Oveseas law

Editor: Colin Picker

INTERNAL COMPLIANCE OFFICERS IN JEOPARDY?

BACKGROUND

The effectiveness of contemporary regulation often turns on the quality of compliance systems and personnel situated within firms, as does compliance with the law more broadly. The complexity of regulation, coupled with the fact that even serious incidents of non-compliance may long remain invisible to enforcement authorities, combine to underscore the importance of internal compliance functions. In the financial services industry, the principal focus of this note, failed internal compliance preceded recent high-profile scandals. Prominent examples, including Bernard Madoff's long-running Ponzi scheme carried out in the guise of investment management and MF Global's use of client funds in an ill-fated attempt to rescue the firm from investment bets gone wrong, illustrate the importance of internal compliance in assuring that firms operate consistently with applicable regulatory requirements. Such assurance, of course, will never be perfect.

Toward this end, regulation may explicitly require that a firm have internal compliance processes that reasonably assure that it will fulfil its legal and regulatory duties. Federal securities regulation in the United States additionally requires that firms registered as broker-dealers, investment advisers, or investment companies designate a chief compliance officer (CCO) charged with responsibility for overseeing compliance functions. More generally, directors' duties under general corporate law require that directors be concerned that the corporation have in place reasonable risk-management processes that are designed and implemented by management, including processes to assure legal and regulatory compliance. Finally, under the federal guidelines applicable to organisations in criminal proceedings, whether an organisation has high-level personnel who assure that the organisation has an effective compliance and ethics program is a specific factor relevant to criminal sanctions.

Notwithstanding the importance of compliance within financial services firms, a CCO's position is always complicated. Much of a CCO's work consists of advising operational managers and senior executive managers, which requires that they trust the CCO and share a perception that all are members of the same team. On the other hand, the tenor of relationships between a CCO and management may become testy and adversarial when inquiries from compliance personnel are resented or resisted, the CCO is perceived to be excessively suspicious or intrusive, or the CCO's advice is ignored. Moreover, as two recent developments illustrate, a CCO's position may additionally be fraught with peril when a CCO's intervention either is unwelcome or ignored by managers.

RECENT CASES INVOLVING CCOS

In re Theodore W Urban

Peril for a CCO may stem from forces external to the firm, from internal sources, and from combinations of the two. Consider first the situation of the CCO and general counsel of a registered broker-dealer and investment adviser in a recent administrative proceeding before the Securities and Exchange Commission (SEC). Section 15(b) of the *Securities Exchange Act 1934* (US) provides a basis for administrative proceedings and sanctions against a broker or dealer who fails reasonably to supervise another person with a view to preventing and detecting that person's violations of securities laws and regulations.

The underlying or primary violations in the recent SEC case, *In re Theodore W Urban* (SEC Release No 3366 (2012) (dismissing proceeding); Release No 63465 (2010) (initial decision)), were committed by a rogue broker who pleaded guilty to one count of federal securities fraud, having (inter alia) invested clients' funds in securities inappropriate to the clients' objectives, permitted customer accounts to become over-margined, and engaged in a scheme to manipulate the price of a security.

The question in the SEC's administrative proceeding was whether the CCO should be characterised as the rogue broker's supervisor and, if so, whether he acted reasonably under the circumstances. The broker divided his efforts during most of the relevant period between two geographically separate offices of the firm and between retail and institutional clients. The two branch managers who were assigned direct line responsibilities to supervise the broker's trading did not do so adequately, perhaps because the broker was a known protégé of the firm's head of private client accounts to whom the broker referred any questions about his activities. Within the firm, including the compliance department, it was widely believed that only the head of private client accounts or a branch manager going through him had the power or authority to direct the broker's conduct or terminate his employment. And the head of private client accounts demonstrated frequent hostility toward compliance programs and personnel.

The CCO intervened in response to red flags indicative of improper conduct by the broker, prompting investigations by compliance personnel. The CCO acted on behalf of the firm's credit committee when customer accounts controlled by the broker became over-margined, and recommended that the head of private client accounts assume direct supervisory responsibility for the broker. Finally, the CCO recommended that the broker be fired, but did not share the recommendation with the firm's board or with its CEO, to whom he reported, because he believed doing so would be futile in light of the deference shown to the head of private client accounts.

Following customer complaints, the broker's employment eventually came to an end, as did the CCO's. The CEO turned against the CCO on the basis that he no longer had confidence in him, having not been informed of the CCO's recommendation that the broker be terminated. The CCO's forced resignation deprived him of the opportunity to participate as an equity holder when the firm was sold to a larger financial services firm.

Matters worsened for the CCO when the SEC's enforcement staff began proceedings against him on the premise that he had been a "supervisor" of the rogue broker. The SEC's administrative law judge held that, under the circumstances, the CCO should be characterised as a supervisor because although he "lacked the traditional powers associated with a person supervising brokers" and did not direct the firm's response to the broker, he dealt with the broker on behalf of the firm's credit committee and thus should be viewed as one of many supervisors within the firm who "acted to affect" the broker's conduct "in a variety of different ways" (*Urban* SEC Release No 63465 at 52).

However, the judge also held that the CCO acted reasonably in his supervision of the broker, addressing indicia of problematic conduct with ever-escalating responses while, in the context of power allocations within the particular firm, having few options for further action. On appeal to the full SEC, the administrative proceeding against the CCO was dismissed. The Commissioners participating in the matter were evenly divided and under the SEC's rules, an initial decision by an administrative law judge lacks effect when a majority of the participating Commissioners do not agree. The CCO's ordeal in *Urban* is troubling. To be sure, the administrative law judge exonerated him, but the SEC's failure to articulate the circumstances under which a compliance professional or a lawyer is subject to liability as a supervisor, creates the possibility that it will be tempting to maintain distance when indicia of wrongdoing surface because more active engagement risks a person being characterised as a "supervisor".

The SEC's leading precedent, *In re Gutfreund* 51 SEC 93 (1992), requires a vigorous response once a CCO becomes involved in addressing red flags, but might be distinguishable from *Urban* because the CCO and other senior officers in *Gutfreund*, all of whom knew that a rogue employee had committed criminal acts, neither investigated nor disciplined him, which enabled him to commit further crimes. In *Urban*, the broker's conduct was suspicious but not known to be criminal, and the CCO informed personnel in the firm's compliance department, who investigated further. And, in *Urban*, business leaders within the firm lied to the CCO and did not fulfil their own direct supervisory responsibilities. On the other hand, it is not surprising that the SEC's enforcement staff reacted with manifest frustration to the unwillingness of the firm's senior personnel to jettison an increasingly problematic (but profitable) employee.

Complicating the SEC's position is the institutional fact that, unlike financial auditors, compliance personnel are not subject to well-articulated professional standards against which their performance may be evaluated. This gap invites equating monitoring an employee's conduct with acting as the employee's "supervisor", as the administrative law judge arguably did in *Urban*. Additionally, compliance officers are not subject to licensing requirements and, although associations of compliance officers develop codes of ethics and furnish educational programs and materials, the field as a whole is not at a state of maturity comparable to financial auditing or law practice, in which well-articulated professional standards provide useful benchmarks for assessing a professional's conduct and demarcating functions within that professional practice from other functions.

Sullivan v Harnisch

A separate issue is the relationship between complex regulation and more general legal doctrines. The modest scope of this note cannot begin to do justice to this issue writ large, but its implications underlie another recent source of discomfort concerning the CCO's position and internal compliance structures more generally. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), enacted in 2010, required registration with the SEC by many hedge funds previously exempt from registration requirements imposed by the Investment Advisers Act.

In *Sullivan v Harnisch* 969 NE 2d 758 (NY 2012), the plaintiff served as the CCO of two affiliated advisory firms that operated a hedge fund. The CEO – also the fund's majority owner – fired the CCO following a dispute over a proposed agreement that would eliminate the CCO's 15% equity interest in the firms. Additionally, the CCO alleged, the firing was retaliatory and was motivated by revenge; the CCO had objected to sales of stock by the CEO for the CEO's personal account and those of family members, that anticipated transactions to be undertaken on behalf of the firm's clients. To front-run client transactions is, of course, a breach of the fiduciary duty an investment adviser owes its clients under the Investment Advisers Act. The firing happened a few days after the CCO objected to these trades and insisted that they be reversed. A majority of the New York Court of Appeals (the State's highest court) held that the CCO did not have a claim for wrongful discharge because he was an at-will employee and the circumstances of his termination fell outside New York's narrow exception to the employment-at-will doctrine.

As it happens, New York is among the small minority of jurisdictions in the United States that decline to recognise a tort of wrongful discharge in violation of public policy. However, in *Wieder v Scala* 609 NE 2d 105 (NY 1992), the New York Court of Appeals held that a law firm breached an implied contractual obligation when it discharged an associate lawyer who insisted that the firm comply with the applicable professional disciplinary rules and report the professional misconduct of one of the associate's colleagues.

Narrow in scope, the exception to employment-at-will recognised by *Wieder* also limits a discharged employee's remedies to those available for breach of contract. The *Sullivan* majority distinguished the CCO's position from that of the associate lawyer in *Wieder*, whose regulatory and ethical responsibilities the court found to be so closely linked to his duties as an employee that they were incapable of separation. In contrast, the CCO in *Sullivan* "was not associated with other compliance officers in a firm where all were subject to self-regulation as members of a common profession" (at 761). Thus, as noted above, the less-developed state of the compliance professions has significant implications for the stature and effective authority of compliance officers. Moreover, the *Sullivan* majority noted (at 761) that the CCO "was not even a full-time compliance officer" because he wore multiple hats, serving also as the firms' Executive Vice-President, Chief Operating Officer, Secretary, and Treasurer.

A troubling implication of this line of reasoning stems from the fact that multiply-titled officers typify smaller firms, but there is no reason to think that compliance issues in such firms are less significant than in larger firms engaged in the same activity. Underscoring this point, firing a CCO is an event that an investment adviser (or broker-dealer) must report to the SEC (and to the Financial Industry Regulatory Authority, the self-regulatory organisation for broker-dealers) and that is highly likely to prompt further investigation. These regulatory consequences, which generate information that may taint an adviser's reputation and attractiveness to clients, may well temper conduct within larger registered investment advisers.

Assessing the merits and impact of *Sullivan* also requires considering the broader regulatory framework in which hedge funds and investment advisers operate. Provisions added to the federal securities laws in 2010 by Dodd-Frank provide protection against employment retaliation for whistleblowers who furnish information about violations of the securities laws to the SEC. However, the CCO in *Sullivan* reported upward – inside his employer to the CEO – not outward to the SEC, and thus fell outside the statutory protections afforded by Dodd-Frank. The *Sullivan* majority characterised this result as, if anything, a shortcoming in federal law, not a reason to recognise a common law basis to protect compliance officers (at 761): "Nothing in federal law persuades us that we should change our own law to create a remedy where Congress did not." On the other hand, nothing in the Dodd-Frank protections pre-empts State law or is incompatible with common law protection for compliance officers.

Additionally, leaving compliance personnel open to employment jeopardy when they attempt in good faith to do their jobs makes it attractive to report-out to the SEC sooner, entirely by-passing or delaying any internal reporting. This incentive seems incompatible with the efficacy of internal compliance systems within financial services firms, which if robust can investigate and respond to indicia of problematic conduct sooner than can the SEC. *Sullivan* thus represents a troubling disconnect between the common law, at least in New York, and the structure and effectiveness of regulation.

Conclusion

Resolving the issues raised by *Urban* and *Sullivan* would require efforts on many fronts. True, federal legislation could define "supervisor" and could pre-empt the State common law of employment otherwise applicable to CCOs within financial services firms subject to federal regulation. And further clarification from the SEC would be helpful in defining the functions that constitute supervision. Short of that, and perhaps more realistic in the shorter run, two routes toward strengthening the position of CCOs seem possible.

First (and even in New York), employment contracts may modify or supplant the default rule of at-will employment by requiring cause to terminate employment, defining what constitutes "cause", and pricing a non-cause termination through a severance provision in the employment contract. That for-cause terms are enforceable does not, of course, mean that any individual CCO has the bargaining leverage to negotiate for one. Second, greater maturation in the compliance professions, perhaps from membership associations to self-regulatory organisations, would be helpful because it would clarify the specifics and scope of duties and functions. Articulated professional disapproval of retaliatory firings would also strengthen the hand of CCOs in jeopardy.

Deborah A DeMott
David F Cavers Professor of Law
Duke University School of Law