



## Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act

### Division of Trading and Markets:

September 30, 2013

In responding to these Frequently Asked Questions ("FAQs"), the Division of Trading and Markets is providing guidance relating to liability that may arise under Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934 in connection with the role and duties of Chief Compliance Officers and other compliance and legal personnel at broker-dealers. Responses to these FAQs were prepared by and represent the views of the Division of Trading and Markets. They are not rules, regulations or statements of the Commission. The Commission has neither approved nor disapproved these interpretive answers.

The staff may update these questions and answers periodically. In each update, the questions added after publication of the last version will be marked with "MODIFIED" or "NEW."

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### Background

Broker-dealers may choose to structure their supervisory and compliance systems in different ways. No matter which particular structure is employed, compliance and legal personnel play a critical role in efforts by broker-dealers to comply with legal and regulatory requirements through the implementation of effective systems.

Liability for failure to supervise is a facts and circumstances determination. The purpose of these FAQs is to provide staff guidance to consider in assessing whether particular facts and circumstances result in potential supervisory liability for broker-dealers' compliance and legal personnel.<sup>1</sup> The Exchange Act does not presume that a broker-dealer's compliance or legal personnel are supervisors solely by virtue of their compliance or legal functions.<sup>2</sup> Rather, the question is whether compliance or legal personnel have supervisory authority over business units or other personnel outside the compliance and legal departments as could be the case, for example, if a chief executive or operating officer also is the firm's chief compliance officer. Supervisory authority also can be implicitly delegated to, or assumed by, compliance or legal personnel.

Section 15(b)(6) of the Exchange Act authorizes the Commission to institute proceedings against a natural person associated with a broker-dealer if someone under that person's supervision violates the provisions of the federal securities laws, the Commodity Exchange Act, the rules or

regulations under those statutes, or the rules of the Municipal Securities Rulemaking Board, and the supervisor failed reasonably to supervise that person with a view to preventing the particular violation. Most enforcement actions against individuals for failure to supervise have involved business line personnel. The Commission has brought failure to supervise actions against broker-dealer legal or compliance personnel only in limited circumstances in which these individuals have been delegated, or have assumed, supervisory responsibility for particular activities or situations, and therefore have "the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."<sup>3</sup>

The Commission has stated that ultimately the responsibility for a broker-dealer's compliance resides with its chief executive officer and senior management.<sup>4</sup> When Commission staff seeks to bring legal actions for failure to supervise, our focus is on the roles and responsibilities of the respective parties. As a general matter, the staff does not single out compliance or legal personnel. Rather we encourage compliance officers and other compliance and legal personnel to take strong and vigorous action regarding indications of misconduct.

## Responses to Frequently Asked Questions

### Question 1.

Is a chief compliance officer or any other compliance or legal personnel a supervisor of broker-dealer business personnel solely by virtue of the compliance or legal position?

#### Answer:

No. Compliance and legal personnel are not "supervisors" of business line personnel for purposes of Exchange Act Sections 15(b)(4) and 15(b)(6) solely because they occupy compliance or legal positions.<sup>5</sup> 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>6</sup>

### Question 2.

What does it mean to have the requisite degree of responsibility, ability or authority to affect the conduct of another employee?

#### Answer:

A person's actual responsibilities and authority, rather than, for example, his or her "line" or "non-line" status, determine whether he or she is a "supervisor" for purposes of Exchange Act Sections 15(b)(4) and 15(b)(6).<sup>7</sup> Among the questions to consider in this regard:

- Has the person clearly been given, or otherwise assumed, supervisory authority or responsibility for particular business activities or situations?
- Do the firm's policies and procedures, or other documents, identify the person as responsible for supervising, or for overseeing, one or more business persons or activities?
- Did the person have the power to affect another's conduct? Did the person, for example, have the ability to hire, reward or punish that person?<sup>8</sup>
- Did the person otherwise have authority and responsibility such that he or she could have prevented the violation from continuing, even if he

or she did not have the power to fire, demote or reduce the pay of the person in question?

- Did the person know that he or she was responsible for the actions of another, and that he or she could have taken effective action to fulfill that responsibility?
- Should the person nonetheless reasonably have known in light of all the facts and circumstances that he or she had the authority or responsibility within the administrative structure to exercise control to prevent the underlying violation?

### **Question 3.**

Can compliance and legal personnel provide advice and counsel to business line personnel without being considered supervisors of the business line personnel for purposes of the Exchange Act?

#### **Answer:**

Yes. Compliance and legal personnel play a critical role in efforts by broker-dealers to develop and implement an effective compliance system throughout their organizations, including by providing advice and counsel to business line personnel. Compliance and legal personnel do not become "supervisors" solely because they have provided advice or counsel concerning compliance or legal issues to business line personnel, or assisted in the remediation of an issue. If their responsibilities or authorities extend beyond compliance and legal functions such that they have the requisite degree of responsibility, ability or authority to affect the conduct of business line personnel, additional inquiry may be necessary to determine if they could be considered supervisors of the business line personnel.

### **Question 4.**

Can a broker-dealer establish and implement a robust compliance program without its compliance and legal personnel being considered to be supervisors for purposes of the Exchange Act?

#### **Answer:**

Yes. Broker-dealers have a duty to build effective compliance programs that are reasonably designed to ensure compliance with applicable laws and regulations.<sup>9</sup> Among the things that firms should consider including in their programs are robust compliance monitoring systems, processes to escalate identified instances of noncompliance to business line personnel for remediation, and procedures that clearly designate responsibility to business line personnel for supervision of functions and persons.

Broker-dealers should consider clearly defining compliance and advisory duties and distinguishing those duties from business line duties in order for persons who perform only compliance and legal functions to avoid becoming supervisors of business line employees. Management at broker-dealers can greatly benefit from the participation and input of compliance and legal personnel.

### **Question 5.**

Can compliance or legal personnel participate in a management or other committee without being considered supervisors of business activities or business personnel for purposes of the Exchange Act?

#### **Answer:**

Yes. Compliance and legal personnel play a critical role in efforts by broker-dealers to develop and implement an effective compliance system throughout

their organizations, including by participating in management and other committees. Compliance and legal personnel do not become "supervisors" solely because they participate in, provide advice to, or consult with a management or other committee. As explained above, the determination whether 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>10</sup>

#### **Question 6.**

Can compliance or legal personnel provide advice to, or consult with, senior management without being considered supervisors of business activities or business personnel for purposes of the Exchange Act?

#### **Answer:**

Yes. Compliance and legal personnel play a critical role in efforts by broker-dealers to develop and implement an effective compliance system throughout their organizations, including by providing advice and counsel to senior management. Compliance and legal personnel do not become "supervisors" solely because they provide advice to, or consult with, senior management. In fact, compliance and legal personnel play a key role in providing advice and counsel to senior management, including keeping management informed about the state of compliance at the broker-dealer, major regulatory developments, and external events that may have an impact on the broker-dealer. In this regard, compliance and legal personnel should inform direct supervisors of business line employees about conduct that raises red flags and continue to follow up in situations where misconduct may have occurred to help ensure that a proper response to an issue is implemented by business line supervisors. Compliance and legal personnel may need to escalate situations to persons of higher authority if they determine that concerns have not been addressed.

#### **Question 7.**

What is the status of the initial decision in the *Theodore W. Urban* matter?<sup>11</sup>

#### **Answer:**

Under the Commission's rules of practice, if a majority of the Commissioners do not agree on the merits (as was the case in *Urban*), the initial decision "shall be of no effect."<sup>12</sup>

#### **Question 8.**

What responsibilities does a person working in a compliance or legal capacity have if he or she is a supervisor for purposes of the Exchange Act?

#### **Answer:**

Once a person has supervisory obligations, he or she must reasonably supervise with a view to preventing violations of the federal securities laws, the Commodity Exchange Act, the rules or regulations under those statutes, or the rules of the Municipal Securities Rulemaking Board. That person must reasonably discharge those obligations or know that others are taking appropriate action. It is not reasonable for a person with supervisory obligations to be a mere bystander to events that occurred, or to ignore wrongdoing or "red flags" or other suggestions of irregularity.<sup>13</sup>

Exchange Act Section 15(b)(4)(E) provides an affirmative defense to potential liability for failure to supervise if a firm has established procedures and a

system for applying those procedures that would reasonably be expected to prevent and detect, insofar as practicable, a violation, and the supervisor has reasonably discharged his or her duties pursuant to the procedures and system, without reasonable cause to believe that the procedures and system were not being complied with.

## Endnotes

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<sup>1</sup>Regardless of their status as supervisors, compliance and legal personnel who otherwise violate the federal securities laws or aid and abet or cause a violation may independently be held liable for the violation.

<sup>2</sup>Compliance and legal personnel may, of course, have supervisory responsibility for personnel within their departments. These FAQs focus on circumstances where compliance and legal personnel are dealing with employees who work outside the compliance and legal departments and report to business line management, *e.g.*, sales and marketing.

<sup>3</sup>*John H. Gutfreund*, Exchange Act Release No. 31554 (Dec. 3, 1992).

<sup>4</sup>*Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995) ("The president of a corporate 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."), *quoting Universal Heritage Investments Corp.*, 47 S.E.C. 839, 845 (1982) (finding securities firm's president had properly delegated duties).

<sup>5</sup>*Gutfreund*, *supra* note 3.

<sup>6</sup>*Id.*

<sup>7</sup>*Id.* at n. 24.

<sup>8</sup>We note that the Supreme Court recently considered the question of supervisory status for purposes of Title VII of the Civil Rights Act of 1964. *See Vance v. Ball State Univ.*, 133 S. Ct. 2434 (2013) (holding that an employee is a "supervisor" of another employee for purposes of vicarious liability under Title VII of the Civil Rights Act of 1964 only if he or she is empowered by the employer to take tangible employment actions against the other employee. Tangible employment actions include hiring, firing, failing to promote, reassigning with significantly different responsibilities, and making a decision causing a significant change in benefits). *Vance* does not address supervisory responsibility for purposes of the Exchange Act, and does not reflect all of the factors that are relevant to establishing such responsibility under the Exchange Act.

<sup>9</sup>*See, e.g.*, Section 15(g) of the Exchange Act and relevant rules of self-regulatory organizations.

<sup>10</sup>Firms should evaluate what role legal or compliance personnel perform on management or other committees. In this regard, broker-dealers could consider whether legal or compliance personnel should serve *ex officio*, as non-voting members, serving in an active but advisory role to the committee.

<sup>11</sup>*Theodore W. Urban*, SEC Administrative Proceeding File No. 3-13655, Initial Decision Release No. 402 (September 8, 2010), *dismissed* by Exchange Act Release No. 66359 (January 26, 2012).

<sup>12</sup>Commission Rule of Practice 411(f), 17 C.F.R. § 201.411(f).

<sup>13</sup>*Gutfreund, supra* note 3 ("Even 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.").

<http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm>

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Modified: 09/30/2013