

Alerts & Publications

PDF



SEC Issues “Failure to Supervise” Guidance for Compliance and Legal Personnel

October 2, 2013

On September 30, 2013, staff of the Securities and Exchange Commission’s Division of Trading and Markets released Frequently Asked Questions (“FAQs”) regarding liability that may arise in connection with the role and duties of compliance and legal personnel at broker-dealers (available [here](#)). Together, Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934 (“Exchange Act”) authorize the Commission to institute enforcement actions against persons who fail to reasonably supervise broker-dealer personnel, with a view to preventing violations of the federal securities laws, rules and regulations. The FAQs clarify when compliance and legal personnel function as “supervisors,” and thereby become subject to potential liability for failure to supervise. The following is an overview of the FAQs.

When do legal and compliance personnel become “supervisors”?

Supervisory liability is a “facts and circumstances” determination, which focuses on the roles and responsibilities of the respective parties. A person’s actual responsibilities and authority determine whether he or she is a “supervisor” for purposes of Exchange Act Sections 15(b)(4) and 15(b)(6). The Exchange Act does not presume that a broker-dealer’s compliance and legal personnel are supervisors solely because they serve compliance or legal functions. Instead, the question turns on whether compliance or legal personnel supervise business units or other personnel outside the compliance and legal departments.[1] A person must have the requisite

degree of responsibility, authority or ability to affect the conduct of the employee whose behavior is at issue.[2]

The FAQs include a non-exhaustive list of factors to consider when assessing supervisory status:

- Has the person clearly been given, or otherwise assumed, supervisory authority or responsibility for particular business activities or situations?
- Do the firm's policies and procedures, or other documents, identify the person as responsible for supervising, or for overseeing, one or more business persons or activities?
- Did the person have the power to affect another's conduct? Did the person, for example, have the ability to hire, reward or punish that person?
- Did the person otherwise have authority and responsibility such that he or she could have prevented the violation from continuing, even if he or she did not have the power to fire, demote or reduce the pay of the person in question?
- Did the person know that he or she was responsible for the actions of another, and that he or she could have taken effective action to fulfill that responsibility?
- Should the person nonetheless reasonably have known in light of all the facts and circumstances that he or she had the authority or responsibility within the administrative structure to exercise control to prevent the underlying violation?

Can compliance and legal personnel participate in management and give advice without becoming "supervisors"?

Compliance and legal personnel can provide advice concerning compliance or legal issues to business line personnel and senior management without being considered "supervisors" of those personnel, and can participate in management or other committees without being considered "supervisors." Broker-dealers may want to consider whether compliance and legal personnel that serve on committees should do so only in a non-voting, advisory role. Similarly, the FAQs explain that broker-dealers can establish and implement robust compliance programs without compliance and legal personnel being considered "supervisors." In so doing, broker-dealers should clearly define compliance and advisory duties and should distinguish those duties from business line duties and should consider developing processes to escalate instances of non-compliance to business line personnel for remediation.[3]

What duties do supervisory compliance and legal personnel have?

Compliance and legal personnel that become "supervisors" must reasonably supervise with a view to preventing violations of the federal securities laws, the Commodity Exchange Act, the rules or regulations under those statutes and the rules of the Municipal Securities Rulemaking Board. Supervisors should not ignore "red flags" or other suggestions of

irregularity and must properly discharge their supervisory responsibility (or know that others are taking appropriate action).

What can broker-dealers do to minimize liability for failure to supervise?

Exchange Act Section 15(b)(4)(E) provides an affirmative defense to potential liability for failure to supervise when the broker-dealer has established procedures that would reasonably be expected to prevent and detect supervisory violations, if the supervisor has reasonably discharged his or her duties pursuant to those procedures. Broker-dealers should strongly consider implementing robust and clearly defined supervisory compliance procedures and a system for applying those procedures to ensure that all supervisors are adequately discharging their supervisory duties. To minimize enforcement risk, firms should:

- Reassess their existing policies and procedures;
- Clearly define compliance and advisory duties;
- Reinforce supervisor compliance through training; and
- Enhance monitoring and testing mechanisms to ensure that supervisors are following procedure.

O'Melveny & Myers is available to advise domestic and non-U.S. investment advisers and fund managers about U.S. securities compliance. For questions, please contact Heather Traeger at (202) 383-5232, Kris Easter at (202) 383-5364 or James Harrigan at (202) 383-5226.

[1] Of course, compliance and legal personnel that supervise their respective departments could be subject to failure to supervise liability for violations within those departments.

[2] The FAQ noted the recent Supreme Court holding that an employee is a "supervisor" for purposes of Title VII of the Civil Rights Act of 1964 only if he or she is empowered by the employer to take tangible employment actions against another employee -- meaning hiring, firing, failing to promote, reassigning with significantly different responsibilities, and making a decision causing a significant change in benefits. See *Vance v. Ball State Univ.*, 133 S. Ct 2434 (2013).

[3] The FAQs provide that assistance by compliance and legal personnel in the remediation of an issue does not solely make such persons "supervisors."

This memorandum is a summary for general information and discussion only and may be considered an advertisement for certain purposes. It is not a full analysis of the matters presented, may not be relied upon as legal advice, and does not purport to represent the views of our clients or the Firm. Heather Traeger, an O'Melveny partner licensed to practice law in the District of Columbia and Texas, Kris Easter, an O'Melveny counsel licensed to practice law in the District of Columbia and Texas, and James Harrigan, an O'Melveny associate licensed to practice law in the District of

Columbia and Maryland, contributed to the content of this newsletter. The views expressed in this newsletter are the views of the authors except as otherwise noted.

Portions of this communication may contain attorney advertising. Prior results do not guarantee a similar outcome. Please direct all inquiries regarding New York's Rules of Professional Conduct to O'Melveny & Myers LLP, Times Square Tower, 7 Times Square, New York, NY, 10036, Phone:+1-212-326-2000. © 2013 O'Melveny & Myers LLP. All Rights Reserved.

Quick links +

Subscribe

' ! \$ #

[Disclaimer](#) | [Privacy Policy](#) | [Contact Us](#) | [Employee Portal](#)
Attorney Advertising © 2019 O'Melveny & Myers LLP. All Rights Reserved.