<u>RECENT SEC ADMINISTRATIVE PROCEEDINGS POINT TO LIABILITY ISSUES FACING CEOS OF FINANCIAL FIRMS</u>

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Being the leader of any organization means that the CEO is faced with direct liability issues. If the CEO has knowledge of a compliance infraction and either turns a "blind eye" or fails to take action, he or she can be cited with either causing or aiding and abetting the firm's violations and with failure to supervise.

For example, in the recent Administrative Proceeding *In the Matter of Thomas E. Meade,*[1] this President and CCO of Denver-based Private Capital Management, Inc. ("PCM, Inc."),[2] is facing charges stemming from his lack of proper supervision and failure to prevent, detect or respond to an internal insider trading scheme in Mariner Energy Inc. ("Mariner").

In 2010, PCM Inc.'s trader, Drew Peterson, his father H. Clayton Peterson, a board member of Mariner, and hedge fund manager Drew Brownstein engaged in insider trading. All three pleaded guilty and were convicted in 2011. The SEC's Office of Compliance and Examinations ("OCIE") proceeded with a cause examination of PCM "out of concerns that Peterson's trading and dissemination of material, non-public information had gone undetected.[3] In a June 11, 2014 SEC cease and desist order against Meade, the SEC contends that Meade not only had a biased perspective on the insider trading, but also failed to provide adequate supervision of employee transactions after the insider trading was detected.

The SEC found that because Meade personally knew Peterson's father's role at Mariner and the risk for misuse of material non-public information by his son, he should have tailored PCM Inc.'s existing Policies and Procedures to specifically address these risks. Meade also failed to adequately supervise employee personal trading, maintain restricted stock lists, and conduct an internal investigation, per the firm's policies and procedures. Additionally, Meade "overly relied on employees to self-report violations and failed to annually assess the adequacy or effectiveness of PCM, Inc.'s policies and procedures that were in place."[4] This insufficient supervision prompted a 2011 SEC provision that warned Meade to more accurately review transactions for the firm – a warning that was not heeded by Meade, and eventually led to the 2014 cease and desist order, a $100,000 fine, and Meade being barred from compliance and supervisory roles.

Meade reminds us that CEOs have a duty to supervise and be aware of internal controls. While in *Meade* the CEO also had a dual role of being the CCO, this does not lessen the significance of bringing this point to the forefront: the CEO ultimately is responsible for overseeing the activities of the organization and supervising the firm's employees.

From a regulatory standpoint, Section 15(b)of the Securities Exchange Act of 1934 provides for the imposition of sanctions against broker-dealers and its associated persons who "fail to reasonably supervise, with a view to preventing violations of the securities laws, another person who commits such

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[1] *See* IA Rel. No. 3855 (Jun. 11, 2014).
[2] Meade was President in CCO for the relevant time period of Jan. 1, 2009 through Jul. 31, 2012.
[3] *See* IA Rel. No. 3855 (Jun. 11, 2014) at page 3.
[4] *Id*. at page 2.

a violation, if such other person is subject to his supervision." Similarly, Section 203(e)(6) of the Investment Advisers Act of 1940 provides that if an investment adviser or its associated person fails to reasonably supervise an employee or other person subject to the adviser's supervision, and that person violates the federal securities laws, then the SEC may take such actions as censure, placement of limitations, suspension or revocation of licensure.

Another case which highlights the liability that CEOs face is *In the Matter of Marc Sherman*.[5] The SEC recently announced charges against the CEO of this Florida-based computer equipment company, QSGI Inc. ("QSGI"), for making misrepresentations to outside auditors and public investors on the state of the company's internal controls over finances.

The Sarbanes-Oxley Act of 2002 mandates a management report on internal controls over finances and this report must be included in the company's annual report. Both the CEO and CFO are required to sign certifications that confirm that all significant deficiencies to external auditors have been disclosed and that they have reviewed the annual report and attest to its accuracy.

Throughout 2008 and leading up to the firm's ultimate bankruptcy in 2009, the SEC alleged, among other things, that CEO and Chairman, Marc Sherman ("Sherman"), made material misrepresentations through multiple signed certifications that the firm disclosed all significant deficiencies to the auditors. During the relevant period, QSGI had inventory at facilities in New Jersey and Minnesota and had been experiencing frequent inventory control problems. Some employees were found to have shipped or removed certain inventory components to customers without noting appropriately into QSGI books and records. As a result, records incorrectly showed certain components as intact systems and those stripped component parts were then sold by QSGI or used for their own maintenance services. These recurring problems escalated at the Minnesota location due to both a policy from the manufacturer of the inventory that inhibited the ability to alter machines which drove QSGI to accelerate their time in which they would strip and sell parts in combination with several key accounting staff members leaving the Minnesota location in 2007. The replacements hired lacked accounting backgrounds and failed to fully carry out their responsibilities. During this time, the SEC alleged that Sherman did not disclose or direct anyone else to disclose to external auditors the inventory and accounts receivable issues and the resulting forged books and records.

Contrary to the above information, Sherman had indicated in multiple signed management certifications that there were no significant deficiencies or that all deficiencies were disclosed. Therefore, the SEC claimed that "Sherman knew, or was reckless in not knowing, that these statements were materially false and misleading."[6] A public hearing will be taking place later this year.

Like the *Meade* case, *Sherman* reminds us that CEOs have a responsibility to be aware of their company's internal controls. While the CEO may not be involved in the day-to-day tasks or updates to their books and records, this does mean they can turn a blind eye or be unaware of what the daily operations are; the CEO is ultimately responsible for supervising all activities that go on within the company.

[5] *See* IA Rel. No. 72723 (Jul. 30, 2014).
[6] *See* IA Rel. No. 72723 (Jul. 30, 2014) at page 6.

A unifying message that we have seen from these and other recent enforcement cases is that the CEOs need to ensure they are aware of the implicit liability they have from their role as the leader of their organizations and to take seriously their duty to supervise. The CEO needs to understand and appreciate the importance of setting the “tone at the top” for overseeing the organization, internal controls and employees.

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