. However, the Commission may view such acts as unprofessional because the compliance director may have breached the duty of confidentiality by disclosing matters to the public. Such a violation may lead to sanctions for the compliance director under Rule 102(e). The compliance director may effectively be barred from practicing before the Commission because of the compliance director's moral code.

The often-conflicting duties or desires of the compliance director make compliance work difficult beyond the mere mandates of the securities laws. The compliance director's duties to the firm may sometimes be at odds with the attorney or accountant professional codes. Moreover, a professional's sense of righteousness may lead the professional to disavow the formal codes and breach the duty of confidentiality to the firm to inform

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183. *See id.* The SEC has indicated that an attorney's failure to inform the SEC and prevent a securities fraud puts the attorney in breach of his or her professional duty. *Id*; *see also In re* John H. Gutfreund, Exchange Act Release No. 31,554, 51 S.E.C. 93, 114 (Dec. 3, 1992) (noting that disclosure to regulatory authorities may be required).

184. *See* Spectrum Systems Int'l Corp. v. Chemical Bank, 78 N.Y.2d 371 (1991).

185. *Id.* at 379–80.

186. *See* HAZEN, *supra* note 147, § 7.15.

the public. In sum, the conflicting allegiances of the compliance officer could have severe repercussions, in both the professional and moral worlds.

IV. DISTILLING AN ADEQUATE COMPLIANCE SYSTEM TO AVOID COMPLIANCE DIRECTOR AND CORPORATE LIABILITY

As seen above, there is tremendous liability associated with a failure to supervise claim.[187] The Commission can bar an individual or a firm from the industry and prohibit an individual from practicing before the Commission[188]. As stated by Paul F. Royce, director of the SEC Division of Investment Management, "the price of compliance is minimal compared to the potential costs of non-compliance."[189] The seriousness of these consequences has put a great deal of pressure on firms and compliance directors to create sufficient supervisory structures and procedures. This Part attempts to create an adequate supervisory model to reduce the liability of the firm and its compliance director.

Unfortunately, the adequacy of a supervisory structure is subjective.[190] The SEC focuses on particular violations of subordinates and thereafter determines whether the supervisory structure was reasonably designed to detect those violations.[191] These subjective considerations of the SEC seem to effectively cause any model to lack absolute applicability. Therefore, there can be no formulaic pronouncement of sufficient procedural or structural integrity.

However, a model helps focus the compliance director's attention when creating a compliance structure and addressing more commonplace areas of liability. It can illuminate procedures and structures that can be manipulated by the firm to satisfy the Commission's requirements listed above. In general, there exist

187. *See supra* Part II.

188. *See supra* Part I.

189. Paul F. Roye, Remarks Before the Investment Counsel Association of America (Apr. 23, 1999), *in* Speech by SEC Staff: Meeting the Compliance Challenge, *available at* http://www.sec.gov/news/speeches/spch271.htm (last visited Dec. 12, 2002).

190. *See supra* Part I.

191. *See supra* Part I.

three areas that an adequate supervisory system must address: 1) placement of responsibility for compliance; 2) implementation of policies and procedures; and 3) informing and auditing of employees. These areas and the appropriate considerations are discussed in the following sections.

A. *Structural Considerations for a Compliance Model*

A firm must implement an infrastructure regarding compliance.[192] The establishment of a compliance department and the ascension of an individual to the head of the department help satisfy the first area of consideration.[193] The compliance director generally assumes much of the responsibility for ensuring the employees' compliance with the securities regulations.[194] However, the ability to investigate a problematic situation and correct it bears greatly on the power, responsibility, and liability of the compliance director.[195] A compliance director in name only does not prevent liability from attaching to the executives of the company.[196] A compliance director and supervisor must also

192. Lori Richards, Speech by SEC Staff: Remarks at "Meet the Regulators" (Mar. 21, 2002), *available at* http://www.sec.gov/news/speech/spch545.htm (last visited Jan. 30, 2003).

193. *Id.*

194. *See* H. Lowell Brown, *The Corporate Director's Liability in the Post Caremark Era*, 26 DEL. J. CORP. L. 1, 137, 144 (2001).

195. *See In re* Louis R. Trujillo, Exchange Act Release No. 26,635, 1989 SEC LEXIS 480, at *4 (Mar. 16, 1989) (stating that Trujillo did not have adequate power to affect the violator and, therefore, was not liable for failing to supervise).

196. It seems that a self-interested compliance director would want a diminished ability to control the actions of others to avoid liability. The managers, on the other hand, would want a powerful compliance director to serve as a lightening rod for the firm. Despite this seeming incongruity, granting the compliance director power benefits both management and the compliance director. A powerful compliance director would have the power to investigate and isolate violations, thereby preventing a proceeding. Moreover, the evaluation of the compliance director's ability to affect his subordinated comes only after the SEC has filed an enforcement action. Therefore, the mere avoidance of placing power in the compliance director does not prevent investigations and enforcement actions by the SEC. *See Trujillo*, 1989 SEC LEXIS 480 (investigating Trujillo before the Commission decided that he lacked adequate power to be viewed as a supervisor).

adequately investigate "red flags" or allegations of irregularity.[197] Supervisors cannot satisfy their duty to supervise by merely relying on the statements of employees.[198]

Once power has been instilled in the compliance director, the rest of the hierarchical structure must be in place. As mentioned in *Sheldon*, mere reliance on branch managers is insufficient.[199] This insufficiency is particularly acute when broker-dealers rely on a network of small, remote offices.[200] Managers can be useful resources, closer to the action than the often further-removed compliance director. However, a more structured hierarchy is necessary to establish a sufficient infrastructure. A regional director can examine the workings of the individual offices and the performance of the managers.[201] Compliance personnel, including the compliance director, can analyze rumblings of wrongdoing. The line of examination and review must extend through the compliance director to the heights of the broker-dealer firm. The principal is ultimately responsible for the compliance of his employees.[202]

Thus, an effective supervisory system will often have multiple layers of employees and supervisors. However, the existence of multiple supervisors requires the delineation of clear lines of responsibility and duty.[203] The structure must clearly define the

197. *See In re* John H. Gutfreund, Exchange Act Release No. 31,554, 51 S.E.C. 93, 108 (Dec. 3, 1992) (stating that supervisors "cannot discharge their supervisory obligations simply by relying on the unverified representations of employees").

198. *Id.*

199. *See In re* Donald T. Sheldon, Exchange Act Release No. 31,475, 1992 SEC LEXIS 3052 (Nov. 18, 1992).

200. *See* Richard D. Marshall, *Trends in SEC Enforcement and Inspections of Investment Advisers*, ALI-ABA COURSE OF STUDY MATERIALS (2001).

201. Lori Richards, Speech by SEC Staff: Remarks at "Meet the Regulators" (Mar. 21, 2002), *available at* http://www.sec.gov/news/speech/spch545.htm (last visited Jan. 30, 2003).

202. *See Gutfreund*, 51 S.E.C. at 111 (noting that the chief executive officer has the "ultimate affirmative responsibility . . . to ensure that steps are taken to prevent future violations of the securities laws and to determine the scope of wrongdoing"); *see also Sheldon*, 1992 SEC LEXIS 3052, at *50.

203. *See* HAZEN, *supra* note 147, § 14.26[6][C].

roles of each supervisor in the investigation of wrongdoing.[204] Additionally, a lower-level supervisor must continue to monitor the situation and address the problem until the supervisor's superior takes control.[205]

B. The Establishment of Policies and Procedures

Compliance programs cannot merely rely on the establishment of a hierarchical structure. The firm must also create seminars and written compliance directives.[206] The establishment of written policies and procedures help add legitimacy to a compliance system in the eyes of others.[207] The use of procedures gives the compliance system a sense of congruency and completeness that would not otherwise exist.[208] Through the establishment of written procedures, the firm can clearly and unequivocally state its policy of compliance.[209]

In addition, the establishment of concrete procedures creates an atmosphere of compliance and access to information within the firm.[210] The employees can refer to these policies when they encounter questionable situations or witness others making ill-informed decisions. The policies should also inform the employees of the organizational aspects of the compliance structure. The employee will then know of the layers of compliance personnel, leaving the employee aware that the system is complete. The use of the structure by the middle management and supervisors helps reinforce the importance of compliance with the regulations.

204. *See Gutfreund*, 51 S.E.C. at 108 (stating that "if more than one supervisor is involved in considering the actions taken in response to misconduct, there must be a clear definition of the efforts taken and a clear assignment of those responsibilities to specific individuals within the firm.").

205. *See* HAZEN, *supra* note 147, § 14.26[6][C].

206. *See* Brown, *supra* note 194, at 119.

207. *Id.*

208. *See id.* at 132.

209. *See id.*

210. *See id.*

C. Informing and Auditing the Employees

Education programs should also be implemented. They show the dedication of a compliance director, and the firm as a whole, to complying with the securities laws.[211] To be effective, the programs must be regular and targeted toward all employees in decision-making positions. The programs should inform employees of the written internal policies and the relevant securities laws and regulations applying to both brokerage firms generally and to broker-dealers and their associates specifically. The maintenance of a hotline that employees and clients can use to confidentially discuss possible illegal conduct may illustrate a coherent structure to the SEC.

Moreover, the use of audits and investigations are an integral part of an effective compliance program.[212] After receiving information of illegal conduct, the compliance director or personnel must investigate the allegations and address the problems.[213] Reliance on the alleged violator's assertions that the actions complied with the securities laws is insufficient.[214] The supervisor must investigate whether the illegal conduct actually occurred, the extent of the violations, and the culpability of the employee.

Even in the absence of known or alleged violations, investigations and audits of client accounts and trades should be conducted.[215] They can help locate, and even prevent, violations of the securities laws.[216] These spontaneous investigations assist in the identification of problem areas and, therefore, the reduction of these by helping identify problem areas before violations occur.[217]

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211. *Id.*

212. *See* HAZEN, *supra* note 147, § 14.26[6][C].

213. *See supra* note 101 and accompanying text.

214. *See supra* note 101 and accompanying text.

215. *See* Lori Richards, Speech by SEC Staff: Remarks at "Meet the Regulators" (Mar. 21, 2002), *available at* http://www.sec.gov/news/speech/spch545.htm (last visited Jan. 30, 2003); Lawrence J. Zweifach, *Internal Corporate Investigations*, 509 PLI/LIT 431 (1994).

216. *See* Zweifach, *supra* note 215.

217. *See* Brown, *supra* note 207, at *128.

CONCLUSION

Congress and the Securities and Exchange Commission have imposed enormous duties on brokerage firms and compliance directors.[218] Arguably, these duties and regulations help protect clients who entrust their money to broker-dealers and the broker-dealer's associates. However, the Securities and Exchange Commission has not sufficiently elaborated on the means by which compliance directors can comply with their duties and avoid liability. Only a fragmentary approach can be distilled from the Commission's enforcement proceedings.

However, much can be learned from the accumulated proceedings. The compliance director must establish adequate internal procedures and policies to reasonably investigate, rectify, and prevent securities law violations.[219] An investigation by the SEC will revolve around the reasonableness of the structure, and the compliance director's role within that structure, in identifying and preventing the securities violation at issue.[220] The SEC is likely to constantly scrutinize the structure and the acts of the compliance director, especially in the current atmosphere of distrust.

The current attention from investors and the SEC makes it necessary for a brokerage firm and compliance director to analyze their current supervisory structure and system and make appropriate changes. However, this role becomes increasingly difficult by the inclusion of subjective considerations, such as the size of the firm and the amount of power given to the compliance director. There may also exist conflicting interests between the well-being of the firm and the clients. The ramifications of these conflicts of interest may become more acute if the compliance director is a professional. A firm, and its compliance director, must exercise care and attention to navigate through the various obstacles and exit unscathed.

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218. *See supra* Part I.

219. *See supra* Part I.

220. *See supra* Parts I.A–B.