



## Legal Risk Management Tip March 2012

### THE URBAN CASE AND AVOIDING SUPERVISORY LIABILITY FOR COMPLIANCE AND LEGAL PERSONNEL

On January 26, 2012, the U.S. Securities and Exchange Commission (“SEC”) issued an order affirming the dismissal of proceedings against Theodore W. Urban, general counsel, executive vice president and board member of Ferris Baker Watts, Inc. (“FBW”), a registered broker-dealer and investment adviser at the time of the misconduct involved in the case. Urban, who was also a former assistant director of the SEC’s Division of Market Regulation, was the subject of an order instituting administrative proceedings (“OIP”) issued by the SEC on October 19, 2009. The OIP alleged that an FBW registered representative, Stephen Glantz, had violated anti-fraud provisions of the federal securities laws,<sup>1</sup> and that Urban, as Glantz’s supervisor, had failed to reasonably supervise Glantz within the meaning of Section 15(b) of the Securities Exchange Act of 1934.

#### Initial Decision of the ALJ

The matter went to a hearing in March of 2010 before SEC administrative law judge Brenda P. Murray, who issued her much talked-about initial decision in the case on September 8, 2010 (“Initial Order”). Murray ultimately found Urban should not be sanctioned for his involvement in the unlawful conduct perpetrated by Glantz, disagreeing with the Division of Enforcement’s arguments that Urban negligently supervised Glantz. Importantly though, Murray held that Urban, who was the firm’s general counsel and also oversaw its compliance function, *was Glantz’s supervisor* for purposes of Section 15(b) of the Exchange Act.<sup>2</sup> Murray looked to the SEC’s earlier decision in *John H. Gutfreund*<sup>3</sup> for the applicable standard:

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<sup>1</sup> Stephen Glantz was sentenced to thirty three months in prison, followed by three years of supervised release, and ordered to pay \$110,000 in restitution for his misconduct, which included *inter alia* federal securities fraud, perjury, market manipulation, and churning and other violations of law related to his handling of client accounts.

<sup>2</sup> Section 15(b) states, in pertinent part:

(b)(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

[D]etermining if a particular person is a “supervisor” depends on 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. Thus, persons occupying positions in the legal or compliance departments of broker-dealers have been found by the Commission to be “supervisors” for purposes of Sections 15(b)(4)(E)...under certain circumstances.<sup>4</sup>

While Murray recognized that Urban was not Glantz’s supervisor in the “normal” sense, noting that Urban “did not have the power normally associated with supervision” such as the ability to “hire or fire Glantz” and direct his activities,<sup>5</sup> she nonetheless determined he was a supervisor pursuant to the standard set forth under *Gutfreund*.<sup>6</sup> The judge found that as General Counsel Urban “played ‘a significant, even if shared, role in a firm’s supervisory structure” and “the fact that he shared in the responsibility to take appropriate action to respond to misconduct or that his authority was subject to countermand at a higher level, does not negate a finding that he had supervisory responsibility.”<sup>7</sup> The ALJ noted that although Urban did not direct FBW’s dealing with Glantz, “as General Counsel, Urban’s opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in FBW’s business units, but not by Retail Sales” (the business unit with primary supervisory authority over Glantz).

Notably, Murray also determined that Urban was not negligent with respect to his supervisory responsibilities. Among other things, she found that:

- He relied on continuous representations by multiple individuals in high level managerial roles with whom “[he had no reason to distrust”];
- He followed up with Compliance on his findings; and
- Escalation to the board, which was controlled by the head of the firm’s retail sales unit who would protect Glantz from repercussion at all costs, would have been futile.

After the decision issued, the Division of Enforcement appealed to the Commission seeking to overturn the ALJ’s decision and to impose sanctions on Urban pursuant to Section 15(b). The Commission’s decision, which was made by just two of the five sitting commissioners,<sup>8</sup> was evenly split, resulting in a dismissal on January 26, 2012.

#### Perspectives by SEC Commissioner Daniel M. Gallagher to Consider

Commissioner Gallagher M. Gallagher (who did not participate in the January 26, 2012 decision) spoke on the topic of supervisory liability for compliance personnel at the Investment Adviser

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(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

15 U.S.C. 78o(b)(4)(E)(i) and (ii).

<sup>3</sup> Exchange Act Release No. 31,554, 51 W.E.C. 93 (1992),

<sup>4</sup> *Gutfreund*, 51 S.E.C. at 113.

<sup>5</sup> Murray found that only Glantz’s branch managers, and those the branch managers reported to, had such authority.

<sup>6</sup> Initial Order at 51.

<sup>7</sup> *Id.* at 51-52 (quoting *Kirk Montgomery*, Exchange Act Release No. 45161, 55 S.E.C. 485, 500-02 (2001)).

<sup>8</sup> The split was between Commissioners Aguilar and Paredes, with Chairman Shapiro and Commissioners Walter and Gallagher recusing themselves).

Association Compliance Conference on March 8, 2012. His remarks expressed concern at the ALJ's finding that Urban was indeed a supervisor. Gallagher noted that *Gutfreund* and the ALJ's order in *Urban* appear to hold that if compliance personnel assist the firm's management team in responding to a potential issue, it may obligate that individual to take affirmative action. Summarily, Gallagher offered: "if a firm employee in a traditionally non-supervisory role has expertise relevant to a compliance matter, that employee shouldn't fear that sharing that expertise could result in Commission action for failure to supervise."<sup>9</sup>

### Practical Tips for Avoiding and Supervisory Liability

While the landscape for liability for compliance and legal staff remains murky, there are a number of practical steps that investment advisers and broker-dealers should take to protect their staff and the firm from supervisory liability:

- Ensure the firm's chief compliance officer and general counsel are on the firm's liability insurance policy. A simple and obvious advice piece of advice, but on that is absolutely critical in light of the uncertainty that exists in this arena.
- Document, document, document. Documentation of the firm's organizational structure and its compliance policies, including documenting the testing that is and will be done to ensure that policies are effective, is another critical safeguard. With respect to the firm's organizational structure, documentation must clearly delineate that legal and compliance positions are advisory in nature and that registered representative ("RRs") and/or investment adviser representatives ("IARs") are supervised by specific business-line managers (not compliance personnel). Further, firms should document that business-line supervisors (not compliance or legal staff) address misconduct, as well as the steps those supervisors take to ensure any misconduct is halted and actions are taken to avoid the conduct from occurring again. The separation between compliance and business units at FBW was a key consideration of the ALJ's determination that Urban exercised his supervisory responsibilities with due care.
- Finally, educate each constituent within the firm about their roles. Make sure business-line supervisors are competent and know their role and responsibilities as supervisors and that RRs and IARs know who they report to and how their supervisors are. Likewise, ensure that legal and compliance personnel understand that their role is *advisory* in nature and not direct supervisors of RRs and IARs.

### Conclusion

The regulatory and enforcement landscape for compliance and legal personnel remains uncertain. Firms are well-advised to take the steps outlined above to protect such personnel, as well as the firm itself, from avoidable supervisory liability.

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<sup>9</sup> Keynote Address, Investment Advisor Association 2012 Compliance Conference, March 8, 2012 (available at <http://www.sec.gov/news/speech/2012/spch030812dmg.htm>).

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