CHIEF COMPLIANCE OFFICER LIABILITY: SETTING THE RECORD STRAIGHT
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Recent decisions imposing liability on individuals who are chief compliance officers ("CCO") have raised concerns that the scope of chief compliance officer liability is being expanded to include supervisory matters. Those decisions, however, do not expand or change the scope of CCO liability. Rather, they support the proposition that the monitoring role of a CCO does not, in and of itself, expose the CCO to liability.

Background

In 2003 and 2004, the SEC adopted Rule 38a-1 under the Investment Company Act of 1940, 15 U.S.C. § 80a, and Rule 206(4)-7 under the Investment Advisers Act of 1940, 15 U.S.C. § 80b, and approved proposed rule changes to Rules 3012 and 3013 of the National Association of Securities Dealers ("NASD" n.k.a. the Financial Industry Regulatory Authority or "FINRA") (collectively the "Rules").

The Rules require that registered investment companies, investment advisers, or broker-dealers, adopt and implement written policies and procedures reasonably designed to prevent violations of the applicable securities laws, rules, and regulations, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer responsible for administering these policies and procedures.

Investment Companies. Rule 38a-1 requires each registered investment company and business development company ("fund") to adopt and implement policies and procedures approved by the fund's board of directors that are reasonably designed to prevent violations of federal securities laws and regulations by the fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator and transfer agent of the fund.[2] These policies and procedures must be reviewed at least annually.[3] Rule 38a-1 also requires funds to designate one individual as CCO to be responsible for administering the compliance policies and procedures.[4]

In addition, Rule 38a-1 contains provisions designed to promote the independence of the CCO from the management of the fund. The CCO reports directly to the fund's board.[5] The fund's

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[2] 17 C.F.R. § 270.38a-1(a)(1)-(2).

[3] 17 C.F.R. § 270.38a-1(a)(3).

[4] 17 C.F.R. § 270.38a-1(a)(4).

[5] *Id.*

board of directors must approve the designation of the CCO and her compensation. The CCO may be removed only at the direction of the board.[6] The CCO must annually furnish the board with a written report on the operation of the fund's policies and procedures and those of its service providers.[7] Further, the CCO must meet in executive session with the independent directors on the board at least once a year, without anyone else present.[8] Because funds typically delegate management and administrative functions to one or more service providers, the SEC envisioned that fund CCOs would often be employed by the fund's investment adviser or administrator.[9]

Investment Advisers. Investment advisers must also adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act and the rules promulgated thereunder.[10] These policies and procedures must be reviewed annually.[11] Further, Rule 206(4)-7 requires that the investment adviser designate a Supervised Person[12] as CCO to be responsible for administering the compliance policies and procedures.[13]

Broker-Dealers. Pursuant to NASD Rule 3012, FINRA member firms must establish, maintain, and enforce written supervisory control policies and procedures.[14] Rule 3012 also requires that an annual report be submitted to members' senior management, detailing each member's system of supervisory controls, the summary of test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.[15]

FINRA Rule 3031, which supersedes former NASD Rule 3013, further requires that each member designate a principal to serve as CCO and that each member's CEO certify annually that the member has in place processes to establish, maintain, review, modify, and test policies and procedures reasonably designed to achieve compliance with applicable FINRA rules and federal

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[6] *Id.*

[7] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2,204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714 (Dec. 24, 2003).

[8] 17 C.F.R. § 270.38a-1(a)(4).

[9] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2,204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714 (Dec. 24, 2003).

[10] 17 C.F.R. § 275.206(4)-7(a).

[11] 17 C.F.R. § 275.206(4)-7(b).

[12] A "Supervised Person" is defined as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides Investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." 15 U.S.C. § 80b-2(a)(25).

[13] 17 C.F.R. § 275.206(4)-7(c).

[14] NASD Rule 3012.

[15] *Id.*

securities laws and regulations.[16] As of July 16, 2007, FINRA member firms may designate multiple CCOs to discharge these responsibilities.[17]

SEC Addresses Potential CCO Liability

The SEC addressed potential concerns over CCO liability in its adopting release for Rules 38a-1 and 206(4)-7. The SEC explained that:

> Having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. Thus, a chief compliance officer appointed in accordance with rule 206(4)-7 (or rule 38a-1) would not necessarily be subject to a sanction by us for failure to supervise other advisory personnel. A compliance officer who does have supervisory responsibilities can continue to rely on the defense provided for in section 203(e)(6) of the Advisers Act [15 USC 80b-3(e)(6)]. Section 203(e)(6) provides that a person shall not be deemed to have failed to reasonably supervise another person if: (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedures; and (iii) the supervising person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.[18]

The SEC also addressed this point in its release approving NASD Rule 3013 by noting that "responsibility for discharging compliance policies and written supervisory procedures rests with business line supervisors" and "consultation on the certification [required by Rule 3013] does not, by itself, establish a signatory as having such line supervisory responsibility."[19]

According to Walter Ricciardi, when he was Deputy Director in the SEC's Enforcement Division, the SEC "would not be looking to target the compliance officer due to the misbehavior by the employee where the compliance officer fulfilled their responsibilities."[20] However, where a legal or compliance officer has the "requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue," and serious misconduct of the

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[16] FINRA Rule 3031.

[17] Nati'l Ass'n of Sec. Dealers, *NASD Amends Rule 3013 and Interpretive Material 3013 to Permit Members to Designate Co-Chief Executive Officers and Multiple Chief Compliance Officers*, Notice to Members 07-32 (July 16, 2007).

[18] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2,204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,720 n.73 (Dec. 24, 2003). A similar safe harbor appears in Section 14(b)(4)(E) of the Securities Exchange Act of 1934 for brokers and dealers. *See* 15 U.S.C. § 78o(b)(4)(E).

[19] Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. Relating to Chief Executive Officer Certification and Designation of Chief Compliance Officer, Exchange Act Release No. 34-50,347, 69 Fed. Reg. 56,107, 56,108 (Sept. 10, 2004).

[20] Peter Ortiz, *SEC Bans Rogue PM, but Leaves Firm Alone*, Ignites (Nov. 1, 2007), *available at* http://www.ignites.com/articles/print/20071101/bans_rogue_leaves_firm_alone.

employee has been brought to the attention of that officer, the officer "becomes a 'supervisor'" and "responsible, along with the other supervisors, for taking reasonable and appropriate action."[21] As discussed below, recent decisions are consistent with this guidance.

Recent Cases

Careful reading of recent regulatory enforcement decisions involving CCOs reveals that those decisions have not imposed liability on CCOs merely because they were responsible for monitoring compliance with securities laws and regulations. Rather, those cases imposing liability have involved (i) the CCO's own misconduct or violation of securities laws and regulations, (ii) a failure to supervise or monitor where the CCO was explicitly required to do so and failed to take any action after becoming aware of the misconduct or failed to investigate obvious red flags or (iii) actors who had multiple roles in addition to CCO, such as principal, president or founding partner.

Liability for CCO's Participation in Wrongful Conduct.

- David A. Zwick, a principal, senior official and chief compliance officer of Suncoast Capital Group, Ltd. ("Suncoast"), was held liable for participating in a scheme with a salesperson he supervised to provide kickbacks to a bond trader employed by New York Life Insurance Company ("New York Life").[22] In exchange for the kickbacks, Suncoast received securities transactions from New York Life at prices favoring Suncoast and through which Zwick received significant compensation. Zwick failed to disclose that Suncoast paid these kickbacks to New York Life in exchange for the business and favorable prices. Based on the Zwick's fraudulent conduct, he was ordered to pay disgorgement of $161,539.58, together with prejudgment interest in the amount of $138,609.64, and he was ordered to pay a civil money penalty of $75,000. In addition, he was barred from association with a broker or dealer. Zwick's supervisory responsibilities were not attributed to his role as CCO. In addition, Zwick not only failed to fulfill his supervisory responsibilities, but he also personally participated in the wrongful conduct.

- Joe D. Meals was a founding partner and shareholder of Consulting Services Group, LLC ("CSG") and was the chief compliance officer for CSG and its wholly owned broker-dealer affiliate.[23] In violation of Section 204 of the Investment Advisers Act and Rules 204-2 and 204A-1 thereunder, Meals instructed CSG supervised persons to backdate acknowledgement forms stating that they had received and read the code of ethics and then provided the false acknowledgments to the SEC. In addition, in an attempt to satisfy Rule 206(4)-7's requirement to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder, Meals purchased pre-packaged policies and procedures that failed to adequately address the conflicts of interest unique to CSG. As a

[21] *See* Gutfreund, SEC Release No. 31,554, Securities Exchange Act Release No. 31,554, 52 SEC Docket 2849, 1992 WL 362753, at *16 (December 3, 1992).

[22] Zwick, 91 SEC Docket 2079, 2007 WL 3119764 (Oct. 25, 2007).

[23] Consulting Services Group, LLC, Securities Exchange Act Release No. 56,612, Investment Advisers Act Release No. 2,669, 91 SEC Docket 2079 (Oct. 4, 2007).

result of Meals' actions, the Commission barred him from association in a compliance capacity with any broker, dealer, or investment adviser, and ordered that he pay a civil penalty of $10,000. Here, although Meals was held liable in his capacity as CCO, Meals intentionally provided false information to the SEC in an attempt to show compliance with the Investment Advisers Act.

- Sterling Scott Lee was the president, chief compliance officer, and principal of a former NASD member firm who was found liable for violating Exchange Act Rule 10b-10, which requires the disclosure of markups to customers on riskless principal transactions.[24] The company's supervisory procedures manual made the CCO – and thus Lee – responsible for maintaining copies of transaction confirmations. Lee admitted that he received copies of the confirmations and testified that he had responsibility for the markups not being posted on the tickets. Lee testified that either he or the CEO had instructed the clearing firm to disclose to customers the compensation that the firm received in connection with the transactions, but Lee failed to follow-through to make sure that these instructions were implemented. Thus, Lee was found to have violated Section 10(b) and was responsible for the firm's violations of Exchange Act Rule 10b-10. Lee also was found liable, along with another officer/principal, for enabling an unregistered principal to guide the affairs of the firm for more than three years and failing to amend the firm's Form BD to notify NASD of the unregistered principal's involvement. Lee was sanctioned to a six-month suspension, with a thirty-day concurrent suspension for his violation of Section 10(b). In addition, he was ordered to pay restitution, jointly and severally with the other respondent, in the amount of $20,832.40. This case is another example of someone who filled multiple roles and engaged in conduct that violated the securities laws in one of those other roles.[25]

- Forde H. Prigot was a compliance officer and then the CCO of a registered broker-dealer and was found liable for aiding and abetting the broker-dealer's deceptive market timing of mutual funds.[26] Prigot, who was responsible for communicating with mutual funds that had questions about the broker-dealer's mutual fund market timing customers, knowingly gave the mutual funds false information about the accounts that were trading. In addition, Prigot enabled the market timing by allowing numerous accounts to be opened for the purpose of creating duplicate accounts to allow the market timing to continue. Prigot was suspended from association with any broker or dealer for a period of six months, was prohibited from serving as an employee, officer, director, member of an advisory board, investment adviser, or principal underwriter for a registered investment company or affiliated person for a period of six months, and was fined in the amount of $30,000.

- Marc Freedman, the President, CCO, and part-owner of TriCapital Advisors, Inc., was sentenced by a district court to 63 months in prison for wire fraud and money laundering and

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[24] Gordon, Securities Exchange Act Release No. 57,655, 93 SEC Docket 33, 2008 WL 1697151 (Apr. 11, 2008).

[25] *See also* Kalter, Securities Exchange Act Release No. 58,787, 2008 WL 4587533 (Oct. 15, 2008); CMB Institutional Trading, LLC, FINRA Disciplinary Proceeding No. 2006006890801, 2008 WL 5385253 (Oct. 14, 2008).

[26] Trautman Wasserman & Co., Securities Exchange Act Release No. 57,329, Investment Company Act Release No. 28,154, 92 SEC Docket 1860, 2008 WL 426083 (Feb. 14, 2008).

was ordered to pay $1,200,000 in restitution.[27] The SEC also barred Freedman from association with any investment adviser.

<u>Liability for CCO's Failure to Supervise</u>.

- Robert E. Strong was the chief compliance officer of Jesup & Lamont Securities Corp. ("J&L") and was sanctioned $10,000 for failing to supervise a research analyst whose personal securities trading violated association rules.[28] When Strong was hired as CCO, he prepared written supervisory procedures that assigned the compliance officer – *i.e.*, Strong himself – the responsibility for giving prior approval to transactions in the accounts of research personnel, to retain evidence of securities ownership by research personnel, and to review research personnel's trading activity to ensure compliance with holding requirements. Strong, however, failed to pre-approve all personal trades by analysts, failed to monitor daily trading to identify restricted transactions, and failed to take any action even after he learned of misconduct by one of the research analysts. He also failed to alert NASD to the misconduct. "In sum, the evidence establishes that [the CCO's] unreasonable inaction effectively nullified the supervisory system related to the Firm's compliance with Rule 2711 that he himself had designed and was responsible for enforcing."[29] J&L's procedures also assigned the CCO the responsibility for verifying that J&L research reports contained the appropriate disclosures, which he failed to do with reasonable diligence. Thus, Strong was held responsible for the firm's failure to include the required disclosures. Finally, Strong violated NASD Rule 2711(i) because he filed an attestation regarding J&L's procedures two months late. The sanctions imposed were reduced to $10,000 from $15,000 based on a number of mitigating factors: (i) Strong was the sole compliance person in a 40-person firm that had previously neglected compliance; (ii) the misconduct at issue occurred within months of Strong joining the firm; and (iii) Strong did not personally benefit in any way from his misconduct.

- In another case, Edward H. Price, a president, chief executive officer, and chief compliance officer of a registered broker-dealer, was found to have failed to exercise reasonable supervision over associated persons and was barred from association with any broker or dealer in a supervisory capacity and ordered to pay a $55,000 civil monetary penalty.[30] Price was responsible for supervising two associated persons at Spencer Edwards. The two associated persons were found to have willfully violated Sections 5(a) and 5(c) of the Securities Act of 1933 by offering to sell, selling, and delivering to members of the public shares of common stock when no registration statement was filed or in effect with respect to those securities and no exemption from registration was available. Spencer Edwards's

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[27] Marc Freedman Sentenced to More Than 5 Years in Prison for Wire Fraud and Money Laundering in a Scheme to Defraud Investors, SEC Litigation Release No. 20534 (Apr. 23, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20534.htm.

[28] Strong, SEC Release No. 57,426, Securities Exchange Act Release No. 57,426, 92 SEC Docket 2192, 2008 WL 582537 (Mar. 4, 2008).

[29] *Id.*

[30] Carley, Securities Act Release No. 8,888, Securities Exchange Act Release No. 57,246, 92 SEC Docket No. 1316, 2008 WL 268598 (Jan. 31, 2008).

policies required that the compliance officer review all client correspondence, but Price allowed the two associated persons to retain a separate facsimile machine and assumed that the associated persons would bring him faxes if they were important. Also, Price allowed this despite the fact that both associated persons had previously engaged in wrongful conduct and one of the associated persons had been charged previously with offering and selling unregistered securities. According to the SEC, the CCO's knowledge of this previous misconduct, as well as numerous other red flags, demanded a further investigation by Price, and his failure to do so was unreasonable.

- Thomas Pritchard, the principal owner, managing director, and CCO of Pritchard Capital, was found liable for books and records violations and failure to supervise.[31] Pritchard Capital had multiple offices throughout the United States, and Pritchard only visited the New York office periodically. Pritchard was responsible for developing the supervisory policies and procedures of Pritchard Capital and for supervising the activities of certain associated persons. In part due to his infrequent trips to the office in question, Pritchard gave only a cursory look to mutual fund correspondence and trade ticket files and missed red flags, such as tentative or contingent trade ticket files, suggesting that certain associated persons were permitting late trading in mutual funds. Because of his cursory review, Pritchard failed to recognize or respond to these indications of wrongdoing. The SEC also noted that Pritchard Capital's written supervisory procedures did not contain policies or procedures reasonably designed to prevent or detect illegal late trading. Pritchard was suspended from association in a supervisory capacity with any broker or dealer for a period of nine months and was ordered to pay a civil penalty in the amount of $50,000.

- Richard Campanella, who was the Chief Operating Officer and CCO of vFinance Investments, Inc. during the relevant time period and later became the President and Chief Executive Officer, was held liable for aiding and abetting and causing the Company's books and records violations for failure to preserve documents and produce documents to the SEC.[32] In his capacity as CCO, Campanella had responsibility to ensure that the Company's document retention policies were followed and that business correspondence was retained. In July 2005, the SEC sent Campanella a request for documents regarding trading in a certain stock and seeking documents from all employees involved in vFinance's market-making activity in such stock. One of the employees involved in the trading was Nicholas Thompson, a registered representative at a branch location of the Company. Despite red flags both before and after receiving the SEC's request for documents that Thompson was not complying with the Company's document retention policies, Campanella failed to follow through on addressing these problems with Thompson. Through a forensic expert, the SEC was able to determine that Thompson consistently used a personal email account to communicate with clients and failed to preserve those communications as required by Company policy and that he had deliberately deleted emails and instant messages off of his computer after being notified of the SEC's request for production. Campanella failed to prevent such abuses, failed to generate prompt action by the Company to collect and produce

[31] Pritchard Capital Partners, LLC, Securities Exchange Act Release No. 57,704, Investment Company Act Release No. 28,251, 93 SEC Docket 176, 2008 WL 1820686 (Apr. 23, 2008).

[32] vFinance Investments, Inc., Administrative Proceeding File No. 3-12918, 2008 WL 4826017 (Nov. 7, 2008).

responsive documents to the SEC, and even relied on Thompson – a target of the investigation – to collect documents on behalf of the Company. The SEC found this conduct to be egregious and willful and, because Campanella "provided no assurances against future violations and has not recognized the wrongfulness of his conduct," censured Campanella and ordered that he pay a civil monetary penalty in the amount of $30,000.

Liability for Failure to Establish, Maintain, and Enforce Compliance Policies and Procedures.

- Carlos Martinez, the sole compliance officer at Chanin Capital Partners, was held liable for aiding and abetting Chanin's failure to establish, maintain, and enforce policies and procedures designed to prevent the misuse of material, nonpublic information in violation of Section 15(f) of the Securities Exchange Act of 1934.[33] Chanin, a broker-dealer, had policies and procedures in place to prevent insider trading, including requiring that certain forms be signed by employees to acknowledge receipt of the policies, disclose purchases or sales of securities, and identify private securities transactions, among other things. Martinez had sole responsibility to maintain and enforce these policies and procedures. Martinez, however, had no consistent practice with respect to obtaining signed forms or for tracking whether employees were complying with the policies. For example, the company did not maintain a watch list or restricted list of securities and did not track or monitor employee trading. In 2003, the company revised the policies by adding a restricted list to be maintained by Martinez and a requirement that employees identify all securities trading accounts and release copies of their account statements for review by Martinez. The company also began mandatory training for its employees and associated persons. Despite these improved policies, the company still had no policy or procedure in place for continued training of its personnel on the insider trading policies and did not have a policy or procedure in place for tracking trading accounts opened after personnel made their initial certifications. Thus, there was no ongoing assurance of compliance by the employees. The SEC stressed that it "is important, and that broker-dealers must take seriously their responsibilities not only to establish, but to maintain and enforce, sufficiently robust policies and procedures to prevent the misuse of material nonpublic information."[34] The company itself failed to establish, maintain, and enforce procedures to prevent insider trading, and Martinez, who was solely responsible for enforcing those policies, failed to take steps to ensure compliance. Accordingly, Martinez was found to have willfully aided and abetted the company's violation of Section 15(f) of the Exchange Act. Martinez was censured, was ordered to cease and desist from further violations of Section 15(f), and was ordered to pay a monetary fine of $25,000.

[33] Martinez, Exchange Act Release No. 57,755, 93 SEC Docket 330, 2008 WL 1913369 (May 1, 2008); *but see* Domestic Securities, Inc., FINRA Complaint No. 2005001819101, 2008 WL 4490637 (Oct. 2, 2008) (CCO not named as respondent nor held liable in proceeding where company held liable for failing to develop and implement written anti-money laundering policies and procedures reasonably designed to achieve and monitor compliance with applicable anti-money laundering laws, rules, and regulations).

[34] Martinez, 2008 WL 1913369.

No Liability Where Company Has Adequate Policies and Procedures in Place.

- Geoffrey Brod, a portfolio manager at an investment adviser, was found to have willfully violated certain antifraud and reporting provisions of the Investment Company Act, but no action was taken against the company or the CCO.[35] In fact, the CCO was not even named in the proceeding. In its findings, the SEC commented on the requirements in the company's code of ethics and the compliance department's annual compliance meetings at which employees were educated about and reminded of their obligations under the applicable rules and regulations. The SEC noted that Brod failed to comply with the SEC's reporting requirements and the company's code of ethics and that he falsely reported to the company that he was complying with both. As a result, action was taken only against Brod.

Lessons Learned

Some lessons can be taken away from the major regulatory enforcement decisions and the SEC's own guidance in the adopting releases for the rules and regulations related to CCOs.

- Make sure you have a clear understanding of the demarcation between supervisory responsibilities and compliance monitoring responsibilities within your firm.

- Regularly monitor, test and evaluate the adequacy and effective implementation of your firm's compliance policies and procedures.

- Make sure you are familiar with your company's supervisory compliance procedures and policies and, in particular, any responsibilities explicitly delegated to you under those policies and procedures.

- Take necessary steps to correct deficiencies in the policies and procedures and to correct problems that have arisen from those deficiencies.

- Investigate any questions of concern, and certainly any red flags, and follow through on that investigation.

- And most of all, fulfill your delegated responsibilities, and when appropriate, necessary or even unclear, involve business line supervisors with direct or ultimate supervisory responsibility over the matter.

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[35] Brod, 2007 WL 3101622.