

THE CRUCIAL BUT (POTENTIALLY) PRECARIOUS POSITION OF THE CHIEF COMPLIANCE OFFICER

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INTRODUCTION

Although the importance of internal systems geared to ensure a firm's compliance with applicable law and regulation is widely acknowledged, as is the visibility of major compliance failures in scandal-ridden financial-services firms, the roles and status of compliance personnel are relatively unexamined by scholars. Focusing specifically on the position of Chief Compliance Officer (CCO), this Article explores the functions performed by a CCO as well as circumstances that may strengthen or limit a CCO's effectiveness, including the implications of legal doctrine and regulation. The Article argues that a CCO's position is distinct, drawing comparisons with the position of a firm's general counsel or Chief Legal Officer (CLO) to illustrate. Additionally, situated within a firm, a CCO is responsible for compliance systems that the firm itself designs and implements. To be sure, internal compliance systems and personnel may be characterized as supplements to or substitutes for external regulation, whether imposed *ex ante* to deter problematic conduct or *ex post* through the imposition of legal and regulatory penalties for misconduct. Lines of demarcation between mechanisms of external regulation and internal compliance systems are not identically drawn within the financial services industry as a whole; Morgan Stanley's transformation in 2008 to a bank holding company from a firm regulated as a securities broker-dealer led, *inter alia*, to the physical presence of full-time regulatory personnel within the firm.¹ Nonetheless, in general, a CCO's position differs from those occupied by external gatekeepers such as external auditors or rating agencies; a compliance officer's approval is not requisite to open a point of entry so that a firm may engage in transactions or other activity. Likewise, a CCO's position differs in fundamental ways from those of compliance monitors who are imposed on a firm following major lapses in compliance

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1. See Aaron Lucchetti & Julie Steinberg, *Life on Wall Street Grows Less Risky*, WALL ST. J., Sept. 10, 2013, at A1, A14 (noting that "about 50 full-time government regulators are now stationed at Morgan Stanley"). Additionally, the firm has "doubled the head count" for risk management and shifted its balance of revenue sources away from investment banking and trading toward wealth and asset management. Some highly paid employees departed. *Id.*

and charged with acting as agents on behalf of governmental authorities.² Like a CCO and other internal compliance personnel, a compliance monitor is tasked to engage with and address compliance issues. However, a compliance monitor appointed at the behest of governmental authorities functions as their agent; a compliance monitor works inside the monitored firm to assist its personnel and only once externally detected misconduct triggers the appointment as an alternative to or deferral of criminal indictment.

More generally, assessing the strengths and weaknesses of compliance functions and personnel requires a shift in scholarly focus to look deeper within private-sector firms and away from a single-eyed focus on firms' boards of directors and Chief Executive Officers (CEOs).³ Compliance personnel and processes might be characterized as internal governance mechanisms through which a firm may establish and enhance its reputation for integrity—at a minimum, for legality—in its operations. The law and regulation may enhance a firm's incentives to invest in its reputation by strengthening its compliance functions and the role of compliance personnel, most fundamentally by mandating that regulated firms adopt and implement policies and procedures reasonably designed to prevent violations and designating a CCO with responsibility for their administration.⁴ However, effective compliance may also be undercut by unforeseen consequences of legal doctrine and regulation, in particular consequences that undermine internal compliance personnel and systems, as well as by the underdeveloped professional status of compliance functions. Better results across the board require more recognition of the practical significance of internal compliance and how to strengthen it.

2. Compliance monitors appointed pursuant to deferred prosecution agreements or non-prosecution agreements are beyond the scope of this Article. It suffices for present purposes to note that evident compliance failures precede their appointment and that the choice of monitor is not that of the monitored firm. For a recent example of a post-compliance-failure appointment of a monitor, see *infra* text accompanying notes 10–11. On compliance monitors generally, see Veronica Root, *The Monitor-'Client' Relationship*, 100 VA. L. REV. (forthcoming 2014), available at <http://ssrn.com/abstract=2309498>.

3. For a wide-reaching statement of the importance of scholarly engagement with internal governance mechanisms that lower governmental monitoring costs and operate largely below the level of a corporation's board, see Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. ILL. L. REV. 1131.

4. For registered investment advisers, see 17 C.F.R. § 275.206(4)-3(a), (c) (2013). The U.S. Securities and Exchange Commission (the SEC) adopted this rule in 2003. One consequence of the registration of many hedge funds mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was that theretofore unregistered funds, once registered, became subject to inspection by the SEC and to the compliance requirements imposed by Rule 206(4)-3. *Id.* § 275.206(4)-3. For broker-dealers, see Self-Regulatory Organizations, Exchange Act Release No. 50,347, 83 SEC Docket 2219 (Sept. 10, 2004) (approving proposed rule change by National Association of Securities Dealers (NASD) to require appointment of a CCO who must certify annually that the firm has in place a process to establish, maintain, and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules and federal securities law). The NASD has been succeeded by FINRA.

The Article opens in Part I with an introduction to the now-commonplace observation that internal compliance failures have dogged many financial-services firms in recent years. Part I uses as illustrations two recent incidents that, albeit extreme, are suggestive of internal firm structures and other circumstances that may undermine the effectiveness of internal compliance personnel and systems and may destroy both a firm's reputation and potentially its ability to continue in operation. Part II focuses more narrowly on the CCO's position, contrasting it with roles occupied by other professional and executive agents and personnel whose work is relevant to legal and regulatory compliance, in particular a firm's general counsel or CLO. Part II also sketches the centrality of the CCO's functions to a firm's reputation and explores relationships between reputation and regulation. Part III examines a series of recent cases to illustrate that legal doctrine and regulation may sometimes undermine the effectiveness of compliance systems and personnel, as opposed to enhancing a firm's incentives to strengthen internal compliance systems and the positions of those who staff them. The Article concludes by returning to the theme of relationships between a firm's reputation and the quality of its internal compliance personnel and systems.

I. NARRATIVES OF FAILED COMPLIANCE

A. NOW-HISTORICAL EPISODES WITH LARGER IMPLICATIONS

By definition, narratives of scandal are not celebrations of success achieved by compliance systems and personnel.⁵ Thus, it would be mistaken to base one's overall assessment of compliance within financial-services firms solely on incidents that follow or are associated with major compliance failures. However, it would also be mistaken to ignore the significance of scandalous episodes that were necessarily preceded by compliance failures. This is because their magnitude or outrageous character may suggest that systemic reforms are warranted. Additionally, even singular or exceptional episodes may illustrate factors that explain less spectacular incidents. For example, among now-historic scandals preceded by compliance failures, Bernard Madoff's long-running Ponzi scheme carried out in the guise of investment management was understood by many observers as evidence of flaws in the SEC's inspection regime for investment advisers and in the self-regulatory regime applicable

5. On scandals more generally, see Deborah A. DeMott, *The Stages of Scandal and the Roles of General Counsel*, 2012 WISC. L. REV. 463, 464 (defining a scandal as an organizational crisis that "embroil[s] identifiable actors who are (or should be) held responsible for the consequences of their actions," and noting that "[t]he underlying conduct that makes an incident a scandal often violates the law").

to broker-dealers, as well as in the firm's own compliance efforts.⁶ Similarly, MF Global's use of client funds in an ill-fated attempt to rescue investment bets gone wrong may indicate that regulatory rules applicable to intermediaries' custody and use of clients' assets are suboptimal.⁷

B. RECENT EPISODES ILLUSTRATING MAJOR COMPLIANCE FAILURES

1. HSBC Bank: Organizational Inhibitions to Effective Compliance

Two recent episodes furnish good illustrations of how compliance personnel and systems may be compromised. The first demonstrates the potential impact of structures allocating authority within a firm or a group of affiliated firms, plus inadequate staffing and other resources, as well as inhibitions on the intra-firm flow of compliance-relevant information. In early July 2013, the federal government filed an information charging HSBC Bank USA, N.A. with several criminal offenses, including willfully failing to maintain an effective anti-money laundering (AML) program.⁸ Separately, its affiliate HSBC Holdings plc was charged with willfully facilitating financial transactions on behalf of sanctioned entities in violation of the International Emergency Economic Powers Act and the Trading with the Enemy Act.⁹ Simultaneously, the government filed a deferred prosecution agreement (DPA) with a five-year term, plus an agreement in which both entities consented to the appointment of a corporate compliance monitor.¹⁰ As detailed in the court's order approving

6. Indeed, the SEC itself acknowledged the need for reforms. See *The Securities and Exchange Commission Post-Madoff Reforms*, SEC, <http://www.sec.gov/spotlight/secpostmadoffreforms.htm> (last modified Apr. 2, 2012). As it happens, Madoff operated for many years as a registered broker-dealer. Madoff's advisory business registered with the SEC in 2006, having previously relied on an exclusion available to broker-dealers that provided investment advice "solely incidental" to broker-dealer activities. See 15 U.S.C. § 80b-2(a)(11)(C) (2012). Although investment advisers are not required to belong to an investor-compensation scheme, Madoff's advisory clients were eligible for compensation through the Securities Investor Protection Corporation (the SIPC) because Madoff established no separate business unit for the bogus advisory business and, in communicating with advisory clients, used letterhead bearing the SIPC member logo. See DIANA B. HENRIQUES, *THE WIZARD OF LIES: BERNIE MADOFF AND THE DEATH OF TRUST* 222 (2011).

7. See Ben Protess & Azam Ahmed, *MF Global's Shortfall No Surprise, Some Say*, N.Y. TIMES, Mar. 28, 2012, at B1; Aaron Lucchetti, *Customer Divide at MF Global*, WALL ST. J., May 7, 2012, at C2. Of at least anecdotal interest is the fact that MF Global's senior vice-president for legal matters and head of compliance previously served as the head of compliance at Refco, a broker that failed due to massive accounting fraud. See DeMott, *supra* note 5, at 474 n.45.

8. See Chad Bray, *Judge Approves HSBC Deferred Prosecution Agreement in Money Laundering Probe*, WALL ST. J. (July 2, 2013), <http://online.wsj.com/news/articles/SB10001424127887323936404578582451462472318>.

9. See *United States v. HSBC Bank, USA, N.A.*, No. 12-CR-763, 2013 WL 3306161 (E.D.N.Y. July 1, 2013) (Memorandum and Order).

10. *Id.* at *1.

the DPA, HSBC Bank failed in several respects to implement an effective AML program to monitor suspicious transactions originating in Mexico.¹¹ At the same time, one of its largest Mexican customers had its own significant AML lapses, which enabled Mexican and Colombian drug traffickers to launder hundreds of millions of dollars in drug proceeds through HSBC Bank.¹² HSBC Holdings was aware of these compliance problems but failed to inform HSBC Bank of them.¹³ During an earlier period of time, HSBC Holdings and its subsidiaries (all constituting the “HSBC Group”) knowingly caused payments to be processed on behalf of banks and other entities located in Cuba, Libya, and other countries subject to U.S. sanctions.¹⁴ Indirectly owned HSBC affiliates around the world cooperated to assure non-detection by the United States by “altering and routing payment messages in a manner that hid the identities of these sanctioned entities from HSBC Bank USA” as well as other U.S. financial institutions.¹⁵

Once the dimensions and implications of the scandal became evident, HSBC made major changes in its leadership teams, including the CEO, CLO, and Head of Global Standards Assurance at HSBC Holdings; and HSBC North America’s CEO, General Counsel, CCO, and AML Director, among other high-level personnel changes.¹⁶ However, characteristics of HSBC’s previous compliance systems and AML programs generally illustrate causes of compliance failure more generally that are distinct from the limitations and foibles of particular individuals, even when the consequences of failure seem likely to injure the reputation of both the firm and the individuals implicated in the fiasco.¹⁷ First, responsibility for compliance was diffused across a large organization, and compliance personnel at the overall group level lacked authority to mandate actions at the group-affiliate level.¹⁸ Additionally, at the affiliate level, lines of responsibility were not crisply drawn; it was “unclear” whether responsibility for AML compliance ultimately rested with AML officers or the bank’s business personnel.¹⁹ Second, compliance within HSBC Bank USA was understaffed because since 2007, bank-wide initiatives to cut costs and increase the bank’s return on equity led to freezes on staffing levels and the non-replacement of senior officers, including the regional

11. *Id.* at *8–9.

12. *Id.* at *8.

13. *Id.* at *9.

14. *Id.*

15. *Id.*

16. *Id.* at *10.

17. On the importance of overall organizational coherence in compliance systems beyond particular business units, see Ben W. Heineman, Jr., *Don’t Divorce the GC and Compliance Officer*, CORP. COUNS., Jan. 2011, at 48, available at http://www.law.harvard.edu/programs/plp/pdf/Dont_Divorce_the_GC_and_Compliance_Officer.pdf.

18. *HSBC Bank*, 2013 WL 3306161, at *9.

19. *Id.*

compliance officer.²⁰ Third, HSBC's culture was one that discouraged sharing information across the organization, including compliance-related information.²¹ Thus, compliance problems with Mexican transactions went unreported to personnel at HSBC Bank USA because personnel at Holdings, aware of the problems, did not inform their colleagues at Bank USA.²² At HSBC Bank USA, formal policy did not permit conducting due diligence on other group affiliates, which inhibited Bank USA's ability to assess the AML risks to which it was exposed.²³ Indeed, some affiliates structured transactions so that HSBC Bank USA could not review them adequately even when it requested full details.²⁴

These details illustrate features of organizational structure and culture that could undercut the effectiveness of any complex organization's compliance program. The details are also telling indicators of the status of compliance programs and personnel. The vulnerability of compliance staffing to spending freezes driven by cost-cutting/return-on-equity concerns is inconsistent with placing a high organizational priority on compliance, as is a formal policy that inhibits asking questions about transactions originating elsewhere within a dispersed organization. Lack of clarity about responsibility for AML compliance, additionally, may have undermined the power of compliance officers by furnishing a basis on which its exercise could be contested.

2. SAC Capital Advisors: Alleged Infirmities in Compliance Functions

A separate episode freshly suggests the frequency with which compliance failures may be linked to the relative power of CCOs and other compliance personnel within financial services organizations. If true, the SEC's recent allegations in an order instituting administrative proceedings²⁵ against Steven A. Cohen, the founder and owner of hedge fund S.A.C. Capital Advisors, L.P. (SAC or SAC Capital), depict conduct in an organization in which visible interventions by compliance personnel were

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. The SEC instituted administrative proceedings under section 203(f) of the Investment Advisers Act. This section requires that the SEC "censure or place limitations on the activities of any person" associated with an investment adviser when the Commission finds, after a hearing, that such action is in the public interest and the person has committed any of the acts enumerated in subsection 203(e). *See* 15 U.S.C. § 80b-3(f) (2012). In *Cohen*, the SEC's order alleges that the respondent failed reasonably to supervise two portfolio managers who engaged in illegal insider trading through which they allegedly earned profits and avoided losses totaling in excess of \$275 million. Cohen, Investment Advisers Act Release No. 3634, 2013 WL 3776681 (July 19, 2013) [hereinafter *Cohen Release*], available at <http://www.sec.gov/litigation/admin/2013/ia-3634.pdf>; *see* 15 U.S.C. § 80b-3(e)(6).

striking by their absence.²⁶ In particular, the order details allegations that Mr. Cohen failed to discharge his duty to supervise personnel; he received “highly suspicious information”²⁷ from two portfolio managers who reported directly to him, in interactions replete with “red flags”²⁸ indicative of the possession and proposed use of inside information in violation of SAC Capital’s own Code of Ethics and federal law. Throughout the narrative in the order, the firm’s CCO goes unmentioned, as do activities by any other compliance officer. One interpretation of their absence—of course others are possible too—is that the invisibility of compliance personnel corresponded to a lack of relative power within the firm, which inhibited or shaped their interactions with portfolio managers. In contrast, among hedge funds more generally, portfolio managers are themselves treated as a front line of compliance to enforce prohibitions against trading on inside information because internal rules require that they consult the firm’s compliance personnel immediately if they suspect they have received inside information, including from colleagues within the firm.²⁹ Incentive structures at SAC Capital may have overpowered some actors’ commitment to comply with policies that conformed to industry norms.³⁰

As it happens, compliance personnel appear frequently in the allegations made in the federal criminal indictment of SAC Capital and affiliated entities filed later the same month.³¹ The indictment alleges that the “limited SAC compliance systems” were “overwhelmed” by a business culture “fostered” by the “relentless pursuit of an information edge” to the extent that “there was no meaningful commitment to ensure that such ‘edge’ came from legitimate research and not Inside Information.”³² Allegedly, a portfolio manager was hired over objections expressed by SAC’s Legal Department; an employee of the hedge fund that previously employed the portfolio manager warned he was “known for being part of [that fund’s] ‘insider trading group.’”³³ Indicative of the role compliance personnel may have played in the firm’s operations is the allegation that a recently hired portfolio manager apologized to the firm’s owner for a “cryptic” instant message in which he referred to “recent research” as the basis for a plan to short a stock because “the head of SAC compliance

26. Cohen Release, *supra* note 25.

27. *Id.* para. 3, at 1.

28. *Id.*

29. See Bryan Burrough & Bethany McLean, *The Hunt for Steve Cohen*, VANITY FAIR, June 2013, at 100, 147.

30. See *infra* text accompanying notes 31–36.

31. Sealed Indictment, United States v. S.A.C. Capital Advisors, L.P., No. 13-CR-541 (S.D.N.Y. filed July 25, 2013) [hereinafter SAC Indictment], available at [http://www.justice.gov/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment%20\(Stamped\).pdf](http://www.justice.gov/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment%20(Stamped).pdf).

32. *Id.* para. 7, at 4.

33. *Id.* para. 19, at 15.

‘was giving me Rules 101 yesterday—so I won’t be saying much,’”³⁴ an episode that is even more troubling if compliance personnel explicitly or implicitly furnished instructions on how best to paraphrase emails and other electronic communications to mask indicia of plans to engage in illegal conduct. Indeed, allegedly until 2009, SAC compliance personnel only rarely reviewed intra-firm electronic communications for signs of problematic conduct, despite a recommendation made in 2005 by SAC’s head of compliance.³⁵ Perhaps due to these limitations, the compliance department conducted only a “few” investigations of insider trading, focusing on interviewing research analysts and portfolio managers and “‘confirming’ . . . that an e-mail implying access to Inside Information was an inartfully drafted e-mail.”³⁶ Throughout an era in which several insider-trading cases occurred at SAC that have led to guilty pleas by several individual defendants, the compliance department contemporaneously identified only one instance of insider trading by SAC employees in its entire history.³⁷

As acknowledged earlier in this Part, dwelling on such episodes (and so far only alleged episodes concerning SAC Capital) can generate misleading conclusions about the effectiveness of compliance systems and personnel overall as well as the relative power of CCOs and compliance professionals within contemporary financial-services firms; after all, it seems inevitable that a large organization will experience some lapses in compliance that no CLO or CCO could have prevented.³⁸ However, the narrative power of these more extreme episodes as cautionary tales is undeniable, as may be their potential to strengthen the hand of CCOs within their organizations.

II. THE CCO’S POSITION AND THE FIRM’S REPUTATION

Legal compliance can fairly be characterized as “integral to the daily operations of large companies,”³⁹ and, in the highly regulated context of

34. *Id.* para. 23, at 21.

35. *Id.* para. 24, at 22. SAC did enlarge its cohort of compliance personnel once the SEC began the insider-trading investigation in 2006, from three in 2005 to thirty-six in 2013. Burrough & McLean, *supra* note 29, at 104. SAC also became “one of the first hedge funds” to create a separate compliance department “led by a well-respected professional.” *Id.* at 103–04. In 2013, SAC reportedly further enlarged its compliance staff and, by May, had attempted to recruit a new “senior-level compliance executive,” an effort seen by individuals close to SAC as potentially a diminishment of the internal role of the firm’s CCO. See Jenny Strasburg & Michael Rothfeld, *Four Top SAC Executives Receive Subpoenas in Probe*, WALL ST. J. (May 23, 2013, 9:10 PM), <http://online.wsj.com/news/articles/SB10001424127887323975004578501212048252892>. The recruitment effort was unsuccessful. *Id.*

36. SAC Indictment, *supra* note 31, para. 28, at 25.

37. *Id.*

38. See James B. Stewart, *When Trying to Follow Rules Isn’t Enough*, N.Y. TIMES, Sept. 21, 2013, at B1 (commenting on general counsel of JPMorgan Chase & Co. in light of firm’s agreement to admit wrongdoing and pay close to \$1 billion in fines for its conduct in “London Whale” incident in which firm lost more than \$6 billion and misled bank regulators about its loss).

39. Simmons, *supra* note 3, at 1145.

contemporary financial-services firms, to have a texture that requires engagement with many specifics—some highly technical, others less so.⁴⁰ And legal and regulatory specifics vary in their degree of determinacy over a spectrum that ranges categorically from stated rules that leave no room for interpretation or discretion to more open-ended standards.⁴¹ Overall, compliance programs aim to determine whether a firm's operations meet legal and regulatory requirements, whether indicia of problematic conduct should be investigated, and whether the firm's internal information flow meets requisite standards for accuracy and processing.⁴² Additionally, when warranted, compliance systems should bring material information to management's attention.⁴³ Many internal functions and personnel aid in the design and implementation of these systems, including the firm's internal audit department, its CLO and her staff, as well as the firm's CCO and any other personnel distinctively assigned to compliance functions.⁴⁴ Although a designated CCO bears internal responsibility for the administration of compliance systems and the supervision of compliance-department personnel, the overall efficacy of compliance requires engagement in some form from other internal actors, including the CEO, other members of the senior management team, and the firm's directors,⁴⁵ as well as the firm's general counsel or CLO.

A. THE CCO AND THE CLO

For starters, the same person may serve as CCO as well as CLO.⁴⁶ As a consequence, it can be difficult to specify with precision the functions and roles distinctively served by a CCO. One starting point is to compare the

40. See *id.* at 1145–46 (noting that compliance systems are not uniform and “differ according to jurisdiction, industry, company, and operational context”).

41. *Id.* at 1135.

42. *Id.* at 1145.

43. *Id.*

44. See Heineman, *supra* note 17, at 49.

45. The Delaware Court of Chancery made clear in 1996 that responsibility for legal and regulatory compliance extended upward to a corporation's board. See *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (stating in dictum that “a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system . . . exists, and that a failure to do so . . . may . . . render a director liable for losses caused by non-compliance with applicable legal standards”). More recently, the Court of Chancery explained that *Caremark* liability does not encompass internal systems that are flawed because they do not adequately monitor business risks. See *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009).

46. This Article does not address three questions that are relevant to the situation of CCOs: (1) to whom should a CCO report; (2) who should have authority to hire and fire a CCO; and (3) should a firm's CCO and CLO necessarily be different individuals. Answers to these questions vary, due in part to significant differences among firms and industries. On the third question, the health-care industry has a distinctive history. See John B. McNeece IV, *The Ethical Conflicts of the Hybrid General Counsel and Chief Compliance Officer*, 25 GEO. J. LEGAL ETHICS 677, 692–94 (2012); see also Heineman, *supra* note 17, at 48 (arguing that CCO should report to the CLO and CFO).

functions served by a CCO with those of a firm's general counsel or CLO. In earlier work I identified four distinct roles—some in tension with each other—that a CLO occupies.⁴⁷ These are service as: (1) a legal adviser to the corporation and its constituents, including its senior management and board of directors;⁴⁸ (2) a corporate officer and member of the senior management team;⁴⁹ (3) the administrator of the firm's internal legal department;⁵⁰ and (4) an agent of the firm in its dealings with third parties, including governmental authorities.⁵¹ Although a CCO's responsibilities overlap these roles to some extent, overall their focus is narrower, excluding, for example, the negotiation of transactions on behalf of the corporation and the supervision of internal lawyers who work on matters that are not compliance-related.⁵² Additionally, when a CCO is not a lawyer, the CCO is not subject to the distinctive self-regulation of the legal profession and the obligations it imposes;⁵³ whether the work of a CCO who is licensed as a lawyer constitutes "practicing law" is open to dispute. In contrast, a CLO, like any in-house lawyer, has more crisply delineated duties, including the duty to report-up corporate misconduct imposed by section 307 of the Sarbanes-Oxley Act and Rule of Professional Conduct 1.13.⁵⁴

Otherwise, hard-and-fast lines are hard to draw. In highly regulated businesses like financial services, advice related to legal compliance may be closely related to business decisions to be made by the firm's operational management.⁵⁵ Additionally, determining when and how to investigate based on information that comes to the attention of compliance personnel implicates judgments to be made by personnel charged with the corporation's legal function.⁵⁶ Pursuing what went wrong requires a degree of independence from the firm's management; whether and when to bring in external counsel is itself a decision that can be crucial to the credibility of

47. Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 *FORDHAM L. REV.* 955, 965–74 (2005).

48. *Id.* at 965.

49. *Id.* at 967.

50. *Id.* at 969.

51. *Id.* at 970.

52. See Heineman, *supra* note 17, at 49 (emphasizing "process integration and rigor" as role of CCO and observing that "although substantive lawyers have expertise and knowledge to assess legal and ethical risks in their areas, and to design specific mitigants, they may not have the process skills that great compliance leaders possess").

53. See Dana A. Remus, *Out of Practice: The Twenty-First Century Legal Profession*, 63 *DUKE L.J.*, (forthcoming 2013) (manuscript at 17), available at <http://ssrn.com/abstract=2344888>.

54. *Id.* (manuscript at 27 n.119).

55. See Heineman, *supra* note 17, at 48 (noting the range of critical decisions made by senior management and directors that have "a legal or ethical component—a new deal, a new product, a new geography, a new government investigation").

56. See *id.*

an investigation conducted by an internal compliance officer.⁵⁷ In some reported instances, firms use compliance personnel as their agents in communicating with external constituencies, such as clients, to furnish credible assurances about the quality of the firm's compliance systems and controls.⁵⁸

How compliance functions are perceived and received within firms appears to vary, with some firms' powerfully situated CCOs and personnel contrasting with their counterparts in firms that, through formal structures or less formal cultures, foreclose interventions by the CCO and the compliance department or resist those interventions as unnecessary impediments to operating the firm's business. For example, within JPMorgan Chase & Co., major internal restructurings in the aftermath of the "London Whale" debacle led to the empowerment of compliance and control groups "as equals to their business counterparts," which implies prior inequalities in power within the firm.⁵⁹ And personnel in charge of legal, risk-management, and compliance functions "can no longer be overruled by business heads."⁶⁰

In addition, it may be telling that compliance functions are sometimes associated with modifiers like "rote,"⁶¹ which seems to exclude the

57. See Anton R. Valukas et al., *Investigation and Disclosure of Violations*, in COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING GUIDELINES § 15:7 (Jeffrey Kaplan & Joseph Murphy eds., 2013) (discussing considerations that weigh in favor of, and against, the choice of outside counsel to perform internal investigations).

58. See Strasburg & Rothfeld, *supra* note 35 (reporting that president and CCO of SAC Capital "also hold roles that have been visible to SAC's clients over the past year, as they have conveyed confidence in SAC's compliance and trading controls"); see also Peter Lattman, *4 SAC Executives Subpoenaed in Insider Trading Inquiry*, N.Y. TIMES, May 24, 2013, at B3, available at <http://dealbook.nytimes.com/2013/05/23/4-sac-executives-subpoenaed-in-insider-trading-inquiry/> (reporting that SAC's CCO, who "oversees the firm's internal regulatory regime," has in recent months "been among the SAC executives who have tried to reassure the firm's concerned investors").

59. See Monica Langley & Dan Fitzpatrick, *Embattled J.P. Morgan Bulks Up Oversight*, WALL ST. J., Sept. 13, 2013 at A1, A2. JPMorgan Chase's COO, at the insistence of regulators, now reports to the firm's chief operating officer, not its CLO. *Id.* at A2. The overall cost is an additional \$4 billion, with a commitment of 5000 additional employees. *Id.* at A1.

60. *Id.* at A1. (contrasting relative autonomy of such personnel at JPMorgan Chase with their counterparts in rival banks).

61. In a recent example, albeit in a different context from the other examples explored in this Article, SEC Commissioner Daniel M. Gallagher criticized undue reliance by institutional shareholders on recommendations generated by proxy advisory firms in deciding how to vote shares on behalf of clients. See Daniel M. Gallagher, Comm'r, SEC, Remarks at Society of Corporate Secretaries and Governance Professionals (July 11, 2013), available at <http://www.sec.gov/news/speech/2013/spch071113dmg.htm>. His criticisms may be well-founded, but consider the language in which they were couched:

Given the sheer volume of votes, institutional shareholders, particularly investment advisers, may view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset.

. . . .

possibility that compliance functions may require the exercise of nuanced judgment and to deny the reality that a firm's compliance failures may doom it. It also ignores the fact that the effectiveness of much regulation depends on implementations internal to regulated firms themselves, most likely preceded by discussion within the firm (including its compliance personnel) and productive interactions with the firm's legal counsel, whether situated internally or externally. These internal conversations, like the decisions they precede, help ensure the effectiveness of regulation by resituating regulated firms as participants in the regulatory process that are able to understand, if not share, the regulator's perspective and objectives.⁶²

Finally, the status and evolutionary stage of compliance activity as a profession, distinct from the legal profession, may lurk in the background. Unlike lawyers, compliance professionals as such are not licensed by the state, nor is a particular course of formal education requisite to performing their work. Although compliance professionals may choose to be associated with membership organizations,⁶³ these organizations do not (or, at least, do not yet) perform the sorts of self-regulatory functions associated with professional organizations in classic professions, such as law and accounting. Nor has the organized legal profession yet embraced the challenges posed by compliance work performed by licensed lawyers within organizational settings.⁶⁴

It is troubling to think that institutional investors . . . are treating their responsibility akin to a compliance function carried out through rote reliance on proxy advisory firm advice rather than actively researching the proposals . . . and ensuring that their votes further their clients' interests.

Id. Again, the Commissioner's critique of how institutional shareholders determine to vote may be persuasive, but the assumed opposition between "compliance mindsets" and compliance "functions," on the one hand, and those associated with a fiduciary may carry implications for how compliance personnel and the functions they perform are perceived, at least in some quarters.

62. For fuller development of this point, see ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS 234–36 (2011). As Professor Riles explains, regulatory efficacy always depends on implementation; "new architectures historically have never worked at the level of design. Where regulatory reforms have succeeded, it has been because, in one way or another, they enroll the targets or clients of regulation in the regulatory mission and encourage them to take responsibility for the regulatory problem." *Id.* at 227.

63. Examples of membership organizations focused on compliance professionals in general include the Ethics and Compliance Officer Association, *see* ETHICS & COMPLIANCE OFFICER ASS'N, <http://www.theecoa.org/> (last visited Nov. 17, 2013), and the Society for Corporate Compliance and Ethics, *see* SOC'Y FOR CORP. COMPLIANCE & ETHICS, <https://www.corporatecompliance.org/> (last visited Nov. 17, 2013). An organization specific to compliance professionals in investment advisor firms is National Regulatory Services, which offers certification programs, plus consulting and other services. *See* NAT'L REG. SERVICES, <http://www.nrs-inc.com/> (last visited Nov. 17, 2013).

64. *See* Remus, *supra* note 53.

B. THE CCO AND A FIRM'S INVESTMENT IN ITS OWN REPUTATION

Further vantage points on a CCO's functions are suggested by Jonathan Macey's recent scholarship on corporate reputation.⁶⁵ Tracing a perceived decline in reputation's significance relative to regulation in financial-services firms, Professor Macey notes concurrent shifts in a "reputational industry" consisting of "products and services specifically designed and engineered for the purpose of lowering the costs of attaining the benefits of a reputation for honesty and integrity."⁶⁶ Although Professor Macey's account focuses on such service providers as external auditors, law firms, and credit rating agencies, one might conceptualize a CCO and other compliance professionals as internal forces that under optimal circumstances can institutionalize practices that enhance a firm's reputation and then serve as bulwarks against other internal forces that can jeopardize that reputation.⁶⁷ Seen in this way, the position of a CCO, more singly focused than the CLO's role, constitutes an investment by the firm in the long-term asset that its reputation represents.⁶⁸ Additionally, success in a CCO's role is highly unlikely to stem from an oppositional posture toward regulation. The adversarial posture that a CLO (or another lawyer) may appropriately adopt is inapposite for a CCO because effectiveness will not stem from treating either the relevant law and regulation, or their enforcers, as the firm's adversaries, as a CLO or external counsel might well be warranted in doing.⁶⁹

65. See JONATHAN R. MACEY, *THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET* (2013).

66. *Id.* at 124.

67. Professor Macey's book does not address internal compliance as such, so the implications I draw in this Article, although sparked by his book, are not necessarily ones he would endorse.

68. On theories of reputation and its effects more generally, see, e.g., Rachel Brewster, *Unpacking the State's Reputation*, 50 HARV. INT'L L.J. 231, 259-66 (2009) (arguing that reputation for compliance on the part of states may be issue-specific or may have broader reach); DeMott, *supra* note 5, at 472-73 (characterizing reputation as "an intuitive and somewhat indeterminate concept" that is often personalized to particular actors and that may operate differently depending on whether the subject is an individual or an organization). Additionally, Professor Macey's argument emphasizes that individuals' reputations may be decoupled from the firms for which they work. See MACEY, *supra* note 65, at 96-99. Thus, individuals' reputations may not suffer—nor may their individual wealth—in the wake of a major scandal that consumes their firm. *Id.* at 90-96. But this decoupling is not universally true; following the indictment of hedge fund SAC Capital, which allegedly engaged in a pervasive insider-trading scheme, other hedge fund managers were reportedly reluctant to hire SAC veterans as portfolio managers. See Juliet Chung, *Funds' Employees Face Uncertainty*, WALL ST. J., July 26, 2013, at A6.

69. Somewhat along the same lines, Professor Macey distinguishes lawyers from auditors and accountants more generally, writing:

Although intelligence, thoroughness, and attention to detail are important qualities in both professions, the best accountants are those who stay firmly within the lines when they take up their brushes and paint for clients. In sharp contrast, the very best lawyers are those who develop new ways of doing deals or develop new strategies and tactics to advance their clients' interests and to surprise and confound the opposition.

III. LAW, REGULATION, AND THE CCO'S PRECARIOUS POSITION

If the effectiveness of the CCO is integral to creating and preserving a firm's reputation over time for integrity, as well as to assuring the firm's compliance with applicable law and regulation, it is important that the CCO's position not be undermined by unforeseen consequences that stem from the law, regulatory strategy, or lacunae in professional self-regulation.⁷⁰ Seen in this light, the position of CCOs and other compliance professionals has not been strengthened by recent developments, in particular in the common-law doctrine applicable to compliance personnel, and, in a more diffused way, in the patchwork of federal statutes applicable to individuals who bring to light within a firm information that is suggestive of illegal behavior by others.⁷¹ Together these developments call into question how secure a CCO's position may be when the CCO's actions prove unwelcome to those in control of a firm. Separately, to the extent that a CCO can be characterized as the "supervisor" of a firm's miscreant employee for SEC regulatory purposes, the CCO faces the risk of personal liability for failing reasonably to supervise that employee even when the firm's allocation of power situates the employee within the protective ambit of another officer.⁷²

A. THE CCO AND THE COMMON LAW OF EMPLOYMENT

Consider first the status of a CCO from the standpoint of the common law of employment. In most jurisdictions within the United States, an employer commits a tort when it fires or otherwise retaliates against an employee who reports or inquires in a reasonable manner about conduct the employee reasonably and in good faith believes violates either the law or an established principle of professional conduct that protects the public

See MACEY, *supra* note 65, at 153. For accountants, "creativity" or "creative accounting" has negative connotations ("is a very bad thing") whereas "[c]reative lawyering" is a good thing." *Id.* Although I do not propose conflating CCOs and other compliance officers with accountants, "creative compliance" may not strike the same positive notes as "creative lawyering." As Professor Macey observes, "regulators, lenders, and investors do not want to be known to be associated with accounting firms or accountants that are thought to interpret the accounting rules creatively or aggressively" while "many lawyers pride themselves . . . as being particularly creative and aggressive in asserting and defending their clients' views." *Id.*

70. See *id.* at 248 ("Regulation and reputation are closely connected. A thoughtful, well-considered regulatory strategy might . . . use scarce enforcement resources in order to reinforce rather than to undermine the value of companies' investments in their own reputations for honesty and fair dealing with customers.").

71. For a briefer treatment of some of the same cases, see Deborah A. DeMott, *Internal Compliance Officers in Jeopardy?*, 87 AUSTL. L.J. 451 (2013).

72. See *infra* Part III.C.

interest.⁷³ Although some states require that employees report internally before “reporting out” to governmental authorities and a few do not protect employees who report only internally, in many states the nature of the wrongdoing indicated by the information is determinative.⁷⁴ Regardless, under New York law, an employer’s retaliation under these circumstances is not tortious, even when the point of an employee’s job is detecting and reporting problematic conduct. In *Sullivan v. Harnisch*, a majority of the Court of Appeals held in 2012 that a CCO had no tort claim against his former employer, a group of hedge funds with a common investment adviser, when the CCO was fired after confronting the funds’ controlling shareholder about trading activity on behalf of that shareholder and members of his family that appeared to front-run client orders.⁷⁵ The court reasoned that the CCO, as an employee at will, had no claim for wrongful discharge and, unhappily for him, fell outside of New York’s narrow exception to the state’s especially robust employment-at-will doctrine.⁷⁶ *Sullivan* underlines the narrowness of this exception, articulated by the court in 1992 in *Wieder v. Skala*.⁷⁷ In *Wieder*, the court held that a law firm breached an implied contractual obligation when it discharged an associate who insisted that the firm comply with the applicable professional disciplinary rules and report the professional misconduct of a fellow associate.⁷⁸ Representing as it does a claim for breach of contract, the exception to employment-at-will recognized by *Wieder* limits a discharged employee’s remedies to those available for breach of contract.⁷⁹

Tellingly, the *Sullivan* majority distinguished *Wieder* largely on the basis of a compliance officer’s professional status compared with that of a lawyer like the law-firm associate in *Wieder*.⁸⁰ In the majority’s reasoning, a CCO, “not associated with other compliance officers in a firm where all were subject to self-regulation as members of a common profession,”⁸¹ is too unlike an associate lawyer whose regulatory and ethical responsibilities are so closely linked to his or her duties as an employee that they are

73. See RESTATEMENT (THIRD) OF EMPLOYMENT LAW § 4.02(e) (Tentative Draft No. 2, 2009), available at <http://www.ali.org/00021333/Employment%20Law%20TD%20No%20%20-%20Revised%20-%20September%202009.pdf>.

74. See *id.* cmt. f.

75. *Sullivan v. Harnisch*, 969 N.E.2d 758, 759 (N.Y. 2012). To front-run a client’s order breaches an advisor’s fiduciary duty to the client; front-running consists of executing a purchase (or sale) of a security in anticipation of executing a client’s order to buy (or sell). See ALAN R. BROMBERG ET AL., BROMBERG & LOWENFELS ON SECURITIES FRAUD § 6:77 (2013). In *Sullivan*, the CCO believed that the controlling shareholders’ sales improperly excluded clients from a trading opportunity. See *Sullivan*, 969 N.E.2d at 760.

76. *Sullivan*, 969 N.E.2d at 759–60.

77. *Wieder v. Skala*, 609 N.E.2d 105 (N.Y. 1992).

78. *Id.* at 108–09.

79. *Id.* at 110.

80. *Sullivan*, 969 N.E.2d at 761.

81. *Id.*

inseparable.⁸² Of course, this distinction assumes, as a prototype, a particular mode of professional practice—association together in a firm solely dedicated to furnishing a professional service—that appears to delegitimize the professional stature of work done by members of a profession who are also their clients’ employees. Additionally, the majority’s reasoning implicates the less developed state of the compliance professions by emphasizing the absence of a defined profession with self-regulatory functions.⁸³ Further unhelpful to the CCO in *Sullivan* was the fact that he wore multiple hats, serving also as Executive Vice-President, Chief Operating Officer, Secretary, and Treasurer, which made him “not even a full-time compliance officer” in the majority’s assessment.⁸⁴ This line of reasoning is especially troubling because multiple-hatted status seems more likely to typify CCOs in smaller firms that lack the resources or the practical necessity for a CCO who serves exclusively in that role. That is not to suggest that compliance problems occur disproportionately within smaller firms, only that smaller firms with less hierarchy and less-elaborated management structures may make a CCO particularly vulnerable when his or her interventions prove unwelcome. Underscoring this point, terminating a CCO is a reportable event that a registered investment advisor (like the employer in *Sullivan*) must report to the SEC and FINRA if the firm is regulated as a broker-dealer.⁸⁵ Although it is likely that such a report would trigger investigations into the firm, these foreseeable regulatory consequences did not deter the CCO’s employer in *Sullivan*, although they may temper conduct within larger registered firms with investor clienteles to whom the firm’s reputation for probity is highly material.

82. See *Wieder*, 609 N.E.2d at 108. In *Wieder*, the court held that

in any hiring of an attorney as an associate to practice law with a firm there is implied an understanding so fundamental to the relationship and essential to its purpose as to require no expression: that both the associate and the firm in conducting the practice will do so in accordance with the ethical standards of the profession.

Id.

83. See *Sullivan*, 969 N.E.2d at 761.

84. *Id.*

85. For investment advisers, Item 1J on the required registration form, Form ADV, requires that the adviser furnish the name and contact information for its CCO. See Form ADV, 17 C.F.R. § 279.1 (2013), available at <http://www.sec.gov/about/forms/formadv-part1a.pdf>. The instructions that govern Form ADV require that an amendment be made (and filed) “promptly” when information provided in response to this item becomes “inaccurate in any way.” See *Form ADV: General Instructions*, SEC, <http://www.sec.gov/about/forms/formadv-instructions.pdf> (last visited Nov. 17, 2013). For broker-dealers, FINRA Rule 3130 requires that a CCO be designated and identified to FINRA. See *Overview of FINRA Rule 3130*, FINRA, <http://www.finra.org/Industry/Issues/SupervisoryControl/P038004> (last visited Nov. 17, 2013).

B. THE CCO AND WHISTLEBLOWERS UNDER FEDERAL SECURITIES LAW

Both Dodd-Frank and the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) amended earlier federal securities law to add protections for “whistleblowers,” in particular prohibiting retaliation against employees who report information that establishes violations of the law.⁸⁶ However, the language stating these prohibitions, like its subsequent interpretation by federal courts, does not necessarily strengthen the position of CCOs and other compliance personnel who, like the CCO in *Sullivan*, are employees-at-will, especially those to whom New York law would apply. More generally, these developments may risk undercutting the effectiveness of internal compliance programs, distinct from the position of the CCO and other compliance personnel. In *Sullivan*, the CCO did not report to the SEC the information concerning suspected front-running.⁸⁷ Instead, and as one

86. Specifically, Sarbanes-Oxley provides:

No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 . . . , or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 . . . , or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee . . . because of any lawful act done by the employee—

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by—

- (A) a Federal regulatory or law enforcement agency;
- (B) any Member of Congress or any committee of Congress; or
- (C) a person with supervisory authority over the employee (or such other person working for the employer who has authority to investigate, discover, or terminate misconduct

18 U.S.C. § 1514A (2012). Section 922(a) of Dodd-Frank amended the Exchange Act by creating section 21F, which pertains to incentives and protections for securities whistleblowers. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111-203, sec. 922, § 21F, 124 Stat. 1376, 1841-49 (2010) (codified as amended at 15 U.S.C. § 78u-6). Section 21F(a)(6) defines a “whistleblower” as “any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission.” 15 U.S.C. § 78u-6(a)(6). Section 21F(b) authorizes the SEC to make monetary rewards to whistleblowers to be computed on the basis of percentages of any monetary sanctions imposed in an action stemming from the voluntary provision of information by a whistleblower. *Id.* § 78u-6(a)(6). Although auditors are among those excluded from eligibility for monetary rewards, *see id.* § 78u-6(c)(2)(C), internal compliance personnel are not expressly excluded. Section 21F(h)(1)(A) prohibits retaliation by an employer against a whistleblower “because of any lawful act done by the whistleblower . . . in providing information to the Commission . . . [or] in making disclosures that are required or protected under . . . Sarbanes-Oxley . . . , the Securities Exchange Act of 1934 . . . , and any other law, rule, or regulation” subject to the SEC’s jurisdiction. *Id.* § 78u-6(h)(1)(A).

87. *See Sullivan*, 969 N.E.2d at 761 (observing that “Sullivan does not claim to have blown a whistle—i.e. to have told the SEC or anyone else outside of [firm] about . . . alleged misconduct”).

would think a CCO should generally do, he reported upward within his firm to the firm's CEO.⁸⁸ Both the majority and dissenting opinions in *Sullivan* read Dodd-Frank's prohibition of retaliatory firings to require reporting-out, that is, to the SEC.⁸⁹ Likewise, in the sole decision on point from a federal appellate court, the Fifth Circuit held in *Asadi v. G.E. Energy (USA), L.L.C.* that Dodd-Frank's protections for whistleblowers do not encompass an employee who reports information concerning a violation internally within the firm but not to the SEC.⁹⁰ The Fifth Circuit also declined to defer to the SEC's rule to the contrary that construes Dodd-Frank's anti-retaliation provision not to require reporting to the SEC because, in the court's analysis, the rule redefined the statutory term "whistleblower" to include individuals who never report information to the SEC, whereas the statutory definition itself includes only "any individual who provides . . . information relating to a violation of the securities laws to the Commission."⁹¹

Ironically, some commentators feared that Dodd-Frank's whistleblower provisions would "undermine the effectiveness of . . . internal compliance programs" because Dodd-Frank created incentives in the form of a monetary reward program (not at issue in *Asadi*) to report directly to the SEC.⁹² However, as *Asadi* illustrates, the efficacy of internal compliance confronts a greater challenge because Dodd-Frank's anti-retaliation provision protects only individuals who report-out to the SEC, whether those individuals are compliance personnel or other employees. This appears to create an incentive to bypass internal compliance mechanisms altogether, or to inform the SEC prior to internal reporting or the completion of any internal investigation, in order to avoid jeopardizing an anti-retaliation claim.⁹³ Although most employees as of 2012 at least

88. *Id.*

89. *Id.* The majority concludes that "[n]othing in federal law persuades us that we should change our own law to create a remedy when Congress did not." *Id.* To the dissenters, the majority "creates a problem for legislators to solve where none existed previously" because "[p]rior to today, it was unnecessary for either Congress or this State's Legislature to create a new rule to protect employees like Sullivan" because it would have been assumed that the exception to employment-at-will recognized in *Wieder* would apply to compliance officers. *Id.* at 765 (Lippman, J., dissenting).

90. *Asadi v. G.E. Energy (USA), L.L.C.*, 720 F.3d 620, 630 (5th Cir. 2013).

91. *Id.* at 623 (referring to Dodd-Frank Act section 922). The court declined to find that the statute itself left the definition of covered individuals in doubt; the separate subsection specifying the prohibition against retaliation applies to adverse employment actions "because of any lawful act done by the whistleblower . . . in making disclosures that are required or protected under" the federal securities laws. *Id.* at 624 (citing 15 U.S.C. § 78u-6(h)(1)(A)). The SEC's rule defines "whistleblower" to encompass an individual who "possess[es] a reasonable belief" that information provided "relates to a possible securities law violation" and the information is provided in the manner provided in § 78u-6(h)(1)(A). See *Whistleblower Status and Retaliation Protection*, 17 C.F.R. § 240.21F-2 (2013).

92. See E. NORMAN VEASEY & CHRISTINE T. DI GUGLIELMO, *INDISPENSABLE COUNSEL: THE CHIEF LEGAL OFFICER IN THE NEW REALITY* 22–23 (2012).

93. See Jenna Greene, *Fifth Circuit Cuts Employers Out of Whistleblower Loop*, NAT'L L. J., (July 18, 2013), <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202611485898&Fifth>

initially raised concerns about illegal conduct within their employer's organization,⁹⁴ *Asadi* underscores the importance of reporting to the SEC.⁹⁵

In contrast, although the remedies are more limited⁹⁶ and the enforcement mechanisms more cumbersome⁹⁷ under Sarbanes-Oxley's anti-retaliation provisions, the statutory language, which does not formally define "whistleblower," also does not require reporting-out to the SEC.⁹⁸ However, Sarbanes-Oxley covers only employees of public companies and companies required to file reports with the SEC by section 15(d) of the Securities Exchange Act of 1934.⁹⁹ Among other issuers of securities, section 15(d) applies to issuers of mutual fund shares that may be sold to the public.¹⁰⁰ Given the structure of mutual funds, a question freighted with implications for the effectiveness of internal compliance is whether an "employee" for this purpose includes an individual employed, not by the reporting fund itself (which typically may have no employees),¹⁰¹ but by the investment adviser that manages and markets the fund. In *Lawson v. FMR LLC*,¹⁰² the First Circuit treated the question as one of first impression in 2012, holding that Sarbanes-Oxley's protections did not extend to employees of firms that contract with public or reporting

_Circuit_Cuts_Employers_Out_of_Whistleblower_Loop (quoting statement by plaintiff's lawyer that "[t]he court's decision makes it very clear that an employee who uncovers serious wrongdoing of this type has very little protection from retaliation if that wrongdoing is not reported to the SEC").

94. William McLucas et al., *Dispatches from the Whistleblower Front: Five Common Pitfalls to Avoid*, 45 BNA SEC. REG. & L. REP. 1345, 1348 (2013) (reporting 2012 study by Ethics Resources Center which found that eighteen percent of reporters choose to report externally, and of those, eighty-four percent did so following attempt to report internally).

95. See Yin Wilczek, *Employers Seize on Fifth Circuit Decision to Ask for Dismissal of Whistleblower Cases*, 45 BNA SEC. REG. & L. REP. 1597, 1597-98 (2013) (quoting lawyer who represents whistleblowers, who commented, "In a way, the decision does a service to whistleblowers by giving them a legitimate reason to file with the SEC even as they provide information internally" and observing that an employer's attempts to discourage employee contacts with the SEC could be seen as an attempt to interfere with Dodd-Frank's anti-retaliatory protections).

96. Sarbanes-Oxley limits monetary remedies to back pay, see 18 U.S.C. § 1514A, while Dodd-Frank permits an award of two times back pay, see 15 U.S.C. § 78u-6(h)(1)(C).

97. The statute of limitations under Sarbanes-Oxley, see 18 U.S.C. § 1514A(b)(2)(D) (between 180 days after violation occurs and 180 days after employer becomes aware of it), is relatively shorter than the three- to ten-year limitations period under Dodd-Frank, see 15 U.S.C. § 78u-6(h)(1)(B)(iii). Additionally, a claim under Sarbanes-Oxley must be filed first with the Secretary of Labor. See 18 U.S.C. § 1514A(b)(1).

98. See 18 U.S.C. § 1514A(a)(1)(C).

99. *Id.* § 1514A(a).

100. *Id.*

101. See *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2299, 2305 (2011) (noting that mutual fund's adviser provided all management and administrative services necessary for fund's operation, which included drafting statements in prospectus at issue in case).

102. *Lawson v. FMR LLC*, 670 F.3d 61 (1st Cir. 2012), *cert. granted*, 133 S. Ct. 2387 (2013) (No. 12-3).

companies.¹⁰³ The court noted that Congress itself could have expressly encompassed employees of mutual-fund advisors or other contractors but did not do so.¹⁰⁴ The allegedly retaliatory terminations in *Lawson* occurred prior to the enactment of Dodd-Frank; had they occurred after Dodd-Frank's effective date, recall that its anti-retaliatory protections have been held to apply only to those who report-out to the SEC, bypassing or delaying any internal reporting whether to a compliance officer or otherwise.¹⁰⁵

Overall, it is hard to resist the conclusion that, viewed in retrospect, these statutory protections against retaliation do not appear to be optimally crafted to strengthen internal compliance systems. The Dodd-Frank protection is cast in statutory language open to the interpretation that an employee is unprotected against retaliation unless the employee reports-out to the SEC, not only (or at all) through internal compliance systems.¹⁰⁶ The protection in Sarbanes-Oxley does not contain this limitation, but it has been held not to apply to the most likely sources of relevant information within the typical mutual fund, who would be the employees of the fund's investment adviser, charged as the adviser is with managing and marketing the fund.¹⁰⁷ And *Sullivan* illustrates the perils of employee-at-will status for CCOs, and for others who may report-up compliance-relevant information, in a prominent jurisdiction for financial-services firms.¹⁰⁸

C. THE CCO AS A "SUPERVISOR" WITHIN FEDERAL SECURITIES REGULATION

As noted above, one basis on which the SEC may institute administrative proceedings is that the respondent failed reasonably to supervise a person who committed underlying violations of the federal securities laws.¹⁰⁹ Whether a person in an advisory and support role who is not directly involved in operating a business—such as a CCO—should be characterized as a supervisor is not a question that the SEC has addressed through a general rule. In *Urban*,¹¹⁰ a 2010 decision finding a broker-dealer's CCO/General Counsel to have been the supervisor of a broker, the administrative law judge (ALJ) relied on the facts that the

103. *Id.* at 68. This interpretation of the statute appears to exclude from its protection external lawyers who advise public companies on securities-law issues as well as employees of auditing firms with public-company clients, inconsistently with Congress's intent. See Brief of United States as Amicus Curiae, *Lawson v. FMR, LLC*, 2013 WL 4049264 (U.S. Aug. 7, 2013).

104. *Lawson*, 670 F.3d at 76.

105. See *supra* notes 86–104 and accompanying text.

106. See *supra* notes 86–104 and accompanying text.

107. See *supra* notes 101–104 and accompanying text.

108. See *supra* notes 70–87 and accompanying text.

109. See *supra* text accompanying notes 32–37 (describing allegations in *Cohen*).

110. *Urban*, Initial Decision Release No. 402, 99 SEC Docket 32157 (ALJ Sept. 8, 2010) [hereinafter *Urban*], available at <http://www.sec.gov/litigation/aljdec/2010/id402bpm.pdf>.

CCO's opinions on legal and compliance issues were viewed as authoritative within the firm and were generally followed by personnel in its business units.¹¹¹ Although the CCO did not direct the firm's response to the broker in question, he served on the firm's credit committee and dealt with the broker on its behalf.¹¹² The ALJ additionally found that the CCO discharged his duty reasonably to supervise the broker. On appeal, the Commission itself dismissed the proceeding against the CCO but with no substantive ruling; three Commissioners did not participate, and, under the SEC's rules, an initial decision is of no effect when "a majority of participating Commissioners do not agree to a disposition on the merits."¹¹³

Reading through the extensive findings of fact in *Urban*, one sympathizes both with the plight of the CCO and the frustration of the SEC's enforcement staff, confronted as both were by a firm with business management unwilling to jettison a productive but highly problematic broker. The miscreant broker in *Urban* divided his efforts between two geographically separate offices of the firm and between retail and institutional clients.¹¹⁴ A known protégé of the firm's head of private client accounts, the broker was not adequately supervised by the branch managers assigned to him, and many within the firm believed that only the head of private client accounts or a branch manager going through him had power to direct the broker's conduct or terminate his employment.¹¹⁵ Additionally, the head of private client accounts frequently expressed hostility toward compliance personnel and programs.¹¹⁶ The CCO intervened when red flags indicated that the broker had engaged in improper conduct, which triggered investigations by other compliance personnel.¹¹⁷ On behalf of the firm's credit committee, the CCO acted when customer accounts controlled by the broker became over-margined.¹¹⁸ He also recommended that the head of private client accounts take on direct supervision of the broker.¹¹⁹ The head of private client accounts failed to do so despite assuring CCO that he would assume special supervision over the broker.¹²⁰ The broker's transgressions continued.¹²¹ Although the CCO

111. *Id.* One exception noted by the ALJ was the firm's Retail Sales unit. *See id.* at 52.

112. *See id.* at 52.

113. *Urban*, Exchange Act Release No. 66,259, Advisers Act Release No. 3366, 102 SEC Docket 3284, at 2 n.5 (Jan. 26, 2012), available at <http://www.sec.gov/litigation/admin/2012/34-66259.pdf> (quoting Commission Consideration of Initial Decisions by Hearing Officers, 17 C.F.R. § 201.411(f) (2013)); SEC, RULES OF PRACTICE AND RULES ON FAIR FUND AND DISGORGEMENT PLANS § 411(f), at 67 (2006), available at <http://www.sec.gov/about/rulesprac2006.pdf>.

114. *Urban*, *supra* note 110, at 4–5.

115. *Id.* at 7.

116. *Id.* at 4.

117. *Id.* at 11.

118. *Id.* at 11–13.

119. *Id.* at 27.

120. *Id.*

121. *Id.* at 30–31.

recommended that the firm fire the broker, he did not share this recommendation with the firm's board or CEO because he thought doing so would be futile given the CEO's deference to the head of private client accounts.¹²² Following customer complaints, employment terminated for both the broker and the CCO—for the CCO because the CEO had lost confidence in him when the CEO realized the CCO had left him uninformed about the CCO's recommendation that the broker be fired.¹²³ 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.¹²⁴ His ordeal continued until the SEC, as noted above, dismissed the proceeding.¹²⁵

One potentially troubling implication of *Urban* is the evident risk to a CCO who intervenes, but without success, in response to indicia of wrongdoing. If through more active engagement a CCO may be characterized as a "supervisor," some CCOs may conclude that a more passive or hands-off stance is preferable to defending the reasonableness of their actions as a respondent in proceedings before the SEC. The SEC's leading precedent, *Gutfreund*, states a general and fact-sensitive test for whether an individual is a "supervisor": "whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."¹²⁶ Focusing specifically on compliance personnel and internal lawyers, *Gutfreund* states that "persons occupying positions in the legal or compliance departments of broker-dealers have been found by the Commission to be 'supervisors' . . . under certain circumstances."¹²⁷ The ALJ in *Urban* found *Gutfreund* readily distinguishable on its facts; in *Gutfreund* the firm's general counsel, to whom the CCO reported, was informed by senior management that an employee had committed a federal crime by submitting a false bid in an auction for U.S. Treasury securities in an attempt to corner the market.¹²⁸ The general counsel was part of senior management's collective effort to

122. *Id.* at 28.

123. *Id.* at 32.

124. *Id.* at 38.

125. The high quality of Mr. Urban's defense has been applauded without addressing whether his former employer bore its cost. See Thomas O. Gorman, *When Doing the Right Thing Pays Off: The Ted Urban Case*, LEXISNEXIS LEGAL NEWSROOM (Sept. 13, 2010, 8:19 AM), <http://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2010/09/13/when-doing-the-right-thing-pays-off-the-ted-urban-case.aspx>. The broker and his major client (who ran a Ponzi scheme) both pleaded guilty to charges of securities fraud and were incarcerated. *Id.* The firm paid \$7.2 million in damages to customers invested in the Ponzi scheme. *Id.*

126. *Gutfreund*, Exchange Act Release No. 31,554, 1992 WL 362753, at *15 (Dec. 3, 1992) (order instituting proceedings).

127. *Id.*

128. *Urban*, *supra* note 110, at 49–50.

address the problem, which proved to be grossly ineffective.¹²⁹ In *Urban*, in contrast, many of the firm's business leaders either lied to the CCO or withheld information from him, excluding him from any collective that might have worked together to deal with the crisis presented by the misbehaving broker. In short, despite relatively weak facts of culpability by the CCO, the *Urban* proceedings illustrate multi-faceted risks for a CCO, which include proceeding in a setting in which senior colleagues in the firm withhold or misrepresent information, jeopardizing employment, and hazarding a defense in a later SEC proceeding.

CONCLUSION: INCENTIVES TO ENHANCE REPUTATION BY STRENGTHENING COMPLIANCE

The narratives recounted in this Article suggest that enhancing the effectiveness of CCOs and the compliance systems for which they are responsible requires as a fundamental matter that internal compliance become a more visible focus for concern. However, the potential of strong internal compliance to enhance a firm's reputation—and to mitigate the risk of penalties in the wake of a major compliance failure—does not seem likely by itself to lead to improvement. The episodes in this Article suggest, instead, that changes in law, regulation, and industry-level practices are crucial. More specifically, federal legislation could define “supervisor” for purposes of failure-to-supervise liability (as could the SEC). Legislation in New York could oust *Sullivan* and insulate CCOs from the risk of termination without good cause, as presumably could federal legislation by preempting the state common-law of employment as applicable to CCOs within financial services firms that are subject to federal regulation. Congress could also redraft the relevant language in Dodd-Frank to clarify that reporting-out to the SEC is not a precondition for protection from an employer's retaliation when an employee reports-up within an organization information that the employee reasonably believes to be indicative of a violation of federal securities law. And Congress could also clarify the application of Sarbanes-Oxley's protection against employment retaliation when the employee in question works for an adviser to a mutual fund.

Formal legislative (and regulatory) solutions aside, compliance professionals themselves might consider potential reform strategies. In light of *Sullivan*, and given the prominence of New York for financial-services firms, contractual solutions might be promising. Employment contracts may of course modify or replace the default rule of employment-at-will by

129. The employee, although reprimanded, was returned to his position with no change in duties, authority, or supervision; he repeated his criminal conduct in a subsequent bond auction. The general counsel did not inform the CCO of the known misconduct, nor did he recommend any changes that might have constrained the employee. The senior management group also failed to do as they had agreed, which was to inform the relevant governmental official about the earlier crime. For a fuller account, see DeMott, *supra* note 5, at 478–83.

requiring cause to terminate employment, defining cause, and providing for severance payments in the event of non-cause termination. Contractual provisions requiring that an employer advance attorney's fees in the event of litigation (including a SEC proceeding) that follows a not-for-cause termination could also reduce risk to a CCO.

Further maturation in the compliance professions would also strengthen the quality of internal compliance systems and the individuals responsible for their operation, including their capacity to exercise independent judgment and to resist internal threats to the effectiveness of the systems for which they are responsible. A self-regulatory organization could bring several benefits, including a vantage point from which to express professional disapproval of sub-optimal performance by compliance personnel, as well of retaliatory firings of CCOs and other compliance professionals. A code of conduct for compliance professionals, articulated by a self-regulatory organization, could undergird the exercise of independent judgment, an effect enhanced for members of a licensed profession (like lawyers) who risk the loss of the license if they fail to fulfill their professional duties.¹³⁰ Additionally, the professional obligations of CCOs and other compliance officers who are licensed as lawyers have long been murky; clarifying the obligations they owe as licensed professionals is likely to prompt a clearer articulation of obligations owed by compliance personnel more generally.

130. Remus, *supra* note 53 (manuscript at 32).